

The New ‘New Normal’ | July 2020

“My new normal is to continually get used to new normals.”

Anonymous

The natural progression in economics is for an ‘unprecedented’ crisis to be followed by a ‘new normal’. The old modes and models are discarded and replaced with ones that reflect the new post-crisis reality.

It should, therefore, come as no surprise that amidst a global pandemic that economists are rushing out with their versions of the new paradigm. After all, the world is adapting to living with COVID-19 and several norms are being rewritten. These changes are having and will continue to have a significant impact on the economy and financial markets.

While it is still early in this edition of the ‘new normal’, investors need to consider the changes thus far and their potential consequences, intended and unintended.

A natural and obvious starting point is the prequel or the old ‘new normal’. Following the Great Financial Crisis of 2008, the term was popularized by Mohamed El-Erian to describe a macroeconomic environment of subpar growth, no inflation or deflation, and low-interest rates. It was also a period characterized by accommodative monetary policy including Quantitative Easing and in some cases, negative rates.

In the current version of the ‘new normal’, we have seen an even greater amount of monetary stimulus thrown at the problem. ‘Old skool’ Quantitative Easing has been replaced with Large Scale Asset Purchases. While the operations appear similar, the pedantic difference is in their ultimate objectives. The purpose of QE was to lower interest rates, while the current programs target market liquidity (and as a side effect also keep rates low). Furthermore, the previous stimulus programs were restricted to purchasing government bonds whereas today they have expanded to include corporate debt.

On top of the overwhelming support from central banks, the new ‘new normal’ also includes ‘unprecedented’ fiscal stimulus from our governments. In 2008 there was the moral hazard of bailing out greedy bankers, whereas today, with real businesses, jobs, and people suffering, the support borders on limitless. This spending is being funded by printing money, as governments issue enormous amounts of debt, which in turn is bought by their central banks.

This test of Modern Monetary Theory has led to a spectrum of inflation forecasts from deflation to hyperinflation and everything in-between. The dispersion in expectations rests on where one sees the balance between the tremendous supply of money and the impact of the pandemic on the real economy. With the federal deficit going from a third of GDP to 100% and the government borrowing more long-term debt, there might be greater tolerance for inflation to run a little hotter than the old target of 2%.

Such inflationary pressures would mean even worse news for government bondholders. As it is, owners of sovereign debt are earning next to nothing for the privilege, with yields having moved into a new, even lower range. But unlike the previous ‘new normal’, this time around the central bankers are reluctant to take rates lower and into negative territory. This leaves very little upside from further declines in rates and limited ability for bonds to hedge equity downturns.

And while interest rates are firmly anchored now, the risk factors that could see them rise in the new ‘new normal’ are different and more varied than post-2008. Aside from the potential upward pressure from inflation,



an exogenous factor such as an effective vaccine could see a return to the old 'new normal' world of 10y rates at 2%. Should this occur, long-duration bond portfolios (i.e. 20y) would incur losses of 20-30%.

For now, these are all just possibilities. There is still great uncertainty as to how the sequel to the 'new normal' will play out. From what we've seen in the previews, it seems the themes will be unemployment, the recovery of the real economy, near-zero interest rates, and a heavy dose of government and central bank stimulus.

Of the undetermined plotlines, there is the path of growth and inflation, and the question of who is going to end up paying for all this unprecedented spending. Historically, it has been the taxpayer picking up the tab, but if inflation reappears on the world stage or interest rates rise for other reasons, this 'new normal' could see the bondholders footing the pandemic bill.

The Fund Performance.

July 2020.

The recent trend of strong credit performance continued in July. Markets shrugged off the growing virus case counts and risk assets propelled higher on the back of supportive central bank policies, extremely low-interest rates, and encouraging developments on the vaccine front.

Generic Investment-Grade Credit Spreads

- Canadian spreads tightened 21 bps to finish at 139 bps
- US spreads tightened 17 bps to finish at 133 bps.

The Canadian market saw a markedly slower pace of new issues in July, with under \$5bn being printed. The supply/demand imbalance along with declining dealer inventories meant the new deals were hugely oversubscribed. As such, the deals not only performed well but repriced the issuers' existing credit spreads tighter.

- Great-West Life came with a 30y deal that was met with such heavy demand that the deal was re-opened and the size doubled just a week after the initial offering. Both deals were very well received.
- Reliance LP tapped the market for \$430 mm of 7-year bonds with a negative new issue concession (i.e. priced more expensively than existing debt). Despite the pricing, the deal was met with extraordinary demand and tightened 30 bps.

While these deals were notable, the most interesting transaction award goes to Royal Bank, for their issuance of AT1 regulatory capital via a novel domestic structure. In the end, RBC brought \$1.75bn of Limited Recourse Capital Notes (LRCNs) to market at a coupon of 4.5%. The deal was very well received and rallied strongly in secondary trading.

- The new securities offer NVCC preferred share exposure in a bond structure and count as AT1 regulatory capital.
- The advantage for the bank is that bond coupons are paid pre-tax whereas pref dividends are distributed after tax.
- The advantage for the institutional investor is a more liquid market relative to preferred shares.

The issuance of these notes created a strong rally in certain preferred shares on expectations of reduced issuance of preferreds going forward. Further limiting supply in this market is the increased likelihood that securities will be redeemed by the issuers on call dates and replaced with LRCNs (given the more favourable tax treatment).

The Fund continued to outperform the broader market rally through credit selection and active trading. The sectors driving the outperformance in the month were pipelines, banks, insurance, and REITs.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	3.82%	10.58%	-2.51%	-1.82%	0.66%	3.37%	8.72%	9.76%
F Class	3.77%	10.43%	-2.75%	-2.14%	-0.01%	2.63%	NA	NA

As of July 31st, 2020

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Returns are shown on 'Series 1 X Founder's Class' since inception and for 'Series 1 F Class' since May 1st, 2016 and are based on NAVs in Canadian dollars as calculated by SGGG Fund Services Inc. net of all fees and expenses. For periods greater than one year, returns are annualized.

Looking Ahead.

Since the pandemic panic of March, the rally in risk assets has been driven by government and central bank intervention coupled with a more optimistic picture of the recovery. Credit also has the added benefit of strong investor demand and the direct support of the central bank purchasing programs.

These tailwinds remain in place but must be weighed against potential risk factors in the months ahead.

- The strong technicals in credit markets continue, as robust investor demand is being met with limited supply. The domestic new issue market is expected to be reasonably quiet in August, which should allow for more performance in credit.
- The Bank of Canada Corporate Bond Purchasing program has experienced underwhelming take up, with only a fraction of the available liquidity being utilized thus far. This is not surprising, as dealers can readily sell to institutional investors and have no need to tap the BoC program. This leaves the BoC with more firepower to deploy in weak markets, and as such, its mere presence is supportive of credit.
- The government stimulus programs reduce the risk of insolvencies for investment-grade companies.



On the other hand, certain headwinds keep us cautious and vigilant.

- With the market exceptionally receptive to new credit deals, more challenged companies will inevitably look to issue debt.
- Credit seasonality suggests that supply and activity pick up in the fall. But this is the new 'new normal', so perhaps previous patterns need not apply.
- Negative developments on the vaccine or virus front could complicate the re-opening of the economy and derail markets.
- The looming US election and political jockeying can add volatility, change sentiment, and delay necessary policy action.
- After Q2 earnings were much better than anticipated, the market expectations for Q3 could be overly optimistic, as we swing from overly bearish forecasts to overbullish.
- The fall and winter flu season and the potential for a second corona wave.
- Advanced economies are posting record unemployment and double-digit declines in GDP. In the battle of the 'real economy vs. financial markets', the lost jobs, lower business investment, and drop in consumer spending could manifest itself in higher risk premia.

In the short term, we continue to maintain a medium risk posture, as the demand for credit remains incredibly strong. But given the balance of factors noted above and the strength of the recovery thus far, we are for more selective in our exposures and have been trimming positions that have outperformed. In doing so, we have increased the dry powder available to capitalize on opportunities created by volatility and increased trading activity in the months ahead.

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