

Unprecedented All Over Again | June 2020

“If history repeats itself, and the unexpected always happens,
how incapable must Man be of learning from experience”

George Bernard Shaw

We begin our commentary in the most unimaginative way possible, with a simple dictionary definition.

unprecedented /ʌnˈpres.ɪ.den.tɪd/ adjective
never having happened or existed in the past

This is not due to a lack of inspiration nor is it intended as a nostalgic nod to our grade school essays. It is for clarification purposes.

Somewhere along the way, this simple word lost its meaning. It started out as a gradual process. Over the past few years steadily being diluted as it was used more and more. But in these unusual times, the frequency of its use has hit, well, unprecedented levels.

Yet this is not the world’s first pandemic. Nor is it the first economic crisis or the first-time businesses and entire industries have faced existential threats.

So other than the unprecedented use of unprecedented, what makes this period so unprecedented?

After all, pandemics and our responses to them are a part of our history. Even the Black Plague was met with quarantines, restrictions on public life, economic shutdowns, compulsory hospitalizations, and isolation not only of the sick but of entire cities and regions. All of this without even understanding the pathogen and its transmission.

But we need not reach so far back into history for perspective on our ‘unprecedentedness’. The Spanish Flu named not for its origin but because the Spanish press was the first to report it, is estimated to have taken 40-50 million lives in 1918-19. The events of this period might sound eerily familiar.

The initial response was to ignore and dismiss the threat. But once the severity of the situation became undeniable, nonpharmaceutical interventions were introduced. In addition to quarantine and isolation measures, schools, theatres, libraries, and dancehalls were closed, mass gatherings were banned, and facemasks made obligatory in many cities and regions (i.e. Alberta). Even the 1919 Stanley Cup Final between the Montreal Canadians and Seattle Metropolitans was cancelled with only one game left in a tied series.

A study of these containment measures demonstrated that ‘early, sustained, and layered’ interventions had strong mitigating effects on the Spanish influenza (Markel et al, 2007). It seems logical that the earlier and longer containment measures are in place the more effective they are at containing the pandemic.

Evaluating the economic impact these policies had is a trickier proposition, but Sergio Correia and Stephan Luck of the Federal Reserve, and Emil Verner of MIT took a stab. Their findings indicated that these nonpharmaceutical interventions reduced ‘disease transmission without necessarily further depressing economic activity’ and even produced better medium-term outcomes.



But these are just the containment policies in of themselves, and of course, there was the direct economic damage of the pandemic's effect on health and behaviour. The limited data available shows US industrial production declined 25%, Canada suffered a 7% drop in GDP, and short-term sales were down between 30% and 70%

The difficulty here is parsing the impact of the influenza from the effects of the war. But anecdotal evidence indicates businesses suffering from pandemic related labour shortages, supply chain breakdowns, and a lack of demand, except in the case of mattresses and pharmaceuticals. Coincidentally, one such panacea drug that was unfoundedly prescribed and feverishly sought after was the quinine, the chemical grandfather of hydroxychloroquine.

We share these anecdotes not to draw any conclusions but to point out the risks of overusing 'unprecedented'. By ignoring the past and creating a greater sense of uncertainty, it can provide a convenient excuse to abdicate responsibility and avoid making difficult decisions.

People have faced similar challenges and have either overcome or succumbed. Businesses and entire industries have had to fight for survival many times before and have either adapted or gone extinct. There are lessons to be learnt from these successes and failures.

In 2000, Blockbuster video famously rejected an offer to buy Netflix for \$50mm. We all know how that turned out.

Furthermore, by painting indiscriminately with the unprecedented brush, we also run the risk of missing the truly unprecedented. The sudden and simultaneous shutdown of the global economy, the scale and speed of the monetary and fiscal response, the record levels of deficits government are taking on to fund this crisis. These are uncharted unwaters and need to be given due consideration, as both the intended and unintended consequences could be incredibly significant.

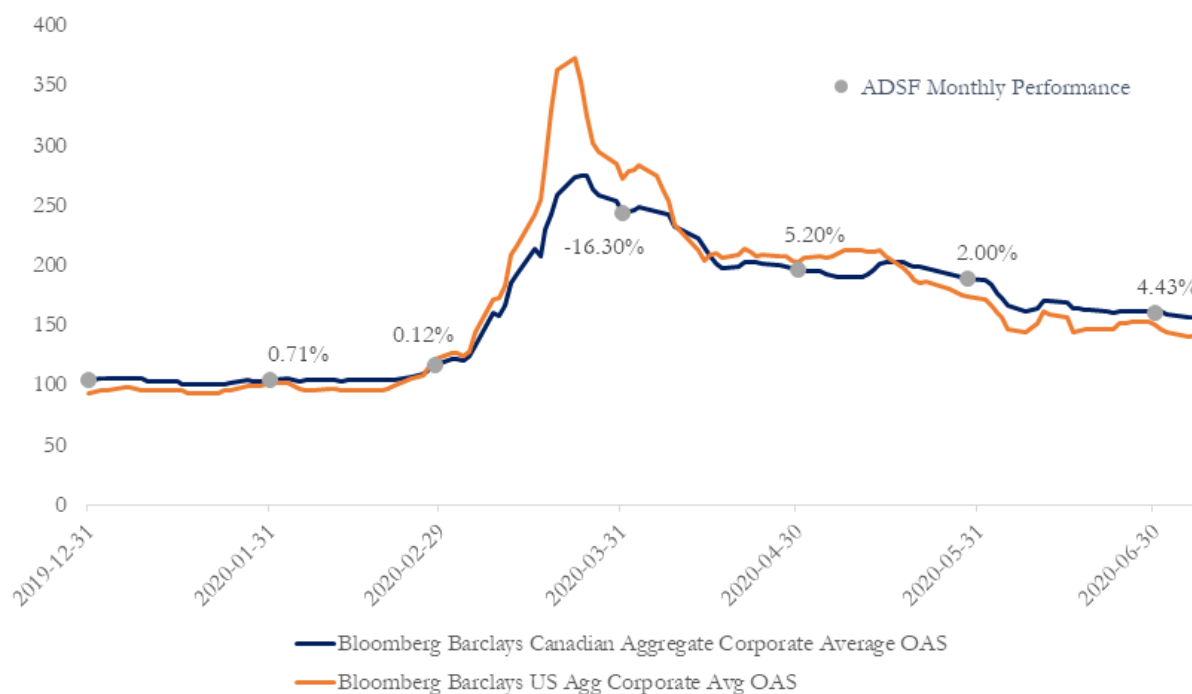
As we adjust to the abrupt changes brought on by COVID19, it would be unwise to ignore history and the implications of the actual precedents being broken. And perhaps we should hope for some more of the truly unprecedented, such as avoiding multiple waves and developing a vaccine in record time.



The Fund Performance.

The Tale of Two Quarters.

Investment-Grade Corporate Bond Spreads & Fund Performance.



While Q1 2020 was not unprecedented, the sell-off in Canadian credit did match the worst quarter of 2008. The shock of the global shutdown combined with an extreme lack of market liquidity saw investment-grade credit spreads widen in a hurry.

Central banks and governments responded just as quickly. Liquidity was injected back in the system and markets recalibrated the impact of COVID against these record amounts of stimulus. Optimism also grew around the effectiveness of containment measures, medical progress, and our ability to recover from this crisis.

Credit markets were offered further direct support as the Federal Reserve and Bank of Canada initiated corporate bond purchasing programs.

At the end of March/beginning of April, the Fund moved from a more defensive position to a medium risk posture. We also utilized the improved liquidity and tone to actively rotate positions. The portfolio rotation revolved around two themes, moving from fragile to more resilient companies and from credits that have outperformed the rally to those offering more value.

June 2020.

The markets engaged in a tug-of-war between the increasing number of COVID cases in the world's largest capital market and the record stimulus coming from central bankers and governments. The latest round of this game favoured the authorities even with some states reclosing after having opened too early.

While the tug-of-war led to volatile equity markets, credit remained resilient and continued to rally in June. Canadian investment-grade spreads modestly outperformed the US but remain wider on an absolute basis.

Generic Investment-Grade Credit Spreads

- Canadian spreads tightened 29 bps to finish at 160 bps
- US spreads tightened 24 bps to finish at 150 bps.

As noted in our previous commentary, domestic credit went into June with several supportive factors.

- June saw large numbers of bonds maturing and paying coupons, resulting in a robust inflow of cash into credit markets
- The record inflows into corporate debt funds in May added to the cash to be deployed into the market
- After the flood of deals in April and May, June experienced a lower than average supply of \$7.5bn
- The Bank of Canada Corporate Bond Purchasing Program was initiated at the end of May and has provided domestic credit markets with increased confidence and stability

We continued to use the market recovery and liquidity to actively trade and make some portfolio adjustments.

- Took profits in issuers that outperformed and rotated to securities offering more attractive valuations
- Exit and reduced positions in more challenged issuers and replaced them with more resilient credits

On top of the generic market performance, the fund benefitted from exposures to outperforming issuers and added a little extra through active trading.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	4.43%	12.06%	-5.43%	-5.43%	-2.27%	2.41%	8.07%	9.16%
F Class	4.38%	11.90%	-5.70%	-5.70%	-2.96%	1.65%	NA	NA

As of June 30th, 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.

Our Portfolio

Below is a summary of our portfolio as of June 30th, 2020.

- Portfolio Yield: 7%
- 97% Investment-grade
- Average Term to Maturity: 2.3 years
- Net Credit Exposure: CR01 10 bps (medium)
- Net Credit Leverage (5y): 2.x
- Total Long Credit Exposure: 5x (not including hedges)

Looking Ahead.

It seems until there is a vaccine, we will need to learn to live with the virus. As such, we expect several more rounds of tug-of-war, as markets determine where the balance lies between several competing factors.

- Governments (and society) will grapple the thorny problem of balancing public safety with economic well being. The gradual reopening of the economy will most certainly lead to a rise in cases (as we are seeing in other countries), so we should expect to see an ebb and flow in this tussle.
- With another global shutdown unlikely, markets need to assess the implications of some regions loosening restrictions while others tighten.
- The progress and breakthroughs made by medical science versus the setbacks to this process.
- The firehose of monetary and central bank stimulus against the disruption to the real economy.
- The power of fiscal stimulus against the growing number of bankruptcies. While government programs delayed the insolvency problem, more and more public companies are filing for bankruptcy, with private companies and individuals likely to follow suit.
- A significant decline in Q2 earnings versus a potential recovery in the latter half of the year.
- Deciphering the permanent losers, the temporary losers, and the winners, as consumer behaviour adjusts and businesses adapt.



Credit.

While credit has recovered with broader markets, Canadian investment-grade spreads are still significantly wider than earlier this year. Generic 5y spreads are over 50% higher, while shorted dated BBBs are still 90% above February levels (with some sectors and issuers more).

Furthermore, with central bankers supporting the space and minimal new issue supply on the horizon, the expectation is for continued performance over the summer (barring negative macro developments). And with such disparate circumstances for specific companies, we anticipate an even wider array of security selection opportunities ahead.

Given the balance of factors, we are maintaining a medium risk posture and continue to actively rotate positions. This allows the fund to benefit from the gradual improvement in the global economy while leaving the flexibility to take advantage of trading opportunities as they arise.

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