

Monkey In The Middle | May 2020

“Clowns to the left of me, jokers to the right,
here I am, stuck in the middle with you”
Stealers Wheel

The 'middle' can conjure up negative images and connotations: mediocrity, compromise, the dreaded middle seat. It is neither here nor there and lacks colour and tone, falling into the realm of boring, average, mundane grey. For minds designed to recognize contrasts and extremes, these neutral shades lack conviction and certainty.

As veterans of the credit markets, we are very familiar with the middle. Existing in a space somewhere between equities and fixed-income, credit is the often-overlooked middle child, lacking the glamour of stocks and the sterling reputation of government bonds.

Living in the shadows of your more popular siblings can be tough. But given the current backdrop and valuations, these days it ain't so bad to be stuck in the middle with credit.

To understand why it's a good time to be the middle child, we begin by looking at the predicament the other siblings find themselves in.

There is traditional fixed-income, the responsible, stable, boring eldest child: the provider of income and absorber of market shocks. Unfortunately, with government yields close to zero, there is very little income to be had, and for bonds to effectively hedge equity sell-offs, rates would need to go negative.

But the Federal Reserve and Bank of Canada have clearly stated that rates are at their 'effective lower bound', which in layman's terms means 'they ain't going negative anytime soon.'

This doesn't imply that central banks are absentee parents. If anything, they can be accused of being overbearing and spoiling the markets with an over-abundance of cash and support. So much so, this showering of love has led to the whispers of higher inflation, higher rates, and losses in fixed income. This does not bode well for the darling firstborn, the apple of the portfolio eye.

At the other end of the family is the young, exciting wild child, equities. Like a spoiled rich kid living a life of extravagance on their parents' money, stocks have staged a tremendous rebound from the COVID scare, resulting in a V shape (or half a W) recovery.

As of last night's close, the S&P is flat on the year, the TSX down 6%, and the Nasdaq up 10%. The question is whether this youthful optimism is unfounded given the problems in the real economy. Many believe earnings won't catch up to the stock markets' lofty expectations, and that another decline may be in order. After all, the main-street recovery may involve a letter or shape other than V, and the equity wild child is known for erratic mood swings.

Squeezed between fixed-income and equities is the misunderstood middle-child, credit: not too boring, not too exciting, but sharing traits with both siblings. In March, this dual nature made credit the monkey in the middle. Its equity-like qualities led to spreads widening as businesses closed and credit risk increased. The fixed-income nature of credit saw spreads get pounded further as corporate bonds were sold to raise cash. The combination led to a sharp and violent sell-off in credit, exacerbating the middle-child insecurities.

But a lot has changed since the dark days of March. With rates racing to historic lows and equity markets roaring towards a full recovery, credit has lagged behind its kin and offers attractive value. As while Canadian investment-grade spreads have recovered from their wiles, they are still 65% higher than at the beginning of the year.

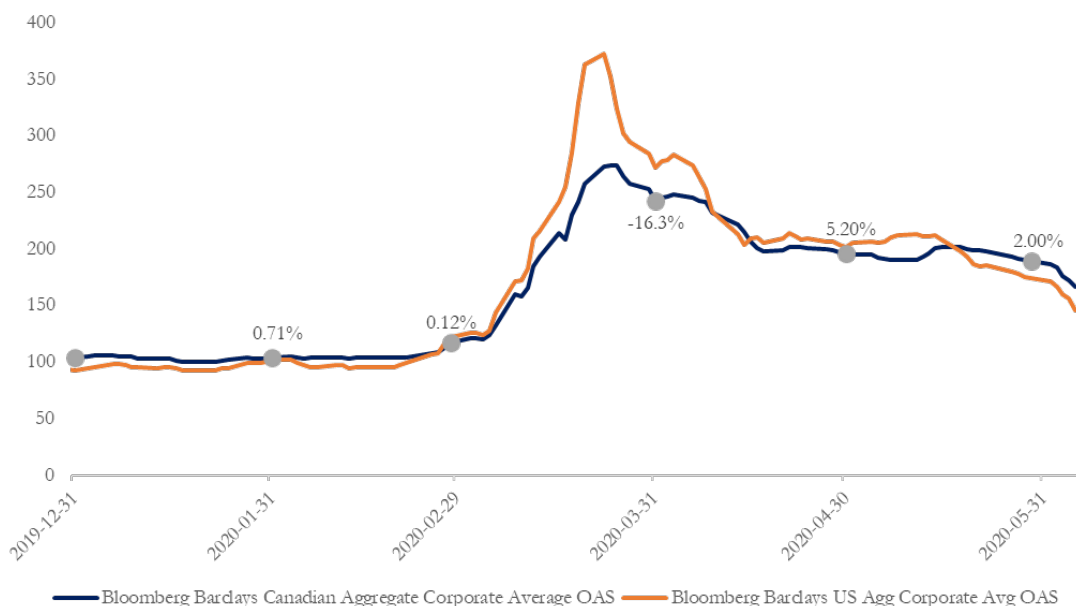
These elevated levels offer attractive yields and the potential for strong performance on normalization and a cushion in risk-off moves. Credit also benefits from direct parental intervention from the central bank, who on top of existing initiatives recently launched their corporate bond purchasing program. Given these factors, investors have started paying attention and pouring funds into corporate debt, adding further support to the space.

Thus, while we recognize that beauty is in the eye of the beholder (and our inherent biases), credit does appear to be the most attractive sibling right now. So perhaps it is time to shake off the negatives associated with the middle and remember that it is also the meeting ground for opposing views, the happy medium, and the best part of an Oreo cookie.

The Fund Performance.

Connecting the Dots.

Investment-Grade Corporate Bond Spreads & Fund Performance.





After a quiet start to the year, markets were roiled by fears of a global pandemic. The initial reaction to the coronavirus and its containment measures was a sharp and violent widening of credit spreads. The sell-off was driven by an increase in systemic credit risk and a lack of liquidity in the financial system.

Since the wiles of March optimism over the re-opening of the economy combined with the response from central banks and governments has led to a partial recovery of credit spreads.

At the end of March/beginning of April, the Fund moved from a more defensive position to a medium risk posture. The increase in exposure and active credit selection has meant a greater portion of the recovery has been captured thus far.

May Flowers.

May saw a continuation of the April trend with credit spreads moving lower. While the rally in the States went unabated, Canadian credit stuttered on a record-breaking amount of new issue supply.

Generic Investment-Grade Credit Spreads

- Canadian spreads tightened 7 bps to finish at 189 bps
- US spreads tightened 28 bps to finish at 174 bps.

The main driver of the performance disparity is the aggressive purchasing programs enacted by the Federal Reserve versus the more measured initiatives of the Bank of Canada.

The other trend that persisted from April to May was the tsunami of new supply.

- Canadian investment-grade issuance exceeded \$20 bn, which was above the \$17 bn issued in April and set a new monthly record
- While April was dominated by higher-quality issuers (obvious winners) coming to market, May saw several BBB and lower quality names access funding
- Notable supply included very well-received deals from the energy midstream sector (Pembina, Inter Pipeline, Keyera), telcos, insurers, autos, REITs and infrastructure
- The issuance thus far in 2020 is above the total amount for all of 2019



The big development in May was the launch of the Bank of Canada's Corporate Bond Purchase Program.

- Unlike the Federal Reserve, which is aggressively buying corporate debt through ETFs, the BoC program is designed more as a market stabilizer and backstop
- The program involves weekly purchases of five-year and under corporate debt of companies with a BBB rating or above (complete lists and details are available [here](#)).
- The mechanics of the program imply that the amounts being purchased will be tapered on strength and increased on market weakness

The Fund continued to maintain a medium risk posture and opportunistically rotated positions in May with the improved market liquidity.

- Utilized the new issue market and improved tone to rotate from more fragile issuers to companies with the resilience to weather a weak economy
- The portfolio earned over 0.80% in yield on the month and over 1% in credit performance, benefitting from positions in outperforming securities and issuers.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	2.00%	-10.18%	-8.49%	-9.44%	-5.43%	1.12%	7.19%	8.43%
F Class	1.95%	-10.27%	-8.80%	-9.65%	-6.16%	0.37%	NA	NA

As of May 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.

Our Portfolio.

Below is a summary of our portfolio as of May 31st, 2020.

- Portfolio Yield: 9%
- 96.2% Investment-grade
 - A slight decrease from Ford being downgraded to high-yield



- Average Term to Maturity: 2.3 years
- Net Credit Exposure: CR01 10.4 bps (medium)
- Net Credit Leverage (5y): 2.07x
- Total Long Credit Exposure: 5.1x (not including hedges)
- The Fund continues to receive net inflows and has significant excess margin with all prime brokers

Looking Ahead.

The path to economic recovery is littered with known unknowns and unknown unknowns. While it is critical to recognize and respect these uncertainties, it is also important to take stock of what we know.

- June is notable for the large numbers of bonds maturing and paying coupons, resulting in a robust inflow of cash into credit markets
- Corporate debt funds have experienced record inflows over the past weeks, adding to the cash to be deployed into the market
- After the recent flood of deals, the summer (and potentially second half of the year) should offer some respite and time to digest the new issuance thus far
- The Bank of Canada continues to inject liquidity through various programs
- The Bank of Canada Corporate Bond Purchase Program adds further stability and confidence to credit markets
- Credit has lagged the recovery in equities
- Canadian credit has lagged US credit since March and is now cheap on a relative basis

Thus barring any virus or macro-related shocks, the expectation is for Canadian credit to continue to perform over the summer months. Given the portfolio's running yield and the tailwinds for corporate debt, there is potential for the Fund to fully recover sooner than our initial expectations.

Contact

Algonquin Capital
1 King Street West, Suite 1502
Toronto, Ontario, M5H 1A1
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 306-8401

Peter Zwicker
Partner
peter.zwicker@algonquincap.com
+1 (416) 451-5139



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