

Extrapolate This! | November 2020

“Extrapolating from the statistical growth of the legal profession, by the year 2035 every single person in the United States will be a lawyer, including newborn infants.”

Michael Crichton - *State of Fear*

One of the favourite tools of forecasters and prognosticators is extrapolation: the art of taking an existing trend and extending it into the future. The simple premise being that long-term patterns and behaviours are, well, long-term, so it's reasonable to assume that they will persist.

That is of course until they don't, and are either disrupted, accelerated, or reach a point of saturation.

Extrapolating television sales from the 1950s would see us owning more TVs than socks today. Conversely, predicting current avocado consumption based on data from the 80s and 90s would grossly underestimate the millennial fascination with pairing this fruit with toast. And just think of all the disruptive technologies of the last decade that have either obliterated or spawned new industries or practices.

On top of these challenges, today's extrapolators are confronted with another dilemma. Given the anomalous nature of this period, we can't assume our current behaviours will continue in a post-vaccine world. As for historical trends, the pandemic has completely disrupted some, while hyper-accelerating others.

Thus, neither the past nor the present are truly reliable indicators of the future.

For choice, we feel the past offers a better picture of the future than the present. After all, our post-vaccine patterns will more closely reflect our lives before the pandemic than under lockdown. Thus, we see the BP era (before pandemic) as a better reference point for the AV (after vaccine) period to come.

This does not mean that we disregard or write-off the pandemic. As aforementioned, it has both disrupted and accelerated certain trends and behaviours. But we must also be careful not to overemphasize the extreme nature of our current predicament.

Take for example the 'work from home' phenomena.

Since the turn of the millennium, the idea has gained varying degrees of acceptance, but with no significant uptake. From 2008 to 2018 there was only a 2-3% increase in working from home, and heading into the pandemic, less than 13% of Canadian workers reported doing any scheduled hours from their residences.

We all know what happened next. Within weeks, millions of people shifted from being productive in a cubicle to being effective from the dining room. But what does work-life look like in a post-vaccine world?

Extrapolating the current situation, and one arrives at the death of the office and workplace. However, assuming a return to pre-pandemic life ignores the changes in attitudes of both employers and employees.

The reality is we probably land somewhere in between, with more flexible work structures, fewer hours in the office, and in some cases, entire businesses operating remotely.

Similarly, we need to make balanced assessments of the long-term impacts this virus will have on other trends that it has either boosted or decimated thus far. How many of us will continue ordering everything online, meeting virtually, or building home gyms? How many of us will return to movie theatres, concerts, and bars, or travel for business? The answer to both sets of questions seems to be: not all of us, but not none of us.



The trick is to not overemphasize the extreme nature of our current predicament but also recognize the permanent changes it will cause. The tendency with sudden and dramatic change is to exaggerate the short-term impact and underestimate the longer-term effects.

Given the severity of this crisis, there could be some indelible marks left on segments of the population. Folks that lived through the Great Depression are notorious for never throwing anything out. Young Americans that watched their parents suffer through collapsing property values in 2008 are more reluctant to become homeowners. Perhaps the scarring from the pandemic leads to greater risk aversion going forward, particularly when it comes to abandoning the safety of employment to start a business.

It will be interesting to see what 'normal life' after a vaccine looks like. While old habits die hard and many pre-pandemic behaviours will return, life will likely be a little different than it used to be. We believe that within those differences lie the most interesting opportunities. And in the meantime, the biggest question is 'when will we return to some semblance of normal?' To which our response is, not soon enough.

The Fund Performance.

November 2020.

November was a very strong month for risk assets. The conventional wisdom before the U.S. election was that any scenario except a contested one would be positive for the markets. It turned out that even a contested result was good enough to start the party. Positive news on the vaccine front added to the euphoria and far outweighed the negative sentiment from surging COVID-19 infections.

Huge amounts of cash on the sidelines began to be deployed into equities with broad North American indices rise by an astonishing 10-12%. Credit was also a benefactor, as investment-grade and high-yield funds saw healthy cash inflows and strong performance.

Generic Investment-Grade Credit Spreads:

- Canadian spreads tightened 19 bps to finish at 118 bps
- US spreads tightened 21 bps to finish at 104 bps

Similar to the equity market, the credit sectors that outperformed were those most likely to benefit from eventual vaccine rollouts. Domestically, this primarily meant issuers in the energy and REIT sectors. Energy names were buoyed by a near \$10 increase in the price of oil (WTI). In REITs, specifically, office, senior care, and retail-focused companies did best.

Higher-yielding and lower-rated bonds outperformed high-quality issuers. This spread compression is likely to continue, as plenty of cash remains to be deployed.

New issues reflected the demand for BBB rated companies. Domestically we saw interesting deals from Ford Canada (which came quite cheap to U.S. equivalents), H&R REIT, AltaGas, and Canadian Natural Resources, to name a few.



One potential negative this month was the spat between the U.S. Treasury Secretary Mnuchin and the Fed on the renewal of certain credit facilities. Any concern, however, was temporary as the market concluded their presence is more psychological than required at this juncture.

The Fund's 2.19% came from a combination of spread performance and carry.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	2.19%	3.00%	13.90%	3.15%	4.23%	4.43%	8.83%	10.11%
F Class	2.01%	2.72%	13.45%	2.50%	3.47%	3.66%	N/A	N/A

As of November 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.

Looking Ahead.

Credit markets continue to enjoy the strong central bank tailwind. Although the Federal Reserve will stop its corporate bond purchase program in a few weeks, it will continue large scale asset purchases of US government debt. The Bank of Canada is also continuing its purchases, albeit at a slightly slower pace than earlier this year.

As a result, the financial system remains flush with cash, meaning liquidity is of little concern. Furthermore, the expectation is for new issue supply to be lower in 2021. The combination of ample cash on the sidelines and dwindling supply ought to provide support to credit markets well into next year.

The prospects of a return to pre-pandemic life have revived investor enthusiasm for allocating to sectors that were hard hit by the lockdown. Despite the recent rally, credit spreads for many of these issuers remain elevated. Undoubtedly this reflects the uncertainty surrounding how fast vaccines can be rolled out, and whether consumers will fully return to BP consumption patterns.

We have been adding exposure to these sectors as we believe that on a relative value basis, there are compelling valuations to be found. While Santa may have come early this year, we expect spread compression to continue, with previously unloved sectors outperforming.

Although central banks will likely keep overnight rates low well into 2022, there is a risk that long end rates rise in response to improving economic strength and worries that the central bank purchasing programs will eventually end.

As a result of the concern surrounding interest rates rising, investors are reluctant to invest in long-maturity corporate debt. With fewer buyers, longer-end credit spreads offer attractive value. Since our fund hedges interest rate risk, we can take advantage of this opportunity and have been increasing the maturity profile of our holdings.

Just as 'normal life,' is apt to be a little different, the fund's composition will also change as we adjust to take advantage of the new opportunities that await us.



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