



Vote Early, Vote Often. | September 2020

“No one party can fool all of the people all of the time;
that's why we have two parties.”

Bob Hope

In the run-up to elections, markets tend to move up and down depending on which candidate is leading the polls. History would suggest that for the most part, this is an exercise in futility because business cycles, not presidents, drive returns.

Democrats might disagree and argue that equity returns have been materially higher during their presidencies. While there is data to support this claim, most of the outperformance is because Republicans held office in 1929 and 2008 when stocks collapsed, and Democrats presided over the subsequent recoveries.

Furthermore, an analysis of Australia, Canada, France, Germany, and the United Kingdom found no systematic relationship between the party in power and returns (Arnott et al, 2017).

In terms of the market impact of the upcoming election, Trump represents the continuation of business-friendly policies (tax, deregulation), trade tensions, and erratic messaging. A Biden victory means higher corporate taxes but significantly more stimulus spending and less disruptive trade and foreign policies.

As such, the economic impact of either candidate seems to be a draw. So why all the fuss ahead of election night?

Because 2020 wants to be a memorably unpleasant year, and it needs to throw in the additional wildcard of a contested election.

Thus, the next question is, what happens when the result of the presidential election is disputed?

In the event of a close vote, most states allow a candidate to request a recount. In some states, if the margin of victory is below a certain threshold, one is automatically triggered. Each state also sets the grounds for contesting the election results through a court challenge. It should be noted that it is not enough to cite a generalized belief of vote-rigging, as the court requires concrete arguments of fraud or voting irregularities to adjudicate.

In terms of timing, the US Constitution sets strict deadlines for challenges and recounts to be completed. A 133-year-old federal law, known as the ‘safe harbor’ provision, requires disputes to be settled six days before the electors meet. Congress has determined that state electors must meet on the first Monday after the second Wednesday in December. This year that date is December 14th, 2020. This leaves only 35 days from election night to resolve any challenges.

If at that point, it is still impossible to determine a winner, then the House of Representatives elects the president and the Senate the vice president. In this case, the new Congress that commences in January would have the task of carrying out the ‘contingent’ election. It is worthwhile noting that only one president has been selected this way, John Quincy Adams in 1825.

Although US constitutional law is titillating for some, the rest of us wonder what this means for the market?

A good starting point would be looking at the previous instance of a disputed presidential result, Florida's 'hanging chad' debacle. From the 2000 election recount, we can draw two profound conclusions: markets abhor uncertainty and the constitutional deadlines are indeed strict. Due to the 'safe harbor' provision, the Democrats couldn't send the recount issue back to the courts, as it was mid-December and time had run out. But in the four weeks between election night and Al Gore conceding to George W. Bush, the S&P fell more than 8%.

So, the good news is there are procedures and timelines in place to resolve any voting disputes. Thus, unlike other periods of uncertainty, at least there is a known process and finish line. The bad news is a contested election could lead to a material weakness in asset prices, and even worse, civil unrest on the streets.

As aforementioned, 2020 can't leave bad enough alone, and on top of a contested election, there is also the potential for social disorder or the president refusing to leave office. We are hopeful that the rhetoric remains just that and doesn't spill over into violence. But sadly, the possibility can't be ruled out.

There is no doubt that this election is divisive. The eventual outcome will have a significant impact on the direction of American society and the government agenda. In the meantime, active investors can look for short-term opportunities amidst the uncertainty and add exposure during sell-offs. For long-term passive investors, this election should be a political, not financial drama, as any market impact will be temporary. And for all of us, let us hope that the drama is contained in the political arena and that it remains both peaceful and democratic.

The Fund Performance.

September 2020.

Back to school month is notorious for being difficult for both children and investors. This year was no exception, with an arduous re-opening of schools and weakness in risk assets.

The S&P was down 4%, the TSX -2%, and interest rates provided little relief, inching a meagre few basis points lower.

Investment-grade credit was relatively resilient, but September was the first month since March that spreads widened. High yield didn't fare as well, with spreads roughly 50 bps wider in that space.

Generic Investment-Grade Credit Spreads

- Canadian spreads widened 7 bps to finish at 138 bps
- US spreads widened 7 bps to finish at 136 bps

The domestic new issuance for September was in line with historical norms, and overall, the deals were well received. The US saw a heavier month of supply as issuers get in front of the potential election volatility.

- Interestingly, BMO, CIBC, and National Bank all issued new AT1 deals, with respective sizes of \$1.25bn, \$750mm, and \$500mm

Amidst the market weakness, shorter-dated and higher quality credits held firmer than their longer-dated, lower-quality peers.

- The extraordinary liquidity injection into the financial system has manifested in higher levels of cash, which get deployed into money market type securities (i.e. higher-rated paper with less than a year to maturity).
- The short-end is further supported by the Bank of Canada 'backstop' (i.e. Corporate Bond Purchasing Program) which is limited to investment-grade bonds with 5y or less to maturity.
- Lower-quality bonds underperformed the broad market moves, with the energy sector being particularly hard hit.

The Fund was well-positioned for these moves and benefitted from concentrating in shorter-maturity, higher-quality bonds and generated excess returns through tactical trading. Thus, despite credit spreads widening over the month, the Fund finished on the right side of zero.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.38%	6.31%	19.12%	0.53%	2.90%	3.98%	8.93%	9.92%
F Class	0.35%	6.19%	18.83%	0.14%	2.24%	3.25%	NA	NA

As of September 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.

Reflecting on Recovery.

Economic indicators have begun to come off life-support but remain well below pre-pandemic levels. To paraphrase Winston Churchill, in terms of recovery, we are not at the end, nor the beginning of the end, but perhaps at the end of the beginning.

Of all the letters in the recovery alphabet soup, it appears the economy is settling into a 'K-shaped' pattern – where some businesses and individuals deal with inconveniences while others fight for survival.

- Under this K scenario, we expect a divergence across investment opportunities. But rather than the usual stratification by sector, rating, or geography, we see the opportunity set divided into four categories:
 - Resilient Businesses — solid names but for the most part lack compelling spread valuations (e.g. grocers)
 - Directly Affected Businesses – distressed credits with attractive valuations but unattractive business profiles (e.g. tourism, hospitality, indoor malls)
 - Goldilocks Businesses – spreads offer decent valuations and businesses relatively resistant (e.g. strip mall REITs, asset managers, public pensions)



- Recovery Plays – credits that perform in the K-recovery (e.g. autos, home construction) or through support from policymakers (e.g. financials)

We have been focussing on the Goldilocks names and selectively adding some recovery plays.

The Path Forward.

Through August and September, overall exposures were reduced to provide the Fund with the flexibility to navigate the coming months. We continue to remain cautious (low-medium) on outlook and positioning but are also opportunistically looking to add exposure on dips.

Looking ahead we are watching the following developments.

- The election of course. Although the probability of a contested election seems to be decreasing, it is 2020, and nothing can be ruled out. We view election-related weakness as an opportunity to add exposure, as once a victor is determined, we expect risk assets to resume their rally.
- The balance between rising virus case counts and progress on a vaccine and other treatments. It appears that governments around the world are choosing to avoid a total shutdown as they attempt to balance public health and economic well being.
- Continued developments in monetary and fiscal stimulus programs. Expansion of current programs or the addition of new ones will support asset prices.
- The growing level of government debt, and the taxes (or inflation) that will be required to deal with this burden.
- The levels of unemployment and the fate of businesses that are directly impacted by the pandemic.

Contact

Algonquin Capital
40 King Street West, Suite 3402
Toronto, Ontario, M5H 3Y2
www.algonquincap.com

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

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