NorthStream CAPITAL

NorthStream Credit Strategies Fund LP

Monthly Commentary: October 2023

The NorthStream Credit Strategies Fund returned +0.43% for the month of October, +8.88% year-to-date and +15.88% for the last twelve months.

Peak Interest Rates: Are We There Yet?

Long-term Treasury yields have slid sharply since late October on speculation that the Fed has completed its most aggressive tightening cycle in decades and the wave of new debt supply is abating. The benchmark 10-year yield has hovered around 4.6% - well below the 16-year high of 5.02% reached on Oct. 23.

The cover page article in Barron's on October 30th was titled "Time to Buy Bonds" and below the caption was a tag line:- "The long bear market in bonds has pummeled portfolios, but boosted yields. How to invest in bonds when they blossom again." Apparently long bond yields have peaked and it is time to add duration in risk-free government bonds. That conclusion was reached several times previously, but it has to be correct if Barron's is making that peak yields call, right? The odds have improved that we are getting closer, but a peak in long bond yields may not be a lock bet. A cover story in Barron's is not a good indicator that the odds are efficiently priced either. Let's ignore the coincident confirmation from Bill Gross on peak rates in handicapping the probabilities.

The yield curve inversion has lasted for 16 months already. Peak yield curve inversion was -108 bps in March 2021 and the 2-year vs 10-year yield curve inversion has narrowed to -41 bps. The yield curve is still inverted but is making progress in heading to being flat or positively sloped - which is positive, right? As yield curve inversions anticipate recessions, surely this steepening means we are out of the woods?

Quite the opposite actually, based on the chart below.

Source: The MacroCompass

The chart shows the blueprint for recent recessions (shaded in orange): *yield curve inversion (2's vs 10's in blue), time lag, yield curve steepening, then recession*. Perhaps we are just haggling about the lag at this point. The longer the yield curve stays inverted, the longer markets are signaling tight credit conditions for the private sector.

If credit conditions are tight, why is it not resulting in widening credit spreads for corporate bonds? Credit spreads in recent decades don't predict much - they are a coincident indicator. What we are seeing is increasing defaults, particularly in sectors with high leverage and high exposure to floating rate debt.

We have highlighted the stress in the commercial real estate sector in previous commentaries. The current crisis in the office market has been described by some real estate experts as being a "trainwreck in slow motion". WeWork's recent bankruptcy resulted in the termination of 70 leases in major North American cities and a default on nearly $19 billion of debt. WeWork now has leverage to reject or negotiate these leases, reduce the rent and rework their business, creating a negative loop in the office market and the credit market.

A recent podcast (ALL-IN: Nov 3, 2023 - link below) outlines the knock-on effects of the stress in the commercial real estate market. Office properties are being auctioned in markets such as San Francisco at a price of $200 per square foot. An example was an office building at 115 Sansone (56% occupancy) which is being auctioned with an asking price of $25M ($199 PSF), a 70% discount from the owner's 2016 purchase price of $83M. BofA funded the purchase with $53.6M of debt at the time of purchase in 2016. It's unclear whether there has been any accounting write down on the loan yet as the value of the property has not been settled. The realized impairment may not be $28.6M but it is unlikely to be zero. When do these distressed sales result in write-downs to the portfolio of CRE loans on bank balance sheets that have yet to default? What will be the impact on the banking sector?

The "Time to Buy Bonds" narrative gives hope to stakeholders in these levered sectors that lower yields will solve these outlier situations where properties are being liquidated. If the decrease in rates is imminent there is a willingness to wait for that shift in rates to arrive before making a decision on the appropriate level of asset impairment (if any).

What if higher rates have exposed problems other than funding costs? Maybe there is a demand problem? One person on the podcast panel who is a venture capitalist and tech entrepreneur, said that moving his staff from virtual to an office in San Francisco would increase his company's operating expenses by 10-20%. He claimed that even if the lease expense was zero, he would not risk asking his staff to move as they have dispersed about the country.

In a higher-for-longer environment the lags may be shorter for some industries, but the debt maturity wall will result in higher borrowing costs for businesses and households. It is just a matter of time. Higher borrowing costs may also result in unanticipated knock-on effects that have yet to be seen.

https://open.spotify.com/episode/56zyYHODKWsZUd9hGc7LaX?si=FWNsynh1Q2qy78zJPPU9Hw&t=1290

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NorthStream Credit Strategies Fund LP - Performance													
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	**YTD**
2023	0.69%	2.65%	0.50%	0.49%	0.75%	1.10%	0.46%	0.81%	0.68%	0.43%	-	-	**8.88%**
2022	1.35%	0.24%	5.67%	3.81%	3.74%	2.09%	-0.95%	-1.33%	-0.62%	1.39%	3.25%	3.09%	**23.70%**
2021	10.84%	4.70%	4.87%	-0.06%	1.23%	4.20%	-0.20%	-0.55%	3.78%	1.09%	-0.56%	0.08%	**32.94%**
2020	0.32%	-0.43%	-14.44%	0.43%	1.03%	3.67%	1.01%	2.99%	1.88%	2.36%	2.18%	9.47%	**9.09%**
2019	1.08%	1.34%	0.41%	0.79%	-1.41%	1.00%	0.99%	-0.31%	0.86%	-1.99%	0.01%	0.75%	**3.53%**
2018	1.32%	0.01%	0.72%	0.72%	0.52%	-0.17%	0.30%	0.30%	-0.11%	-0.61%	-1.44%	-0.67%	**0.85%**
2017	2.69%	0.66%	-0.89%	0.64%	0.63%	0.02%	0.31%	1.30%	1.03%	1.40%	0.66%	1.58%	**10.46%**
2016	-	-	-	-	0.49%	0.81%	3.40%	2.98%	2.29%	2.12%	0.75%	2.88%	**16.80%**

The NorthStream Credit Strategies Fund LP ("the Fund") launched on May 2, 2016. The monthly returns above are shown net of all fees and expenses and are based on the Fund's Class X Lead Series NAV. Monthly NAV and returns are calculated by SGGG Fund Services Inc. Past performance is not indicative of future results. Performance, risk metrics and correlations are as of October 31, 2023. Note that the use of the XGB, TSX, and S&P 500 in the performance tables below is for informational purposes only. The XGB (iShares Canadian Government Bond index ETF), TSX, and S&P 500 have a different composition than the Fund and are not comparable benchmarks. The XGB, TSX, and S&P 500 were chosen to compare the Fund's performance returns against other asset classes.

Return Since Inception: 163.12%

Performance & Risk Metrics	
Return Since Inception	163.12%
YTD	8.88%
1-YR Return	15.88%
Annualized Since Inception	13.77%
% of Positive Months	80.00%
Maximum Drawdown	-14.81%
Annualized Standard Deviation	9.02%
Sharpe Ratio[1]	1.31

Correlation			
Index	**XGB[2]**	**TSX**	**S&P500**
Correlation	-18.48%	39.16%	24.49%
Upside Capture	76.25%	51.38%	34.09%
Downside Capture[3]	-113.10%	-17.10%	-18.32%

1 Using 1-year T-bills.
2 iShares Canadian Government Bond Index ETF (XGB).
3 Negative downside capture vs. XGB, TSX, and S&P 500 is a result of NorthStream generating positive returns in months when these indices generated negative returns.