The Bonds Must Be Crazy | June 2021

"Since becoming a central banker, I have learned to mumble with great incoherence.
If I seem unduly clear to you, you must have misunderstood what I said."
Alan Greenspan

Summer has officially arrived and brought with it a healthy dose of optimism. The sunshine and second jabs have pierced through the corona clouds, as the positive vibes spread far and wide.

Stock markets continue to make new highs, oil is trading above $70, and good luck getting a patio reservation. Optimism and hope abound everywhere, everywhere except the bond market that is.

Despite forecasts of a strong economic recovery, good employment growth, and lots of inflation uncertainty, interest rates remain glued at very low levels. With 10y rates hovering around 1.3%, the yield curve is not painting the rosiest of macroeconomic pictures.

So why amidst all the optimism is the bond market sending out ominous signals?

Some of this pessimism might be attributed to concerns over variants, and perhaps a portion can be blamed on the cynical nature of bond traders. But one must also take into account the moves being made by the biggest players in the game, the central bankers.

Since the start of the pandemic, the Federal Reserve has purchased close to $4 trillion in assets, including $2.7 trillion in treasuries. For context, the total assets purchased in the three rounds of Quantitative Easing from 2008-2014 was $3.6 trillion.

Analyses of these post-2008 programs suggest they were effective in lowering yields by 0.50% to 1%. Given the speed and scale of the current iteration of QE, it seems safe to assume that significant downward pressure is being exerted on rates, which is interfering with the bond market's signals.

What happens when the biggest buyers in the land stop buying?

In 2013, when the Fed indicated that it was contemplating ending QE, yields spiked up over 1.3%, in what is now referred to as the 'taper tantrum'. Once investors got comfortable with the pace of the tapering and were confident inflation would remain contained, 10y rates settled into a range of around 2 - 2.5%.

With both investors and central bankers having learned lessons from the tantrum of 2013, we do not anticipate such a violent reaction this time around. However, as we learned in high-school physics, all else being equal, removing a downward force on an object will cause it to rise.

When will they start tapering?

Central banks base their moves on both recent data and economic projections. With the Federal Reserve looking for signs of 'substantial progress' in employment, non-farm payrolls will be the greatest determinant of the timing.

The good news is that the Fed wants to avoid a repeat of the 2013 tantrum and will telegraph its intentions early. As such, we could see some trial balloons about tapering in speeches by Federal Reserve members after their Annual Jackson Hole Policy Retreat at the end of August. And if the summer data is supportive, they could use the September meeting to announce the tapering to begin in early 2022.

So where does that leave yields, and what about inflation?

History has taught us that forecasting inflation during periods of change is a mug's game. Despite the conviction with which the pundits speak about their forecasts, the reality is that no one knows what to expect.

If CPI returns to the pre-pandemic levels, it seems reasonable to expect yields to settle back into their old 'new normal' band of 2-2.5% as the pace of quantitative easing slows down.

If inflation ends up running a bit hotter for a couple of years, a case could be made for yields to break this range and settle somewhere between 2.5% to 3%. If the crowd who believe we return to 70's style inflation is proven correct, then all bets are off as to just how high yields could go.

The Month of June.

Credit.

June set the record for the highest monthly new issuance in Canadian history, with over $19 bn in new corporate bonds brought to market. Notable deals included a $2.6 bn multi-tranche issue from North West Redwater, three LRCNs (RBC, BNS, and Sun Life), sustainability-linked bonds from Telus and Enbridge, and a surprise '3-trancher' from Dream Industrial REIT to fund the acquisition of European assets.

The flood of supply was met with strong demand but nonetheless kept domestic spreads on their back foot while US credit continued to perform. The cross-border differential now sits at 27 bps, making domestic credit cheap on a relative basis. Even if domestic spreads do not move tighter, they are unlikely to widen much if US spreads reverse course.

Generic Investment-Grade Credit Spreads:

- Canadian spreads widened 2 bps to finish at 107 bps
- US spreads tightened 4 bps to finish at 80 bps

Interest Rates.

The Federal Reserve surprised markets with a slightly more hawkish view. This brought the expected timing of rate hikes forward and eased fears of the Fed losing control of inflation. As a result, interest rate curves flattened with short-end rates pushing higher as longer-end yields came down.

Sovereign yields:

- Canadian 5y finished at 0.97% (+7 bps) and the 10y at 1.39% (-10 bps)
- US 5y finished at 0.87% (+8 bps) and the 10y at 1.45% (-13 bps)

The Funds.

Given the shift in stance by the Federal Reserve, we have shortened interest rate duration in both funds. The Debt Strategies Fund is now running short with a duration of -1y, and Fixed Income 2.0 has minimal exposure with a duration of 1y.

The majority of this repositioning has come via shorting US 2-year rates. With a yield of 20bps or so, the negative carry of the short positions is not particularly punitive, while the asymmetric return profile is rather attractive.

Despite domestic credit finishing the month modestly wider, both funds were able to put together a decent month through the yield earned, trading activity, and exposures to outperforming sectors (i.e. energy, REITs) and securities (i.e. called preferred shares).

Algonquin Debt Strategies Fund

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.27%	1.25%	2.52%	2.52%	13.22%	5.15%	6.98%	9.78%
F Class	0.21%	1.05%	2.12%	2.12%	12.26%	4.33%	6.04%	N/A

As of June 30th, 2021

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.

Algonquin Fixed Income 2.0

	1M	3M	6M	YTD	1Y	2020
F Class	0.41%	2.14%	1.59%	1.59%	10.78%	10.53%

As of June 30th, 2021

Algonquin Fixed Income 2.0 Fund is an Alternative Mutual Fund and was launched on December 9, 2019. Returns are shown for Class F since inception and are based on NAVs in Canadian dollars as calculated by SGGG Fund Services Inc., net of all fees and expenses. Investors should read the Simplified Prospectus, Annual Information Form, and Fund Facts Documents and consult their registered investment dealer before making an investment decision. Commissions, trailing commissions, management fees, and operating expenses all may be associated with mutual fund investments. An Alternative Mutual Fund is not guaranteed, its value changes frequently and its past performance is not indicative of future performance and may not be repeated. Payment of quarterly distributions is not guaranteed and paid at the discretion of the manager, therefore, it may vary from period to period and does not infer fund performance or rate of return

Looking Ahead.

After the June rush, it appears that the supply train will slow down through the summer. Given the significant divergence between the Canadian and US credit markets, we are optimistic that domestic spreads have a chance to catch up and grind tighter in the weeks ahead.

We continue to closely monitor any developments with Rogers' deal to buy Shaw. The market expects Rogers to raise a significant amount of debt to finance the acquisition which will require issuance in both Canada and the US. With a final decision expected early next year, possibilities range from the deal falling through to Rogers

opportunistically issuing debt that is contingent on the acquisition closing. While for many, following the nuances of telecom spread movements is akin to watching paint dry, for bond nerds this constitutes real excitement. Regardless of the outcome of the transaction, the telecom sector remains an opportunity to generate excess return.

Although rates have been slowly moving lower, as long as employment growth remains robust, central banks should continue to prepare markets for a reduction in monetary stimulus (tapering followed by rate hikes). We believe, barring negative development on the COVID front, this limits how far rates can drop. As such, we do expect to see hints from central bankers airing their views on when and how a reduction in bond purchases would occur, which could result in a little more rate volatility than one would expect during the summer doldrums.

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