Inflation Conflation| July 2021

"Inflation is when you pay fifteen dollars for the ten-dollar haircut
you used to get for five dollars when you had hair."
Sam Ewing

Every now and then it would be nice to have a crystal ball. As complete and utter bond nerds, one of the questions we would be asking is the direction of inflation. After all, it is one of the biggest risks facing investors, and in today's environment, completely unpredictable.

Under more normal and stable conditions, we could rely on the current trend for our inflation forecasts. In other words, because price pressure is persistent, use the data from previous quarters to forecast the coming months. But with the recent spikes in CPI, extrapolating the trend would see us returning to 1970s style hyperinflation.

While some folks might be dusting off their shag carpets and disco balls, most investors are debating how transitory these inflationary pressures are, and where do we eventually land.

Given we don't have the benefit of a crystal ball, we begin with the base case as laid out by the central bankers. The big guns continue to maintain that the pace of price growth will not persist, and attribute the recent spikes to the base effects of year-over-year comparisons, and pent-up pandemic demand being met by supply bottlenecks. Accordingly, they expect that sometime in 2022 for CPI to fall back to the pre-pandemic levels of 2% or so.

On the surface, this seems like a reasonable conclusion. The CPI numbers are indeed comparing today's prices to last year's COVID discounts. Furthermore, commodity prices have fallen/flat-lined, suggesting that supply and demand could be reaching an equilibrium. And lastly, the forces that kept inflation contained over the last decade - aging populations, global trade, and automation - could continue to exert downward pressure on prices.

On the other side of the debate, is the camp that believes inflation will persist. This group is quick to point out that prices for services remain depressed. And with the re-openings, surges in these sectors will compensate for any drop-off in goods. This offset plus the 'unprecedented' stimulus and wage inflation could allow CPI to remain elevated well into 2022.

Some in this 'higher for longer' crowd also argue that the deflationary forces of the past decade might be losing their power. After years of exporting inflation to China, growing political tensions and national security concerns could cause a slow down in global trade.

Furthermore, some argue that deflationary trends in demographics may be waning. As the boomers enter retirement, their drop-off in goods consumption could be replaced by spending on services i.e. travel and medical. And then we have the significant cohort of millennials in the midst of their #primespendingyears (lol).

Thus, perhaps demographics and globalization will no longer act to contain inflation, and it could run hotter for some time.

At the extreme of the run hotter scenario, we have the red-hot disco crowd. For these groovy cats, the potent combination of monetary and fiscal stimulus, within a rapidly growing economy, is a flashback to the conditions of the late '60s which led to the double-digit inflation of the '70s. This group foresees a confluence of factors that will keep prices rapidly rising on a more permanent basis.

This debate on how long today's inflationary forces persist will undoubtedly rage on. And despite all the fancy multi-variate models and the conviction with which the pundits speak, the reality is nobody knows where inflation will go. Only time will tell how transitory the spikes are and where we eventually settle.

In the meantime, one can follow the lead of the central bankers and worry when they do. After all, inflation is their thing, and they employ the most experts on the subject. And for the next several months they seem intent on ignoring the spikes in CPI.

This does not mean that they will disregard inflation forever. But for the balance of this year, we do not foresee inflation driving monetary policy, but instead, those decisions will be determined by progress on the job front.

So when it comes to inflation, the short-term mantra is 'don't worry, be happy.' And perhaps later in 2022, we will see if the pandemic altered the inflation paradigm and if the genie has indeed escaped the bottle. In the meantime, if you do have a crystal ball, you might want to ask about the payroll numbers.

The Month of July.

Credit.

The 'corporate Canada' borrowing binge continued with a July record of $12.3 bn in new issues. Foreign and domestic banks were busy issuing securities across the capital structure, with auto financing companies joining the party.

Perhaps the most interesting transaction was Air Canada selling bonds in both the US and Canada. The $2 bn domestic tranche was Canada's largest high-yield issue, ever. Despite the size, the deal was well received and traded $1 higher soon after launching.

Generic Investment-Grade Credit Spreads:

- Canadian spreads widened 1 bps to finish at 108 bps
- US spreads widened 6 bps to finish at 86 bps

Interest Rates.

The story for July was the puzzling decline in yields across the curve. Several theories have been advanced, with the causes ranging from (i) large asset allocation from equities to bonds, (ii) European and Japanese investors being enticed into owning positive versus negative-yielding sovereign debt, and of course (iii) the rise of the delta variant. In our view, all of these factors, and probably a few we do not know of, coupled with the (iv) enormous buying by the Federal Reserve conspired to send yields lower.

While moves in yields can be important signals of economic health, the distortion created by quantitative easing makes it difficult to separate a true signal from the noise. In our view, the North American economies are well on the way to healing which will result in the Fed announcing the commencement of tapering sometime in the fall (the Bank of Canada has already shaved their buying program from $5 bn to $2 bn per week). As such the longer-term trajectory for yields remains upwards.

Sovereign yields:

- Canadian 5y finished at 0.81% (-16 bps) and the 10y at 1.20% (-19 bps)
- US 5y finished at 0.69% (-18 bps) and the 10y at 1.31% (-20 bps)

The Funds.

We continued being selective on credit, passing on deals that did not offer sufficient value. With investment-grade spreads broadly unchanged, most of the return from credit positions this month came from carry.

In terms of rates, the move lower was a drag on ADSF as the negative duration of 1.25 years erased the yield earned. FI2.0 benefited slightly from the move in government yields due to its duration of positive 1.25 years.

Algonquin Debt Strategies Fund

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-0.06%	0.67%	1.45%	2.46%	9.00%	4.97%	6.60%	9.64%
F Class	-0.09%	0.51%	1.12%	2.02%	8.08%	4.17%	5.69%	NA

As of July 31st, 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	0.44%	1.62%	1.47%	2.04%	7.82%	10.53%

As of July 31st, 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.

Normally, July is a quiet month in credit with only a few deals, and portfolio managers are left to pick away at dealer inventories. Given the record-breaking supply last month, bond funds were busy buying the new deals and dealer inventories continued to build. Although not tremendously worrisome, we are watching the situation closely and keeping an eye on upcoming new issues.

One of the big wildcards on the supply front is Rogers. Should the Shaw acquisition be approved they will need to do some significant debt financing. The timing and amount of debt required are uncertain, as is the distribution across markets (i.e. US v Canada) and the structure of the deals. This uncertainty coupled with the recent spectrum auction has pressured telecom spreads, and valuations are beginning to look attractive. We are cautiously adding exposure in the sector and closely watching the developments on the Rogers front.

With the economy continuing to heal, credit spreads remain supported. On top of the delta variant, a new risk factor we are watching is the potential for redemptions from bond funds if investors become fearful of rising rates. So far, there has been little evidence of this fear, but that could change very quickly if the Federal Reserve becomes more aggressive.

As we have noted before, the inflation data will do little to guide central bank activity in the coming months. For the moment the pace of employment growth dominates the decision-making.

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