ALGONQUIN
CAPITAL

The Free Lunch Experiment | August 2021

"Free lunches don't come cheap."
Charles Petzold

In the nineteenth century, taverns and saloons would offer their drinking patrons a 'free lunch'. These inexpensive and salty meals kept the customers staying longer and consuming more of the high-margin alcoholic beverages. This practice, which led to some saloons being charged with false advertising, gave rise to the expression, 'there's no such thing as a free lunch.'

This concept of the 'free lunch' and the lack of its existence plays an integral role in various fields, from science to economics. In its simplest form, it refers to the fact that you can't get something for nothing. Every benefit comes with an associated cost, even if it is solely an opportunity cost.

But as with every idiom, there are counterexamples. In this instance, there are the 'almost free lunches'. One such example is when benefits accrue to a particular individual or group with the costs being borne by another party or society at large. In the case of the taverns, perhaps you invite a heavy drinker for lunch and get away with ordering water while dining gratis. In modern economies, we have subsidies targeting specific industries (i.e. agriculture and energy), where a small group benefits at the expense of the taxpayers.

Another version of the complimentary lunch was eloquently captured by the computer scientist Fred Brooks, 'you can only get something for nothing if you have previously gotten nothing for something.' Returning to our 19th-century tavern, if you were in the habit of drinking a few beers at noon and paying for your meal, then the advent of free lunch special was truly a gratuitous gain for you. Some libertarians argue that introducing free markets into a communist system has a similar impact, by taking a country's existing labour and improving its productivity and standard of living.

Some folks even argue that we are currently in the midst of a free lunch, with governments and central banks having engineered an all-you-can-eat buffet.

The smorgasbord on offer is being funded through the emergency quantitative easing programs. Through the pandemic, the world has embarked on a fascinating experiment, where governments issue vast sums of debt that are purchased by the central banks. The governments then disperse these funds to the public as they see fit. The central banks are willing to lend at any rate and don't seem to care about getting their money back as they simply roll over maturing bonds into newly issued ones. In return, governments can spend money freely without any negative repercussions.

The natural reaction is one of disbelief. Surely there have to be some negative consequences to printing money. Economic theory suggests the costs would manifest in a weaker currency, higher yields, inflation, or any combination of these ill effects.

For those worried about currency debasement, it is important to remember that foreign exchange is a relative game. With every central bank engaged in quantitative easing, it doesn't seem likely that any single currency will depreciate significantly against the others.

The hardcore skeptics of helicopter money warn of higher inflation. Indeed, in recent months we have seen the highest CPI prints in decades. But the central banks, who employ the most inflation experts in the world, maintain that this trend is transitory. They are comfortable that disinflationary forces will reemerge pushing inflation back down to pre-pandemic levels.

As for higher yields, while rates have risen from the lows of last summer, the 10y is still only around 1.2% which is the lower range of the past decade or so. Furthermore, the central bankers don't seem to be in any hurry to start hiking overnight rates from their 'effective lower bound'.

So, if currency, yields, and inflation are not significant concerns, have our governments and central banks orchestrated a free lunch? It does feel counterintuitive for there not to be any consequences to printing trillions of dollars and running up massive debts.

Perhaps we are on a deferred payment program, where the bill comes much later. Or maybe with governments borrowing at 1% and nominal GDP expected to be 3-4%, naturally growing tax revenue (without increasing tax rates) could be enough to pay down the debt. And while a trillion dollars seems large to us, in the context of the global economy, it might be a negligible amount, akin to a bar offering patrons a few complimentary peanuts.

As fixed-income investors, we are naturally a skeptical bunch. So we are far from insinuating that the world has discovered a new 'freebie'. But maybe, just maybe, the costs of printing all that money will be far outweighed by the advantages, and we will have in some sense pulled off a 'dine and dash'.

The Month of August.

Credit.

The spring and summer trend continued in August, with minimal volatility in Canadian credit, as generic investment-grade spreads finished the month flat. Defensive issuers faired the best, while the energy sector saw a bit of weakness. In the middle of the pack, telecommunications recovered some of the July spectrum-based sell-off.

Issuance was unusually light, even for August, with Granite, Allied Properties, and Crombie issuing bonds in the 7-10 year bucket. Goldman Sachs and Macquarie brought Maple deals, Great West Life did $1.5 bn of LRCN, while Tourmaline sold a 2029 bond.

We expect credit to remain resilient in the fall, with any widening finding buyers desperate to pick up any bit of additional yield.

Generic Investment-Grade Credit Spreads:

- Canadian spreads were flat to finish at 108 bps
- US spreads widened 1 bps to finish at 87 bps

Interest Rates.

Rates traded in a narrow range as people patiently wait to see how the inflation story, employment growth, and the tentative steps towards tapering QE proceed. The much-awaited Jackson Hole event provided no further insight into Chairman Powell's thoughts around when to commence the taper. Oddly enough, the promise of further fiscal stimulus on both sides of the border had little impact on sovereign debt markets. Perhaps that will change once the various spending bills actually get passed.

Sovereign yields:

- Canadian 5y finished at 0.84% (+3 bps) and the 10y at 1.22% (+2 bps)
- US 5y finished at 0.77% (+8 bps) and the 10y at 1.28% (-3 bps)

The Funds.

With credit trading flat over the month and minimal market volatility, for both funds, the monthly return was mostly comprised of carry. We continued to trim exposures and focus on areas where we see pockets of value and potential for performance. Also, with Canadian investment-grade credit spreads 20 bps cheaper (higher) than their US counterparts, our domestic exposure is heavier than normal.

Having lightened overall exposures through the summer, both funds are well-positioned for the pick-up in activity that is anticipated for the fall.

Algonquin Debt Strategies Fund

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.12%	0.33%	1.23%	2.58%	6.98%	4.83%	6.28%	9.53%
F Class	0.07%	0.19%	0.92%	2.10%	6.06%	4.04%	5.39%	NA

As of August 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	0.20%	1.06%	2.47%	2.25%	6.85%	10.53%

As of August 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.

September marks both the return to school and the return of deal flow. Utilities are usually featured issuers, as is the auto sector. This year, telco funding should be robust to cover spectrum spending, and there is always the Rogers wildcard. Banks, who are normally quite active, may be quieter than usual, given their high capital ratios and funding levels.

The fundamental backdrop in Canada is still constructive despite the weaker Q2 GDP print. Vaccination rates are high in the most populous provinces, and with many employers mandating inoculations plus the introduction of vaccine passports, it's likely more people get the 'jab.' That said, we are keeping an eye on other jurisdictions, especially Asia which has far less tolerance for case counts than the US.

With Jackson Hole shedding little new light on the path to removing monetary stimulus, employment data and Federal Reserve meetings could be volatile events, however, we do expect the eventual taper announcement to be a non-event in the bond market. For some reason, the equity folks always seem to be surprised when the Fed decides to reduce stimulus, so we could see a few days of excitement in stock markets on the taper announcement.

Contact

Algonquin Capital	Raj Tandon
40 King Street West, Suite 3402	Founding Partner
Toronto, Ontario, M5H 3Y2	raj.tandon@algonquincap.com
www.algonquincap.com	+1 (416) 306-8401

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