ALGONQUIN
CAPITAL

# My Central Bank Is Badder Than Yours | October 2021

"Two roads diverged in a yellow wood…"
Robert Frost

With the exception of hockey and South Park, Canadians are rarely accused of being more aggressive than the Americans. We are, after all, the docile neighbours to the north, eh.

But when it comes to post-pandemic monetary policy the gloves are off. Canadian central bankers have been, and are expected to be, far more aggressive than their counterparts at the Fed.

A couple of weeks ago, the Bank of Canada (BoC) ended their quantitative easing program, and have moved to simply reinvesting the proceeds from matured bonds. This sets the stage for rate hikes, with the market pricing in four to five next year. Lift-off is projected for April, with some forecasters flirting with the idea of a January start.

Meanwhile south of the border, our Fed has just begun tapering its QE program, and at the current pace won't be done until June. This would leave rate hikes for the latter half of the year, with the market expecting only two in 2022.

Does such a cross-border divergence in interest rate policy make sense?

Despite our economies being intertwined, the central banks are not bound to act in unison. In the 90s the Canadian policy rate went from being 6% above the US Federal Funds Rate to 4% below.

Since then, things have settled down and over the last decade the biggest differential (a whopping 1%) came in the aftermath of 2008. With US housing and banking at the epicenter of the crisis, the Fed maintained a zero-rate policy until the end of 2015. Given Canadian banks and homes were relatively unscathed, the BoC was able to squeeze three hikes into 2010.

We once again find ourselves in the aftermath of a crisis with the Canadians leading the charge to higher rates. Despite the almost endless lockdowns, the Canadian economy has recovered quite rapidly. We have the same number of people employed today as in January 2020, and the strong demand for labour is forcing wages higher.

This wage pressure coupled with the current supply/demand imbalances and higher energy costs has led to concerns that higher inflation might persist well into 2022. And while the BoC believes the current price increases are due to one-off supply chain issues, they also expect the economy to be at full capacity by the summer. Balancing these factors and a mandate to keep inflation around 2%, it should come as no surprise that the BoC has served notice that rates are going higher.

The Federal Reserve on the other hand has two mandates. One is managing inflation, while the other is fostering conditions that lead to full employment. Last summer, Chairman Powell unveiled an approach where the Fed would be willing to let inflation run hot for a little while in order to push unemployment lower.

This new approach has allowed the Fed to 'look past' the recent CPI prints and focus exclusively on employment. With the US still around 4mm jobs short of the February 2020 numbers, Chairman Powell's attention remains focussed on getting these people back to work. Furthermore, the Fed still maintains that the recent surge in prices is temporary and that the economy will soon return to pre-pandemic inflation levels.

This leaves investors confronted with two divergent roads in the 'yellow wood'. The first path has the Bank of Canada worried that inflation becomes entrenched and hiking early to avoid it becoming an ongoing issue. This despite the high debt burden of the Canadian consumer (another area where we are more aggressive than the Americans).

One the second path, we have the Federal Reserve's 'don't worry be happy', inflation is transitory rehtoric. They see little risk to inflation becoming a persistent problem, believing that CPI will subside to pre-pandemic levels on its own in the coming months. As such, there is no need to move quickly on rates.

We find it hard to foresee a world where both central banks are correct. The forces driving prices higher are the same in both countries, and barring a sharp devaluation of the loonie, we can't imagine a scenario where Canadian inflation is materially higher than the US.

Thus, at least one of these outlooks must be incorrect. We say 'at least', as while both central banks cannot be right, there is certainly the possibility that they both are wrong.

## The Month of October.

### Credit.

The September concerns over earnings evaporated as companies generally reported strong numbers. Equity markets recovered, while credit remained resilient. Even unusually volatile rate moves did little to dampen the enthusiasm for new issues and corporate debt. The US IG market printed an impressive $120 bn worth of new deals, while Canada managed to get $11 bn done. In the domestic market, the focus was largely on infrastructure and asset backed issuers.

Energy names performed well as oil prices remain high leading to a gush of cash in the oil patch. The drama at Rogers shed light on corporate governance concerns but did comparatively little to move credit spreads. The REIT space saw some excitement with H&R performing well after announcing a plan to streamline their business and focus on the residential and industrial sectors. Meanwhile the pending acquisition of Cominar opens the door for interesting developments on their outstanding bond issues.

With the recent announcements of effective anti-viral treatments for COVID-19, the prospect for economic recovery remains high and should act as a strong tailwind for credit markets.

Generic Investment-Grade Credit Spreads:

- Canadian spreads tightened 3 bps to finish at 102 bps
- US spreads widened 3 bps to finish at 87 bps

## Interest Rates.

In their October meeting, the Bank of Canada surprised markets with a more 'hawkish' tone than expected. The market reaction was swift and violent, as short-end rates spiked on the expectation of a more aggressive hiking schedule for 2022.

In comparison, US rates moved modestly higher, as the Fed continues to focus on jobs and is taking a more passive approach to interest rate hikes.

Sovereign yields:

- Canadian 2y finished at 1.09% (+56 bps) and the 10y at 1.72% (+21 bps)
- US 2y finished at 0.50% (+22 bps) and the 10y at 1.55% (+6 bps)

## The Funds.

### Algonquin Debt Strategies Fund

The sharp rise in Canadian 1y and 2y interest rates caused some temporary pain in the part of the portfolio holding unhedged short-dated bonds. The mark-to-market losses incurred on these holdings dented the profits generated from credit trading to finish +0.15%.

| | 1M | 3M | 6M | YTD | 1Y | 3Y | 5Y | SI |
|---|---|---|---|---|---|---|---|---|
| X Class | 0.20% | 0.95% | 1.63% | 3.43% | 7.02% | 5.07% | 5.85% | 9.42% |
| F Class | 0.15% | 0.77% | 1.28% | 2.81% | 6.07% | 4.26% | 4.99% | NA |

As of October 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

Despite running duration at the low end of the range, around 2y, the move in Canadian rates was violent enough to offset the yield earned and returns from credit.

| | 1M | 3M | 6M | YTD | 1Y | 2020 |
|---|---|---|---|---|---|---|
| F Class | -0.15% | 0.10% | 1.73% | 2.14% | 6.32% | 10.53% |

As of October 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.

Sovereign yields should continue to be choppy as traders digest each new data point and attempt to guess the timing and path of future rate hikes. Given how transparent the central banks have been, moves in interest rates should not significantly affect credit markets.

With earnings behind them, CFOs should be quite active locking in financing ahead of the Christmas lull. Accordingly, we expect supply to pick up. Demand for corporate debt remains strong as there seems to be plenty of cash waiting to be put to work at the recently improved all-in yields.

One particular area of interest is the Maple market which appears to be attractive for foreign issuers at the moment. The potential for large multi-national borrowers to tap the market should create some trading opportunities either through secondary market flows or on a relative value basis.

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