ALGONQUIN
CAPITAL

New Year. New You. | December 2021

“I’m not making any New Year’s resolutions.
They just go in one year and out the other.”
Jane Ace

New Year’s resolutions. Every year we make ‘em. Every year we break ‘em. At least that’s how it goes for most of us, with an estimated 80% of resolutions going unfulfilled.

Every January the diets begin, and the gyms fill up, only for our resolve to fade by month’s end. According to research by fitness app Strava, the day we are most likely to give up is January 19th, a date they have dubbed ‘quitter’s day’.

With such high failure rates, it makes you wonder why we even bother with this annual tradition.

But changing old habits can be extremely hard, and often requires multiple attempts before success is achieved. Thus, one could argue that a 20% success rate is very good.

Furthermore, one of the most daunting and difficult parts of personal change is getting started. And at the very least, the New Year resolution gives us an impetus to get in the game and on the path to change.

So, the question becomes, how can we put ourselves in the minority that succeeds in seeing their resolutions through?

The obvious starting point is to set achievable and realistic goals that are within your control. It can also be helpful to break these goals into bite-sized milestones and track your incremental progress along the way.

It is also worth considering the types of battles you pick to fight. Evidence would suggest that we have greater success with our financial pledges (i.e. save more and spend less) than maintaining our diets and exercise programs.

Once you have set your resolutions, then comes the hard part, sticking to them. Standing in our way are the usual demons of procrastination, laziness, and the power of old habits. To overcome these barriers, behavioural scientists recommend forgetting what you learned in Economics 101.

Traditional economic theory assumes that we all want more freedom, flexibility, and optionality. But to boost your odds of resolution success, a useful strategy is to impose restrictions, constraints, and penalties upon yourself.

To combat procrastination, Professors Ariely and Wertenbroch of MIT offered their students the option to self-impose deadlines (with penalties) for their assignments rather than have the freedom to hand them in at any time before the end of the term. Contrary to economic theory, the majority (68%) of students took the restrictive first option (and produced higher-quality papers than their freer peers).

Following a similar approach, Green Bank, one of the largest retail banks in the Philippines introduced a ‘locked savings account.’ This account pays the same amount of interest as a normal savings account, but the funds can not be accessed until a certain date or balance has been reached. Surprisingly, 28% of customers chose the locked option over traditional accounts or no account at all. Unsurprisingly, these customers saved considerably more than their unlocked peers.

But sometimes, adopting new behaviours and regimes seems impossible or borderline painful.

For these instances, behavioural scientist Katy Milkman offers a strategy she calls 'temptation bundling.' It is akin to Mary Poppins' principle of 'a spoon full of sugar helps the medicine go down.' Examples of bundling include, only listening to your favourite podcast while working out, or treating yourself to a special cheat meal during boring estate planning meetings or portfolio reviews (maybe even on your advisor's dime).

While these tactics might make traditional economists grumble, so too should the very concept of a New Year resolution. After all, a perfectly rational person would not alter their behaviour just because the calendar flipped over. But the new year is often a time of reflection, and we can use the bigger picture to disrupt some of our old habits and patterns. It offers us a fresh start and a clean slate, with the opportunity to relegate failures and bad habits to the past. And if all else fails, you can always start anew next Monday.

The Month of December.

Credit.

With early jitters about Omicron subsiding, as evidence pointed to less severe disease outcomes, credit spreads attempted to stage a Santa Claus rally. Although US spreads narrowed substantially, our domestic market was held back by a higher-than-normal wave of issuance, with well over $7 bn worth of deals done.

The most exciting transaction was the $2 bn subordinated hybrid security from Rogers Communications. The note came with a 5% coupon and was the first hybrid in the telco/cable sector. Despite the large size of the deal, it was very well received.

Now that banks are free of temporary capital regulations and engaging in shareholder-friendly actions, senior bank spreads continued widening, as they return to more normal levels. While inflicting a little pain along the way, at current valuations they are becoming attractive.

Generic Investment-Grade Credit Spreads:

- Canadian spreads were flat to finish 2021 at 111 bps
- US spreads tightened 7 bps to end the year at 92 bps

Interest Rates.

Between inflation expectations, the Omicron variant, and reading the central bank tea leaves, markets adjusted their expectations for the timing and pace of rate hikes. Ultimately, yield curves flattened over the month.

Sovereign yields:

- Canadian 2y finished at 0.95% (-3 bps) and the 10y at 1.42% (-16 bps)
- US 2y finished at 0.73% (+19 bps) and the 10y at 1.52% (+10 bps)

The Funds.

Algonquin Debt Strategies Fund

Overall, the moves in credit spreads and minor losses on derivative hedges lead to a small loss for the month.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-0.04%	-0.22%	0.47%	2.99%	2.99%	5.77%	5.09%	9.12%
F Class	-0.07%	-0.33%	0.20%	2.32%	2.32%	4.94%	4.28%	NA

As of December 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

On top of the yield earned through the month, the fund generated excess returns through yield curve flattening positions (i.e. short US 2y and long Canadian 10y).

	1M	3M	6M	YTD	1Y	2020
F Class	0.65%	0.12%	0.81%	2.42%	2.42%	10.53%

As of December 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.

As many of you know, we do not like making predictions, especially about the future. Instead, we like to think about what the market is expecting and what events could force a recalibration. Fortunately, the sovereign yield curve and the plethora of associated derivative instruments provide a great deal of insight into the consensus view on interest rates.

First of all, despite expectations for good economic growth, the bond market expects the recent string of hot inflation numbers to slow and head back to 2% by the end of the year or early next year. Investors are expecting between three and four 25 bps hikes from the Bank of Canada and Federal Reserve in 2022. Perhaps, most importantly, the consensus is that overnight rates will peak in the range of 1.25% to 1.5%. Under this scenario, 10-year yields could drift upwards towards 2%, and the removal of stimulus would be a rather benign event.

Given this base case, we consider what economic variable(s) can change perception. Last year, we believed employment numbers were the most important. This year, we think it is all about the inflation data. We believe a terminal interest rate of 1.5% is predicated on inflation reaching close to 2% by the end of 2022. If CPI numbers drop quickly and threaten to go below 2%, then central banks could stop hiking earlier, allowing yields to drop towards 1%. While everything is possible, we think this outcome is a low probability event.

To have inflation drop, not only do supply chains have to improve, but more people need to join the labour market. At the moment, there appears to be a large number of people who are not looking for work, which is forcing employers to raise wages at a rapid pace as they battle competitors for talent. We think the odds are fairly high that at least one of these variables proves to be more problematic than anticipated, allowing CPI to remain more elevated than currently forecast.

If inflation proves to be stubborn, then the bond market will shift yields higher in anticipation of central banks moving rates higher (i.e. overnight to 2.5%) or at a faster pace. This is the scenario we are most worried about.

Under the base case scenario, long duration bond funds could eke out a small positive return, however, if inflation is problematic then these funds could experience painful losses.

Contact

Algonquin Capital
40 King Street West, Suite 3402
Toronto, Ontario, M5H 3Y2
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 306-8401

Disclaimer

Algonquin Capital Corporation ("Algonquin") is registered with the Ontario Securities Commission as an exempt market dealer, investment fund manager, and portfolio manager. This commentary is confidential and for authorized use only. Under no circumstances are its contents to be reproduced or distributed to the public, media, or potential investors without written authorization. The information contained herein, while obtained from sources believed to be reliable, is not guaranteed as to its accuracy or completeness.

The information contained in this commentary is not investment or financial product advice and is not intended to be used as the basis for making an investment decision. This commentary by Algonquin is not, and does not constitute, an offer to sell or the solicitation, invitation, or recommendation to purchase any securities.

This commentary contains statements that constitute "forward-looking statements". Examples of these forward-looking statements include, but are not limited to, (i) statements regarding future results of operations and financial condition, (ii) statements of plans, objectives or goals and (iii) statements of assumptions underlying those statements. Words such as "may", "will", "expect", "intend", "plan", "estimate", "anticipate", "believe", "continue", "probability", "risk" and other similar words are intended to identify forward-looking statements but are not the exclusive means of identifying those statements. Forward-looking statements included herein are based on current expectations and beliefs, and Algonquin disclaims, other than as required by law, any obligation to update any forward-looking statements whether as a result of new information, results, future events, circumstances, or if Algonquin's expectations or opinions should change, or otherwise. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that such predictions, forecasts, projections, and other forward-looking statements will not be achieved. A number of important factors could cause Algonquin's actual results to differ materially from the plans, objectives, expectations, estimates, and intentions expressed in such forward-looking statements. As such, undue reliance should not be placed on any forward-looking statement.