ALGONQUIN
CAPITAL

A Central Bank Bedtime Story | January 2022

"The job of the Central Bank is to worry."
Alice Rivlin

We imagine that central bankers have endured many sleepless nights since the start of the pandemic. After all, even in the best of times, stewarding monetary policy to optimize growth, inflation, and employment is a difficult balancing act. Having to navigate the unchartered waters of a global pandemic must have caused some serious tossing and turning in the beds of Misters Powell and Macklem.

Now with rate hikes set to begin next month, the Federal Reserve and Bank of Canada face a new set of headaches. The challenge before them is to determine the appropriate monetary policy that sustains growth and tames inflation, all while understanding the new dynamics in employment, consumption, and savings.

But first, perhaps they can enjoy a few months of rest. As it appears we have entered into a rare moment of economic clarity where the path of monetary policy is obvious.

To illustrate our point, let us consider today's economic landscape compared to right before the virus disrupted our lives. Below are a few of the important metrics that economists love to constantly blabber on about.

	December 2019	December 2021
CAD Unemployment Rate	5.70%	5.90%
US Unemployment Rate	3.60%	3.90%
CAD Headline CPI (YoY)	2.25%	4.80%
US Headline CPI (YoY)	2.29%	7.04%
BoC Overnight Rate	1.75%	0.17%
Effective Fed Funds Rate	1.55%	0.08%

Source: YCharts

	2019 Annual	2022 Annual Forecast
CAD Real GDP	1.90%	4.00%
US Real GDP	2.20%	4.00%

Source: Annual Change: World Bank, Projections, Bank of Canada, Federal Reserve – Summary of Economic Projections

To borrow from Sesame Street, 'one of these things is not like the others'. The economy is pretty much back to where it was in 2019, albeit with expectations for stronger growth, employment, and inflation. Thus, it seems emergency settings on interest rates are no longer needed nor warranted. Even if inflation cools to 2% later this year, the appropriate level for the overnight rate appears to be around 1.5% to 1.75%.

We, therefore, feel that it is an easy call for the central bankers to deliver a steady series of hikes until rates are somewhere between 1% and 1.5%. After which, the banks will once again become data-driven.

Last year, the data of most importance was jobs. Unless we see some surprisingly bad payrolls, we do not foresee employment as the focal point. Instead, the Fed and BoC will be consumed with reading the inflation tea leaves.

The central bankers have acknowledged that an inflationary environment poses unequal hardships on people with a low or fixed income and could eventually lead to a rise in unemployment. As such raising rates to minimize the chance of persistently high inflation, also improves the odds of a prolonged economic expansion.

Thus, while the first few rate hikes should be mechanical, the terminal level is not pre-ordained. And with expectations for strong growth and the potential for labour shortages, there is a non-trivial probability that higher than 2% rates will be required to tame inflation.

We, therefore, encourage the central bankers and our fellow bond nerds to use the next few months to catch up on any lost sleep. As come this summer, the restless nights will begin anew, with the need to agonize over every bit of economic data to determine when rate hikes will end.

The Month of January.

Credit.

Credit markets were not able to maintain the resiliency demonstrated during the first half of the month, with spreads gapping wider by 5–20 bps during the last week or so of January. New issue activity was high, with over $11 bn hitting the domestic market and $153 bn of deal flow south of the border.

Even though equities seemed to find some stability, we think that 'shades of March 2020' still haunt fixed income portfolio managers as they seemed far more intent on selling securities to raise cash. As far as we can tell, the move wider was mainly due to an increase in liquidity premium rather than concerns over the risk of default.

Generic Investment-Grade Credit Spreads:

- Canadian spreads widened 9 bps to 120 bps – highest level since November 2020
- US spreads widened 14 bps to 106 bps – highest level since November 2020

Interest Rates.

Yields shot higher as both the Federal Reserve and Bank of Canada have made it clear that not only are rate hikes coming but so is a reduction of the balance sheet. While hikes were anticipated, reducing the balance sheet (Quantitative Tightening) by the Federal Reserve was a surprise, suggesting their complacency with inflation is ebbing.

Sovereign yields:

- Canadian 2y finished at 1.28% (+33 bps) and the 10y at 1.78% (+36 bps)

- US 2y finished at 1.31% (+58 bps) and the 10y at 1.93% (+41 bps)

The Funds.

Algonquin Debt Strategies Fund

Although yield movements had a negligible effect on the fund, the sharp move wider in spreads during the latter half of the month 'left a mark,' resulting in a loss of 79 bps.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-0.79%	-1.20%	-0.27%	-0.79%	1.17%	4.78%	4.56%	8.88%
F Class	-0.83%	-1.30%	-0.54%	-0.83%	0.57%	3.97%	3.78%	NA

As of January 31st, 2022

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

The sharp increase in rates, coupled with the widening of spreads left little room to hide. The 'one-two punch' led to a loss of -1.82% in January. We are maintaining duration around 2y as we see little reason for yields to move substantially lower.

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-1.82%	-1.55%	-1.45%	-1.82%	0.00%	2.42%	10.53%

As of January 31st, 2022

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.

Although central bank moves will dominate the news flow, we think it will take several months of inflation numbers before the market gets enough information to place its bet on when and at what level the overnight rate will get to.

Credit is the more interesting story in the near term. Over the past three months, domestic investment-grade spreads have widened in the range of 20-30%. Meanwhile, the stock price for many of these issuers has appreciated by 10 to 20%. In our 25 plus years of trading credit, we have rarely seen a divergence of this magnitude. Given the performance in equities, we believe the widening is largely due to liquidity premiums increasing. This is a very interesting environment for levered credit because we can invest in bonds where the risk of default has not changed (or perhaps is lower) but get paid more.

This kind of dislocation not only improves the yield on the fund but also provides some interesting trading opportunities particularly as companies will need to pay larger concessions to access the new issue market. We expect to cautiously increase exposure in the coming weeks as we have ample dry powder to capitalize on increasingly attractive valuations.

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