Another Brick In The Wall | March 2022

"I had a horrible nightmare. I dreamed that I went...back in time. It was terrible."
Marty McFly

Over the past two years, investors have dealt with a constant string of 'new normals.' At every turn, there are new changes, new uncertainties, and new unknowns to contend with. While some of these developments are transitory (or not), others represent deeper, longer-term trends.

One such paradigm shift is the move towards de-globalization. What started with Trump's 'America First' policy and was accelerated by pandemic disrupted supply chains, has now taken on a new life with the Russian invasion of Ukraine. Not only has the trend gained momentum, but it now also has much broader implications.

To understand this shift we rewind the clock back to New Year's Eve 1989 when David Hasselhoff serenaded the collapse of the 'Wall' with his German hit 'Looking for Freedom'. The Knight Rider's historic concert and the drawing of the iron curtain not only altered the geopolitical landscape but also ushered in a new era of global trade.

Western democracies started doing business with authoritarian regimes and former foes, taking advantage of the cheaper labour on offer. This in turn grew the middle classes in these non-democratic nations, which increased the market for western goods.

For decades, economies and consumers benefitted from the peace dividend that came with the end of the cold war. Goods and services flowed freely between nations in what became a global marketplace.

The Russian invasion of Ukraine has erected a new wall, and no, not along the US/Mexican border. As per Jamie Dimon, this new wall could see a 'realignment of alliances and a restructuring of global trade' whereby nations and companies 'cannot rely on countries with different strategic interests for critical goods and services.'

Simply put, national security and supply chain resiliency will trump the lowest cost of production. In hindsight, it was sheer lunacy for Germany to phase out its nuclear reactors and rely on Russia for 70% of its natural gas (something Ronald Reagan warned them about). Now they are scrambling to find new sources to avoid having to ration energy supply.

According to various estimates, the world relies on China for 70% to 90% of its rare earth needs. These minerals are used in electric vehicles, solar panels, wind turbines, and precision-guided munitions. Post-February 24th, 2022, democratic governments around the world will likely rethink the wisdom of such reliance.

Similarly, Taiwan controls about two-thirds of the world's semiconductor foundries. Given China's interest in Taiwan, it seems unreasonable for this to continue. Intel has already announced plans to invest $40 bn to construct plants in Arizona and Germany.

We would not be surprised to see other companies following suit and fortifying their supply lines. And in industries where national security is an issue, we expect production to be relocated back into democratic countries, despite higher labour costs.

While this process will take years to play out, we do think it will have far-reaching implications for bond markets.

For the past few decades, along with technology and demographics, globalization exerted a downward force on inflation and even led to fears of deflation. With the shift to de-globalization, we expect central bankers will once again become preoccupied with containing price increases rather than fretting about deflation.

This does not mean a return to 1970s style inflation. With automation and technology continuing to apply downward pressure on prices, we foresee a more modest shift in price appreciation in the long run.

Instead of inflation slightly undershooting the 2% target, central banks might find it necessary to maintain higher overnight rates to keep CPI in the 2-2.5% range.

While the change might seem modest, it could redefine the long-term range for interest rates. Prior to the GFC 10y rates traded between 4-6%. Post-2008, the range shifted down to 1-3%. With de-globalization and the potential for bond investors to demand a premium over inflation from government yields, it is foreseeable that the new ballpark is 2-4%.

The world is in flux, and with so many factors to consider there is still much uncertainty on how this all plays out. But it does seem obvious that one of the factors containing inflation, globalization, has reversed course. That is unless 'the Hoff' can work his magic and bring down another wall.

The Month of March.

Credit.

As the saying goes, March came in like a lion and went out like a lamb. In the first half of the month, Canadian spreads were 16 bps higher and then rallied to finish only 1 bps above February month-end levels. In the US, credit had an even wilder ride, widening 23 bps and then power rallying to finish 6 bps tighter on the month.

Various factors impacted credit markets, including the war in Ukraine, China's COVID resurgence, commodity price moves, and the interest rate curve moving sharply higher and flatter.

It is interesting to note that Canadian credit has underperformed the US this year, despite the opposite trend in equity markets.

Generic Investment-Grade Credit Spreads:

- Canadian spreads widened 1 bps to 138 bps
- US spreads tightened 6 bps to 116 bps

A record $28.5 bn of new issuance hit the Canadian market in March across a wide spectrum of issuers. Banks were particularly active, and we saw Rogers Communications' much anticipated jumbo deal with C$4 bn in the domestic market and over US$7 bn south of the border.

With the sharp rise in both interest rates and credit spreads, the all-in yields on corporate bonds have attracted buyers. We increased our exposure by selectively adding new issues and shorter-dated credit.

Interest Rates.

We have lost track of the number of times forecasts for interest rate hikes have changed. At this point the expectation is for both the Bank of Canada and Federal Reserve to deliver two to three 50 bps hikes, followed by a string of 25bps hikes. This series of hikes would bring overnight rates to anywhere between 2.5% and 3.5% early next year.

Bond markets have priced the overnight to reach 2.5-3% within 12 months. Given how much is already baked into the yield curve, rates could remain in a volatile yet contained range for a few months, while markets digest the inflation data.

Sovereign yields:

- Canadian 2y finished at 2.29% (+86 bps) and the 10y at 2.41% (+59 bps)
- US 2y finished at 2.33% (+90 bps) and the 10y at 2.348% (+51 bps)

The Funds.

Algonquin Debt Strategies Fund

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-0.22%	-2.85%	-3.07%	-2.85%	-1.17%	3.53%	3.76%	8.35%
F Class	-0.27%	-2.99%	-3.30%	-2.99%	-1.77%	2.76%	3.00%	NA

As of March 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

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-1.06%	-4.71%	-4.60%	-4.71%	-1.88%	2.42%	10.53%

As of March 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.

With central banks focused on ensuring that inflation expectations do not become unmoored from the 2% target, it seems reasonable to assume that they are willing to push rates high enough to risk causing a shallow recession. The logic behind such a move would be to avoid having to cause a deep, prolonged recession with a nasty interest rake spike. This is what happened in 1980 when Fed Chairman Paul Volcker moved the overnight rate to 20% causing a steep slow down and double-digit unemployment.

Higher rates could cause equity markets to become unsettled. This leads us to conclude that interest rate exposure could be an ineffective hedge and lead to further losses.

Inflation numbers remain the key piece of economic data going forward. Given the uncertainty and difficulty of forecasting CPI, we are adhering to the philosophy 'that quality matters' in credit. The widening of spreads means that an attractive yield and return is achievable by concentrating on companies that can readily navigate a slower economy. While securities such as senior bank paper and telecommunications are never the topic of discussion at cocktail parties, we believe that these credits are cheap, and also offer a measure of resilience should monetary policy become restrictive.

Since the fight against inflation is in the early stages, we should not be surprised to see market volatility continue as investors grapple with the collateral damage from the battle.

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