ALGONQUIN
CAPITAL

Has The Sky Stopped Falling? | April 2022

"The sky is falling. No, I'm tipping over backwards."
Steven Wright

At several points over the past 18 months, we were accused of being 'Chicken Little' with our warnings of rising yields. People looked at us funny when we said the central banks had a clear path to raise overnight rates to 1.5-2%. Our sanity was questioned when we added that they might need to go to 3% or higher to combat inflation.

Now that transitory is a punchline, forecasters are scrambling to outdo each other with calls for higher rates and more aggressive hikes. The bond market has also been swift to react, with Canadian and US 10y rates breaching 3%.

After initially underestimating the current hiking cycle, has the pendulum swung too far in the other direction?

While only time and inflation will tell, for now, we have what the central bankers and bond markets are telling us.

The Fed and BoC seem intent on getting the overnight rate to a neutral level, where it is neither stimulative nor restrictive. They see this as lying somewhere between 2-3%, and likely will get to the bottom of this range with two more 50 bps increases.

Thereafter the magnitude and pace of hikes could be tempered. As per Chairman Powell's speech last week, the Fed is not going to mechanically raise rates until CPI hits 2%. Instead, they will be watching the trajectory of inflation and monitoring financial conditions.

So, what does the bond market make of all this?

Based on yield curves, the expectation is for inflation to force central banks into restrictive monetary policy. From what is priced in, overnight rates are anticipated to be 3-3.5% early next year.

If the trend in inflation remains unchanged, this seems a reasonable assumption. The idea being central bankers would risk a shallow recession, higher unemployment, and a sell-off in stocks to avoid the long-term consequences of persistently high inflation. Or in central bank speak, tighter financial conditions are required to keep inflation expectations from being unmoored. In essence, the Fed put is kaput.

But this need not imply rates of 4-5%. A policy rate of 3.5% would put us 50 – 150 bps above neutral. Holding such a restrictive stance would have a cooling impact on growth and demand, easing the pressure on supply chains and labour markets. If such a scenario played out, one could foresee inflation settling around 2.5% sometime in 2024.

In such a world, 10y government yields above 3% offer some value. Particularly since it has been over a decade since 'guvvies' have offered a positive real yield. And if over the next several months inflation shows a sufficient downward trajectory, then the value in rates becomes even more compelling.

This is not to say we should all be running out and buying government bonds. As we have always maintained, nobody truly understands inflation, particularly in today's world. And should inflation expectations exceed the central banks' comfort zone, the hiking cycle could go beyond what is currently priced in.

But given the balance of factors, we are putting the 'Chicken Little' routine on hold. The pendulum might not have completed its arc, but it has swung far enough to start watching the data to see when value re-emerges in rate exposure.

The Month of April.

Credit.

This year, the traditional April showers were accompanied by a veritable market downpour. Concerns over inflation, the war in Ukraine, and China's intolerance of even a single case of covid led to doubts that central banks can engineer a soft landing. Accordingly, risky assets are pricing a greater risk of recession.

The result was one of the worst months for equities in years (TSX -4.96% and SPX -8.72%). Meanwhile, credit went from weak to weaker, with investment-grade spreads pushing out 10 – 25 bps.

Generic Investment-Grade Credit Spreads:

- Canadian spreads widened 16 bps to 154 bps
- US spreads widened 19 bps to 135 bps

With investors fatigued from the record issuance in March, the domestic primary market experienced a quiet month with only $5.2 bn of new deals. Smaller banks, financials, and REITs dominated the flows. In ratings news, Morguard REIT was downgraded to high yield (expected) and Canadian Natural Resources and "son of CNQ" (Northwest Redwater) were finally upgraded to BBB+ and A- respectively (the wonders of $100 oil).

Interest Rates.

Despite the carnage in risk assets, interest rate duration offered no respite, as sovereign bond yields soared. Canadian 10y yields have eclipsed the highs of the last decade and are sitting roughly in the middle of what we believe is the new trading range of 2-4%.

Sovereign yields:

- Canadian 2y finished at 2.62% (+33 bps) and the 10y at 2.87% (+46 bps)
- US 2y finished at 2.72% (+38 bps) and the 10y at 2.94% (+60 bps)

The Funds.

Algonquin Debt Strategies Fund

The losses from wider credit spreads outweighed the yield earned over the month, resulting in a loss of -1.31%. While at current levels spreads offer attractive value, we continue to maintain a medium amount of exposure with a focus on higher-quality issuers with the wherewithal to navigate an economic slowdown.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-1.31%	-3.37%	-4.53%	-4.13%	-2.98%	2.55%	3.28%	8.05%
F Class	-1.36%	-3.50%	-4.76%	-4.31%	-3.53%	1.81%	2.53%	4.45%

As of April 30th, 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

After maintaining an interest rate duration of 2y for 16 months, we used the sell-off to increase our exposure to just above 3y (4y is neutral for the fund). Our approach to duration management is based on whether there is value in the exposure. When yields were below 1%, we thought duration was simply 'return-free risk' and inefficient insurance. At 3% we think there is some value in rates and adjusted our position accordingly.

The increase in yields and widening of credit spreads made for a painful month as the fund lost -2.5%. The silver lining is that the portfolio yield now sits above 7%.

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-2.50%	-5.37%	-6.84%	-7.09%	-5.23%	2.42%	10.53%

As of April 30th, 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.

The expectation is for the Fed and BoC to deliver 50 bps hikes in both June and July. Barring any deviation from this path or change in central bank rhetoric, inflation numbers will drive interest rate markets.

In credit, we see the domestic corporate bond supply remaining constrained in the short term. The new issues that do come to market will likely require significant concessions. We are maintaining a lot of liquidity to take advantage of the opportunities that these new deals could offer.

Since the Great Financial Crisis, we have seen generic investment-grade spreads above 150 bps in 2012, 2016, 2018, and 2020. All these periods turned out to be great buying opportunities. In our experience, earning an extra 150 bps to own senior bank paper is an attractive proposition. Credit is a mean-reverting asset class, and spreads do not typically hang out at high levels for too long.

That said, until there is clear evidence that the trajectory of inflation has turned lower, risk assets will be under pressure. So while credit offers attractive value, caution is still warranted.

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