ALGONQUIN
CAPITAL

In Preparation For Landing | May 2022

"Flying a plane is no different than riding a bicycle,
just a lot harder to put baseball cards in the spokes."

Captain Rex Kramer - Airplane

When descending from high altitudes there are three ways we can land: soft, hard, or crash. This applies in both aviation and economics.

Now that central banks are attempting to bring inflation back down to earth, the big question is what type of landing are we in for. Opinions span the spectrum, from mild turbulence to crashing and burning.

But unlike aviation, where each landing is clearly defined, there is some ambiguity around economic descents. After all, one person's interpretation of a smooth touchdown can be another person's hard landing.

The oft-used definition of a soft landing is one that avoids a recession, i.e., two-quarters of negative growth. But for central bankers, a shallow recession with a mild uptick in unemployment and inflation below 3%, would be considered a victory.

Meanwhile, many investors will define the landing based on the performance of the stock market. Positive GDP prints will offer little consolation should equities fail to recover or continue their decline. And for most households, economic growth and stock returns are academic when compared to job security and the cost of groceries and gas.

However you define the different economic landings, the glide path will ultimately be dictated by inflation. Thus determining the nature of our descent requires predicting the path of CPI which we view as 'mission impossible'.

The immense difficulty of this task does not stop prognosticators from forecasting stocks hitting new highs or the impending end of the world. And while much attention is focused on these extreme scenarios, the dogfight with inflation creates a myriad of possible outcomes and unintended consequences. This makes it difficult to have any strong convictions on the macro outlook.

But what we can be fairly certain of is that the central banks will have both feet firmly planted on the brakes until wage and price pressures abate. This means the longer inflation remains elevated the more turbulence we can expect.

The current expectation is for the inflationary winds to push the Fed and BoC into restrictive monetary policy, i.e., overnight rates in the range of 3 – 3.5%. While such policy rates conjure concerns of the 'R-word' and market sell-offs, we think the central banks are willing accept such turbulence.

Ultimately the world's central bankers will be judged on their success in wrestling inflation to the ground. The smoothness of the landing is of secondary concern for them. So for those that have gotten used to central banks coming to the rescue when the economy wobbles or the market declines, we will use the four most dangerous words in investing 'this time is different'.

As the one thing we can be confident of is that the central bankers will not 'buzz the tower' until the inflation battle has been won.

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The Month of May.

Credit.

May saw a cross-border divergence in credit markets. US credit benefitted from the month-end rally in stocks and finished the month 5 bps tighter. Meanwhile, Canadian credit continued to sell off due to supply concerns.

Given that new issues are coming to the domestic market with healthy concessions, portfolio managers are reluctant to buy secondary paper, thus pressuring spreads wider. As a result, Canadian investment-grade credit sat 32 bps higher/cheaper than the US. We can not recall the cross-market differential ever being this big.

Of particular note in the Canadian market was the underperformance of senior bank spreads which widened 12-17 bps on the month. The banks that did come to market with new issues (i.e. TD and BMO) were forced to offer significant concessions of 8-10 bps. Meanwhile, their equities rallied and traded higher over the month.

Generic Investment-Grade Credit Spreads:

- Canadian spreads widened 8 bps to 162 bps
- US spreads tightened 5 bps to 130 bps

Interest Rates.

While Canadian interest rates traded in a 25-35 bps range through May, they finished the month modestly above where they started. US yields also traded in a similarly volatile range with the curve shifting lower and steeper.

Sovereign yields:

- Canadian 2y finished at 2.66% (+4 bps) and the 10y at 2.89% (+2bps)
- US 2y finished at 2.56% (-16 bps) and the 10y at 2.85% (-9 bps)

The Funds.

The sell-off in Canadian credit which began in November has been relentless and sharp. On a historical and relative value basis, investment-grade credit spreads are offering attractive value. Balancing this value with an uncertain macro environment has led us to a medium level of credit exposure with a focus on high-quality issuers.

Algonquin Debt Strategies Fund.

The move in Canadian credit, and in particular the sell-off in banks, led to a loss of 0.99%. The portfolio remains concentrated in shorter-dated, higher-quality credits with minimal interest rate exposure.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-0.94%	-2.46%	-5.06%	-5.03%	-4.33%	2.18%	3.13%	7.82%

F Class	-0.99%	-2.60%	-5.32%	-5.25%	-4.86%	1.44%	2.38%	NA

As of May 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

With the Canadian 10y interest rate crossing above 3%, we increased portfolio duration towards our neutral level of 4y. From this position, we are monitoring the inflation picture and will adapt to either increase or decrease our interest rate exposure.

Through May, the yield earned and gains from rate exposures were offset by the losses from the widening of domestic credit spreads.

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-0.43%	-3.94%	-6.89%	-7.49%	-6.36%	2.42%	10.53%

As of May 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.

Inflation concerns continue to hobble fixed income. Despite central banks around the world aggressively raising rates there are no signs that inflation is abating. Monetary policy works with long lag times, which means that central bankers will have to gauge the pace and timing of rate hikes without the benefit of seeing lower inflation numbers. As a result, other indicators such as consumption data, employment, loan demand, and confidence numbers will become increasingly important to watch in the coming months.

Despite inflation being a global problem, domestic investors continue to be more reserved than Americans when it comes to committing capital to fixed income. The continued widening of spreads has seen periods where Americans commit significant capital to fixed income resulting in some remarkable credit rallies. The Canadian market, on the other hand, has been a story of capitulation, resulting in the gap between domestic and US spreads reaching levels that we have not seen before. We are continuing to cautiously increase exposure via new issues which are coming with large concessions.

History tells us that credit spreads revert to the mean. However, predicting when the momentum reverses direction remains elusive as ever. Until then we continue to favour high-quality names such as banks, telecommunications, and energy. Aside from these companies having resilient business profiles and strong debt fundamentals, they come with the added bonus of being highly liquid. Thus if inflation shows no sign of coming back down to earth, we have the flexibility to reverse course and withstand the turbulence.

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