ALGONQUIN
CAPITAL

Clean Up On Aisle Three | June 2022

"Whether we're talking about socks or stocks,
I like buying quality merchandise when it is marked down."
Warren Buffett

Coupons, discounts, sales, clearances, markdowns, etc. represent an old and powerful set of weapons in the marketer's arsenal. Their ubiquitous use and enduring effectiveness are indicative of how everyone loves a good bargain.

Snagging a deal comes with feelings of winning and of being smarter. We compare our situation to the alternate reality of paying full price and feel pretty darn good about ourselves.

Bargain hunting can even increase our dopamine and oxytocin, the feel-good and love hormones. A study by Claremont University found that coupons reduced stress, increased happiness, and boosted oxytocin levels by 38% (which is even more than kissing).

Suffice to say, there is a tremendous sense of satisfaction and joy in picking up something at a discount. Except for when that something is a tradeable security. Time and again, when the prices of securities fall, we see investors heading for the exit.

As one client put it, 'the market is the only store where customers run out screaming when there is a big sale.'

When markets appear to be in free fall, we panic and succumb to the pain and fear of loss. We over-extrapolate the current trend and jump ship before it can go down further. This phenomenon is well documented in study after study showing how people buy high and sell low.

But surely such misbehaviour does not occur in the boring, patient, unemotional world of bonds. After all, the 'fixed' in fixed income is the yield and potential upside, which are known at the time of purchase.

But contrary to popular belief, bond investors are humans too, or at least that is what the inflows and outflows would indicate. When interest rates decline, bonds get more expensive, and people buy. And when prices fall, and the yield and potential return increase, they head for the exits.

In 2018, hawkish sentiments from the Fed led to US rates rising around 1%. Fearful that the trend would continue and cause further losses, investors fled the fixed income markets in the fourth quarter. The following year, yields drifted lower and most fixed income products returned 7-9%.

In 2020, we saw interest rates drop to their historic lows, as central banks responded to the global pandemic. One would think that with 10-year bond yields at 0.5%, everyone would be put off by the paltry income and upside. Yet, bond funds saw steady and healthy inflows from April 2020 until the end of 2021.

This brings us to the current situation, with investors once again fleeing toward the exit. So far this year, interest rates have moved 1.5-2% higher, which means most fixed income indices are down double-digits.

While many people have been conditioned to 'buy the dip' in equities, we are unaccustomed to this strategy in fixed income. Until recently, such declines in this asset class were unimaginable for most of us. After all, bonds

are supposed to be our steady, reliable shock absorbers, so losses in this part of the portfolio can carry an extra sting.

Adding to the confusion, we have headline after headline stoking fears of interest rates going to the moon. While there is every possibility that yields go higher and bonds experience further losses, we need to remember that the media (and pretty much everybody else including central banks) lags behind the collective wisdom of the market. By the time journalists are writing about the direction of interest rates, yields have already moved.

So before you make your way out of the store, it is worth pausing to note that after years of ultra-low yields, fixed income is showing some decent value and return potential. A year ago, 5y senior bank paper was yielding 1.5% and buyers came out of the woodwork on every deal. Today, banks are issuing debt with 4.5% coupons (levels not seen since the Great Financial Crisis) and the 'sellers' outnumber the 'buyers.' This seems odd to us since even a '5th grader' knows that earning 4.5% is much better than getting 1.5%.

But as with any red tag deal, there is always the potential for further discounts and price drops, and it is this niggling concern that has people queuing up for the exit. But with bonds offering yields not seen in over a decade, long-term investors should be browsing the aisles and considering picking up an item or two.

The Month of June.

Credit.

For the past several months, Canadian credit, in particular investment-grade spreads, had underperformed other asset classes. In June, that trend was reversed as most risk assets sold off hard, while domestic credit was only modestly weaker.

At the end of the month, we had stock indices down 8-9%, US investment-grade spreads +23 bps wider, and Canadian IG credit +2 bps.

Generic Investment-Grade Credit Spreads:

- Canadian spreads widened 2 bps to 164 bps
- US spreads widened 23 bps to 152 bps

Primary issuance is historically robust in June, but the market volatility kept issuers on the sidelines. So far this year, financials have been the primary source of deal flow, with the banks having printed more new issues thus far in 2022 than they did all of last year. June was consistent with this theme as domestic supply was dominated by banks, insurance, and ABS deals.

Interest Rates.

Ahead of the June 14th Federal Reserve meeting, interest rates moved sharply higher crossing 3% with momentum. Canadian and US 10y yields got as high as 3.62% and 3.49%, before drifting lower after Chairman Powell expressed confidence that inflation would abate. At the end of a volatile month with rates trading in 60-90 bps ranges, yield curves on both sides of the border were higher and flatter.

Sovereign yields:

- Canadian 2y finished at 3.01% (+44 bps) and the 10y at 3.22% (+33bps)
- US 2y finished at 2.92% (+36 bps) and the 10y at 3.01% (+17 bps)

The Funds.

Algonquin Debt Strategies Fund.

The modest widening in domestic credit ate into the yield and trading profits, but the fund still managed to finish the month on the right side of zero.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.12%	-2.13%	-4.91%	-4.91%	-4.47%	1.87%	3.04%	7.74%
F Class	0.07%	-2.26%	-5.18%	-5.18%	-4.99%	1.15%	2.30%	NA

As of June 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

While the weakness in credit put a minor dent in the performance, the main driver of returns in June was the move higher in interest rates. We entered the month with an interest rate duration of 3y, and given the sharp sell-off in the first two weeks, at mid-month, we extended our exposure to 4y (neutral for the fund).

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-1.38%	-4.26%	-8.77%	-8.77%	-8.03%	2.42%	10.53%

As of June 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.

Based on financial market valuations and economic forecasts, a recession appears to be a foregone conclusion. We suspect the debate will now turn to how deep or prolonged a slowdown should be expected, and whether the market has under or overprices the amount of 'bad' to come.

After the Bank of Canada shocked everyone today with a 100 bps hike (the expectation was 75 bps), the focus shifts to whether the Fed will deliver a similar move later this month. From our perspective, there is little value in agonizing over what the central banks will do in any given meeting. Whether they deliver 50 bps or 100 bps

hikes is immaterial relative to the importance of where they will stop. At the moment, the market is pricing in overnight rates to finish the year between 3.25 – 3.5%. This seems a reasonable base case scenario, with the final landing spot to be determined by the trajectory of inflation through the fall and winter months.

The last six months have been dreadful for credit. Looking forward the picture appears a little brighter. Spread levels have incorporated a considerable risk of recession while the pace of issuance is slowing. 2021 saw approximately $135 bn of corporate debt issued. At mid-year, issuance stood at $69 bn, with banks far ahead of last year's pace, bringing $41.3B of paper this year. Excluding banks, issuance is lower by roughly 50% compared to last year. Based on what we are hearing, the expectation is for 2022 to finish in the $100-110 bn range. The decline in supply could lend some support to spreads as portfolio managers might find it difficult to replace any bonds that they sell.

With inflation and central bank actions remaining dominant themes, our focus continues to be on bank senior paper, telecommunications, and energy infrastructure. We prefer these sectors as they can weather a long period of substandard economic growth without defaulting.

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