An Ode To Sideways | July 2022

"You can get with this, or you can get with that."
Black Sheep

In philosophy, a false dichotomy is when a situation is framed as a choice between only two alternatives when, in reality, other options exist. These either/or arguments are often used rhetorically to present one side as the obvious choice.

You are either with us or against us. You are either a conservative or a communist.

These black-and-white arguments simplify complex issues by ignoring and avoiding the murky grey areas. While such binary thinking lacks nuance and accuracy, it offers the comforts of simplicity, clarity, and certainty.

Perhaps this is why in the search for answers, amidst so much volatility and uncertainty, many investors are gravitating to a false dichotomy of their own.

The binary fallacy in question is whether markets go up or down from here, which on the surface seems uncontroversial. After all, following double-digit declines in most asset classes, people are wondering if we are in for a rally or further pain.

The 'up' camp believes inflation will come down, the central banks can engineer a smooth landing, and markets will experience a healthy recovery. The other side feels higher yields and a recession are inevitable and is bracing for asset values to take another leg down.

While both sides have sound arguments, the current debate seems to neglect the other possible direction: sideways. Amidst the excitement of recent years, it appears we have forgotten that sometimes markets can be boring. That every now and then, they can stay bound in a narrow range.

History is littered with such mundane periods, with the bulls and bears engaged in a tight game of tug-of-war. Long stretches where interest rates and stocks just muddle along. There are no dramatic moves leading to big profits and losses, with the vast portion of returns coming from collecting dividends and coupons.

These days such a benign world feels unimaginable, or at least implausible. But that does not mean it is impossible nor should it be ignored.

This is not to say that we are forecasting boring, flat markets ahead. We know better than to make predictions (about the future).

But what we can be confident of is that most of the attention and coverage will be focused on the extreme binary outcomes of up and down. After all, nobody makes headlines forecasting the status quo. But just because it lacks star potential, it does not mean we relegate it to an excluded middle.

Making sound investment decisions involves having a full, complete, and accurate picture. Unfortunately, such a balanced approach does not seem to be of interest to most media commentators. Hence we thought to shine a small spotlight on the oft-neglected direction of sideways.

The Month of July.

Credit.

July saw a better backdrop for risk assets across the board, but the U.S. outshone the Great White North. The S&P climbed 9.1% vs 4.4% for the TSX. And in credit, the U.S. significantly outperformed as broad IG credit indices tightened by 11 bps down South and by only 2 bps in Canada. We think part of the reason for the underperformance in Canada is that portfolio managers are reluctant to buy existing bonds, preferring to wait for new issues with healthy concessions.

New issue volumes were lighter than average in July. The theme this year remains the dominance of financial institutions tapping the primary market and non-financial deals remaining scarce. As a result, valuations on higher-rated and more liquid banks are looking attractive relative to BBB corporate spreads.

The one non-financial investment-grade deal that came last month was a 10-year Ontario Power Generation bond that, unsurprisingly, saw very robust demand. Financial deals included an ABS transaction, as well as senior and subordinated offerings. TD and BMO also brought institutional preferred shares to market. Although August, is generally a low supply month, lower yields might push some borrowers to tap the market sooner rather than later.

- Canadian spreads tightened 2 bps to 162 bps
- US spreads tightened 11 bps to 144 bps

Interest Rates.

Despite large policy rate moves from the BoC (+100bps) and the Fed (+75bps), yields dropped with the curve becoming sharply inverted. The expectation for the terminal level of overnight rates shifted from 3.5% into the neighbourhood of 3%. Furthermore, with recessionary fears mounting, the yields are pricing in a significant chance of rate cuts later in 2023.

Sovereign yields:

- Canadian 2y finished at 2.96% (-13 bps) and the 10y at 2.61% (-61bps)
- US 2y finished at 2.89% (-7 bps) and the 10y at 2.65% (-37bps)

The Funds.

Algonquin Debt Strategies Fund.

With Canadian spreads trading in a narrow range, the performance was mainly driven by the yield earned. The stability in Canadian credit spreads, despite volatile equity and rate markets, leads us to believe that domestic credit could remain resilient should equities experience further declines.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.25%	-0.57%	-3.92%	-4.67%	-4.18%	1.68%	2.9%	7.69%
F Class	0.21%	-0.71%	-4.19%	-4.99%	-4.71%	0.98%	2.17%	NA

As of July 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

Most of July's performance was driven by the powerful move in rates and active duration management. In June when Canadian 10y rates rose above 3.5%, we increased the duration to approximately 4.5y. As 10y yields moved below 2.75% last month, we took profits and reduced the duration to around 3y.

Our management of interest rate exposure is based on an assessment of valuations and the likely actions of the Bank of Canada. As a result, we expect to be more active than normal over the coming months, as we adjust the duration based on incoming economic data.

	1M	3M	6M	YTD	1Y	2021	2020
F Class	2.58%	0.73%	-4.69%	-6.42%	-6.07%	2.42%	10.53%

As of July 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.

Equities and bonds rallied after Chairman Powell announced that the Federal Reserve had shifted from 'auto-hiking' to letting economic data serve as a guide to further action.

The move in yields that followed is a bit of a 'head-scratcher'. It seems that everyone has forgotten that central bankers said that they need to move rates into restrictive territory (higher than 3%) to put downward pressure on inflation. Although there are certainly signs within the commodity complex that inflationary pressures might be subsiding, a reasonable risk remains that inflation may prove to be sticky in the 4-5% percent range.

We also suspect that economic weakness will not prompt a reversal by central bankers. We believe that they are operating with the view that a '6% unemployment rate affects 6% of the people while a 6% inflation rate affects 100% of the people,' and so will keep rates elevated even in the face of weak data until lower CPI numbers materialize.

As long as the labour markets remain tight and put upward pressure on wages, we think there is little chance of inflation quickly falling back to 2%. As such, employment data has become more important, where an uptick in unemployment will likely be needed to help reduce price pressures.

The US employment numbers show no signs of slowing, while Canada has seen two straight months of job losses. We, therefore, think there is a high probability that the Bank of Canada stops hiking well before the Federal Reserve does.

Until we see signs that inflation is abating, we continue to lean towards high-quality borrowers who can weather a sustained period of sub-par economic growth.

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