ALGONQUIN CAPITAL

Your Back To School Cheat Sheet | August 2022

> "The human brain is special. It starts working as soon as you get up and it doesn't stop until you get to school."
> Milton Berle

For millions of students and teachers, it is that dreaded time of year again, back to school. The long days of summer fun are relegated to the memory bank, as schools return to the business of teaching and learning.

Given this was the first 'unrestricted' summer in three years, both educators and pupils can be forgiven for not being fully prepared to start the new academic year. Unfortunately, the markets are less forgiving and do not care about the adventures you had at summer camp.

With that in mind, we have prepared a back-to-school bond cheat sheet. Your 'Coles notes' (or SparkNotes for our younger readers) summary of what happened over the summer, and the questions your teachers might be asking in the coming weeks.

Cabin crew, prepare for landing.

Before school broke out last year (i.e. in the spring), central bankers were full of hope and optimism. They believed they could wrangle inflation down by raising rates without tipping the economy into a recession. Over the summer, while at their version of camp, they conceded that a soft landing is probably a pipe dream.

Bond investors were ahead of the curve (excuse the pun), having concluded that a recession is likely the only way that inflation can be brought to heel. As a result, over the last three months, 2-year rates rose almost 1% and yield curves inverted in early July.

The trouble with the curve.

As we type the Canadian 10-year interest rate is around 0.50% below the 2-year yield. These types of inversions occur during hiking cycles, as the blunt force of higher rates often results in a recession. This in turn sees the central banks rushing to cut rates and ease the tension.

Based on what is priced into the yield curve, the current expectation is for the Federal Reserve (Fed) and Bank of Canada (BoC) to stop raising overnight rates at around 3.75% sometime this year, and then start cutting next summer.

The look back.

This expectation for central banks to pivot from hiking to cutting within 9 months is predicated on their previous behaviour. Over the past 20 years, the Fed and BoC have been very quick to deliver monetary stimulus when it became apparent that economic growth was in jeopardy.

Students of history will recall the 'tech wreck' in 2002, the Great financial crisis of 2008, the oil price shock of 2015, the inflation scare of 2018, and most recently the 2020 pandemic. Using these events as a proxy, surely a couple of negative job numbers and a few negative GDP prints will have central bankers throwing in the towel and easing 'like they always have.'

This time is different.

But over the past 20 years, inflation was well behaved. As a result, central bankers could focus on growth and employment with the comfort that inflation was unlikely to be a real problem.

Today inflation is the Boogeyman keeping economists up at night. Our read of the current thinking is that '6% unemployment affects 6% of the population while 6% inflation affects 100% of Canadians'. Furthermore, the longer inflation goes untamed, the greater the likelihood of even greater evils lurking in the long term. As such, a falling stock market, lower house prices, and rising unemployment will not necessarily bring about a quick pivot.

What goes up, must come down.

So what will cause the central bankers to reverse course and begin lowering rates? The obvious answer is inflation. Both the Fed and BoC have mandates to keep inflation in the vicinity of 2%.

Although it appears that super high inflation prints are behind us, it is far too early to declare victory. Most economists do not expect inflation to fall to 2% until at least 2024. But will the central banks keep hiking or keep rates high until inflation reaches 2%? We certainly hope not.

Higher for how much longer.

Thankfully, central bankers are prognosticators and have an army of PhDs that build models to forecast the path of inflation. Whilst not perfect (e.g. the 'transitory' call), these models do drive their decision-making.

As such, falling inflation and GDP coupled with rising unemployment will at some point allow central banks to stop raising and take a wait-and-see stance. Should inflation continue to moderate, then they should feel comfortable moving rates gradually towards neutral levels (around 2.5%), if not lower depending on how dramatic the slowdown is.

But in the meantime, as we have written before, the 'Fed Put' is 'kaput.' Messrs Powell and Macklem have made it clear that a soft landing is a 'nice to have,' but is not an objective in the war against inflation.

The Month of August.

Credit.

With central banks reiterating their determination to take out inflation, yields rose and equities sold off by around 4%. Very few assets offered sanctuary, with the notable exception of investment grade credit, where US and Canadian spreads tightened 4 bps on the month.

- Canadian spreads tightened 4 bps to 158 bps
- US spreads tightened 4 bps to 140 bps

In terms of domestic supply, August saw $6.3 billion of issuance with a notable tilt away from financials. Utilities and infrastructure issuers dominated the month, with Altagas and Capital Power issuing hybrids, Enbridge issuing 10s and longs, EPCOR coming with longs, Anglian Water tapping the maple market, TriSummit Utilities issuing longs, and 407 ETR issuing $675mm across two tranches. Outside of that, an NVCC deal from Desjardins, an LRCN from National Bank, a deposit note from Canadian Western Bank, and deals from Sunlife and Loblaws rounded out the new issuance. Notably absent were the domestic big 5 banks.

In other major news, Rogers' management had to offer almost $800mm in incentives to bondholders to extend the SMR covenant in their recently issued bonds. The 'Special Mandatory Redemption' clause meant Rogers had to buy back the bonds at $101 if the merger was not concluded by December 31st, 2022. Rogers now has an extra year to consummate the deal before being forced to redeem the bonds.

Interest Rates.

After misinterpreting Chairman Powell's post-FOMC comments, people realized the 'error of their ways,' and reversed course bringing yields more in line with hawkish central bank rhetoric. With overnight rates clearly in (or soon to be in) restrictive territory, the possibility of a pause in the tightening cycle is growing.

Sovereign yields:

- Canadian 2y finished at 3.64% (+68 bps) and the 10y at 3.11% (+50 bps)
- US 2y finished at 3.45% (+56 bps) and the 10y at 3.15% (+50 bps)

The Funds.

Algonquin Debt Strategies Fund.

With the portfolio yield running around 9%, the majority of the August return came from 'clipping coupons.' The modest narrowing in spreads and active trading added further gains.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	1.04%	1.41%	-1.08%	-3.69%	-3.30%	2.32%	3.13%	7.75%
F Class	0.99%	1.27%	-1.36%	-4.05%	-3.83%	1.59%	2.40%	NA

As of August 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

We lowered duration from over 4.5y in June to just below 3y at the end of July, following the dramatic drop in yields. The adjustment coupled with a yield of 7.4% helped limit the damage when the market reversed course last month.

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-0.77%	0.38%	-3.57%	-7.14%	-6.98%	2.42%	10.53%

As of August 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.

The Fed is on pace to hike by 75 bps later this month. We do get a look at August CPI before the meeting, however, we do not think it materially changes the Fed's plan.

The rising odds of a recession are being reflected in most sectors, with equities, investment grade credit, and many commodities factoring in weaker future demand. One risk premium that is not like the others appears to be high yield (HY) spreads which remain at relatively narrow levels compared to where they have been during previous recessions.

At month-end, generic high yield spreads were trading around 500 bps with all in yields in the 8.5% ballpark. During previous periods of economic weakness (e.g. 2002, 2011, 2016) HY spreads got to 900-1,100 bps. Meanwhile, Canadian investment-grade (IG) credit finished August at 158 bps, and during the same periods of stress traded between 175-200 bps. This divergence in valuations between high and low-quality credit has us scratching our heads, as surely it is the high yield sector that has the greatest risk of default should a recession materialize.

As such, we continue to favour and focus on high-quality investment grade issuers and have reduced exposure to the lower end of the IG spectrum.

Contact

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