The Return of The Bond Vigilantes | September 2022

"They're back."
Poltergeist

After a long and dormant hiatus, it seems that 'bond vigilantes' are making a comeback. The term, first coined in the early 80s by Ed Yardeni, refers to investors selling bonds to drive up yields and thus a government's borrowing costs.

It is a form of bond market activism to protest monetary and fiscal policies seen as inflationary. The vigilantes of old punished governments that over-borrowed or over-spent and battled central banks that were viewed as too accommodating.

But for the past two decades, there has been little need nor room for vigilantism. Until recently, inflation was tepid, and it was deflation lurking in the dark corners. Following 2008, the central bank bond-buying programs drove the vigilantes into hiding, with any attempts to raise yields quashed by big brother's quantitative easing.

But after the shenanigans in the UK last month, governments and central bankers are on notice. The vigilantes are back and ready to pounce on any policy mistake.

The origin story.

The year was 1983, and the world was introduced to Mario Bros., Fraggle Rock, and the concept of bond vigilantes. In one of his commentaries, Dr. Yardeni noted that "even before the Fed really started to aggressively raise interest rates, the bond vigilantes figured it out and kind of jumped ahead of the line and pushed interest rates up dramatically.".

He concluded that the vigilantes could continue to police the central bankers if they did not stay the course in fighting inflation. "If the fiscal and monetary authorities won't regulate the economy, the bond investors will."

The heyday.

While their origins lay in the 80s, the vigilantes were at their most forceful in the early 90s. In response to federal governments running large deficits, rates were pushed higher with US and Canadian 10y yields hitting 8% and 9% respectively.

This forced Messrs. Clinton and Chrétien to change policy and prompted top Democratic advisor James Carville to remark, "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."

But with the new millennium, their influence dwindled, and economists eulogized these deficit and inflation-fighting heroes. After all, inflation vanished from the scene, and the might of the central banks kept rates from being bullied higher. But now with CPI running amok and central banks moving to restrictive monetary policies, the vigilantes are back on the prowl.

Gilt trip.

Perhaps the best example of their force came last month in the UK. Downing Street announced a bold plan to boost economic growth through massive tax cuts that would tremendously increase government borrowing. Almost immediately, panicked investors sent yields soaring over 1%.

The carnage saw 50-year Gilts drop to £25. So much for boring, safe, bonds. The magnitude of the move threatened the stability of the UK financial system, forcing the Bank of England to roll out a bond-buying program (yes, QE) to bring about stability and push yields back down.

On a much smaller scale, this also occurred in Canada. Given the number of recent initiatives announced by the federal and provincial governments to 'help Canadians cope with inflation,' the bond market moved yields higher on expectations that the Bank of Canada would need to hike rates to 4% rather than 3.75%.

Under the mask.

While the idea of vigilantism is romantic, the reality is that investors require adequate compensation to own bonds. And when inflation concerns dominate, that compensation needs to adjust higher.

The good news is, for now, investors seem to have faith that central banks have the fortitude to bring inflation down. This is signaled by the inverted yield curve, with Canadian 10y rates 62 bps below the 2y.

Simply put, investors believe that higher rates in the short term will cause an economic slowdown and bring inflation down. This will eventually allow central bankers to cut rates, so earning 3.1% over 10 years from government debt seems a fair proposition.

But policymakers should not be fooled. This is a precarious situation, and the bond vigilantes are poised to attack anyone not on board the inflation-busting train.

The Month of September.

Credit.

The only good thing about September is that it is over. With the Federal Reserve making sure the markets understood its intention to slay the inflation beast, rates, credit, stocks, and commodities all traded down. The only safe haven was the US dollar.

Most equity indices were down a horrendous 9-10% on the month, although the TSX managed to shine at -4%. Broad investment grade credit indices widened significantly with US credit +19 bps and Canada +14 bps.

Poor sentiment resulted in below-normal issuance for September. Financials dominated (banks, auto finance, ABS, credit unions) the domestic scene, while on the corporate side we saw a jumbo $2 bn multi-tranche deal from Telus.

We expect issuers that are sitting on the sidelines to take advantage of any market stability in October. Often, after such a horrible month, we see a bounce back in risk. However, this quarter, earnings will be in the spotlight. Releases will be scrutinized for any deterioration in earnings and outlooks (which did not show up in Q2).

High-quality, investment-grade credit spreads look attractive as they reflect a recession-level risk premium. For example, bank senior spreads are at the widest/cheapest we have seen outside of 2008 and March 2020. Until there is more comfort around inflation, spreads ought to trade with 'higher-than-normal' volatility.

- Canadian spreads widened 14 bps to 172 bps
- US spreads widened 19 bps to 159 bps

Interest Rates.

US bond yields moved higher on expectations the Federal Reserve will need to hike overnight rates in the vicinity of 4.75%. The domestic market is comfortable with the Bank of Canada reaching 4% this year and then easing in the latter half of 2023. The risk remains tilted towards central banks pushing rates higher and/or cutting later than is currently anticipated.

Sovereign yields:

- Canadian 2y finished at 3.79% (+14 bps) and the 10y at 3.17% (+5 bps)
- US 2y finished at 4.28% (+79 bps) and the 10y at 3.83% (+64 bps)

The Funds.

Algonquin Debt Strategies Fund.

Despite having a yield over 9%, the move in spreads swamped the interest earned in the month, leading to a loss of 77bps. As of September 30th, the portfolio metrics were:

- 9 – 9.5% yield
- Average maturity ~ 2y
- Average credit rating: A-
- IR Duration ~ 0y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-0.77%	0.52%	-1.62%	-4.42%	-4.64%	1.71%	2.83%	7.55%
F Class	-0.81%	0.37%	-1.90%	-4.83%	-5.14%	1.01%	2.10%	NA

As of September 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

As rates move higher, we have decided to shift our duration higher by increasing exposure to the under 5yr part of the yield curve. As of September 30th, the portfolio metrics for the fund were:

- 8 – 8.5% yield
- IR duration 3 – 3.5y
- Average Maturity ~ 3y
- BBB+ average credit rating

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-1.31%	0.46%	-3.81%	-8.35%	-8.24%	2.42%	10.53%

As of September 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 is 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.

With overnight rates in restrictive territory, we do not think it bold to say that 'we are closer to the end than to the beginning of the rate hike cycle.' By year-end, or early Q1 2023, we would not be surprised to see central bankers pause and assess the path of inflation.

Although the bond market is quite optimistic that rate cuts are coming, we believe that risk remains tilted to central banks either needing to hike a little more or being very slow to cut rates.

We are constructive on high-quality credit spreads, given they have widened to levels one would expect to see in recessionary times. We are, however, very cautious around high yield since spreads seem very narrow compared to what has been experienced during previous recessions.

In both funds, we continue to maintain a medium exposure, with a tilt towards bank senior paper, telecommunications, and energy infrastructure. It is time to clip some coupons.

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