Bonds Are Back, Baby. | October 2022

"Fashions Fade. Style is eternal."
Yves Saint Laurent

For years, ultra-low yields led to fixed income falling out of fashion and being discarded from racks in favour of cooler, hipper trends. Bonds were bullied off the catwalk and out of portfolios with taunts of 'return-free-risk' and 'there is no alternative (TINA).'

Then this year, bonds went from being overlooked and ignored to attracting the wrong kind of attention. The once reliable, boring khakis have surprised everyone by inflicting double-digit losses, with most fixed-income indices down 12-17% on the year.

One might think this would be enough to have the entire asset class banished from the wardrobe. But fashion is fickle, and with higher yields offering greater income and return potential, the cool kids are being lured back.

This has the fashionistas wondering whether it is time to invite bonds back to the after-show party.

Are we there yet?

To misquote Bob Dylan, 'the answer is blowing in the inflationary wind.' After all, inflation will ultimately determine when and where the central bankers stop raising rates. At present, yields imply that the Bank of Canada (BoC) will stop at 4.25%, with another 50 bps of hikes priced in.

In their latest forecast, the BoC foresees a recessionary environment for the next few quarters with the potential for a light recovery later next year. Inflation is expected to be 7% in Q4, falling to 3% at the end of 2023, and then down to 2% by the end of 2024.

These inflation projections might seem optimistic in light of current data, but there are some positive signs on this front. Supply chain disruptions are getting resolved, and both higher interest rates and prices are putting a drag on the demand side of the equation. Canada has also experienced mixed job data over the past few months, potentially creating some slack in an otherwise tight labour market.

While it is difficult to predict whether another 0.50% hike will break inflation's back, it does feel safe to say that 'we are closer to the end than to the beginning' of this hiking cycle. Even so, the critics and designers demand to know whether now is the time for retro or avant-garde.

What goes up, must come down?

Interest rates, like hemlines, can go up and down. But nothing says just because they have risen that the next trend is for them to go down. So far this year, we have seen rates hiked higher by 3.5%. The question remains whether central bankers raise eyebrows by going even higher, or reverse course.

The BoC sees the neutral level for the policy rate in the range of 2-3%. This is where rates are neither stimulative nor restrictive. Thus, an overnight rate of 4.25% puts us firmly into a restrictive monetary policy, designed to slow the economy and tame inflation.

It, therefore, seems logical that once inflation shows a sufficient downward trajectory, the BoC would move back towards neutral and start cutting rates. They might sit on the brakes longer than anyone wants, but once the market senses cuts are on the horizon, rates could gap down. And as we learnt in bond math 101, this is good for fixed-income returns.

There is always a risk.

The other side of the coin is inflation persists at uncomfortably high levels and rate hikes continue. The central banks have made it clear that beating down inflation is their number one priority. If it does not come down, then yields will continue to rise.

Such a high inflation, low growth (stagflation) environment would leave few places to hide. Most asset classes would suffer. Cash would be king, but after adjusting for inflation, it could just be an emperor with no clothes (or at least a horrible sense of fashion).

Rising rates would not bode well for fixed income either, but today's yields provide value and some cushion against losses. As an example, if you hold a 2y government bond with a coupon of 4% for one year, rates would have to go to 6% before you give up the income earned. On the value side, long-term investors can purchase high-quality bonds yielding 6-7%, which is competitive with long-run equity returns. The ride might be bumpy, but earning such returns with the safety of bonds is appealing.

Friends with benefits.

Perhaps not the most fashion-forward dynamic, there is another potential benefit from adding bonds to next season's collection. Higher yields could mean that bad news is good news for fixed income. A higher rate world means a more fragile economy that is susceptible to negative macroeconomic or geopolitical shocks. Central banks may respond with monetary stimulus, allowing bonds to once again provide diversification benefits within a portfolio.

Timeless portfolio accessory.

Although boring bonds will never be the talk of fashion week, like the little black dress or a pair of comfortable jeans, they are a quintessential part of a wardrobe that is coming back into vogue.

The Month of October.

Credit.

October saw Canadian credit markets get spooked, while south of the border, US spreads offered some Hallowe'en-sized treats.

Domestic new issuance finished the month at $8.75 bn. Although this was only a touch higher than the 10-year average of $8 bn, people were not happy to see 70% of it coming from banks. An overabundance of financial paper saw senior 5y bank spreads push out to 185-190 bps. To offer some context, a year ago these were trading at around 70 bps, and current levels are the highest seen outside of 2008 and for a minute in March 2022.

- Canadian spreads widened 7 bps to 179 bps
- US spreads narrowed 1 bps to 158 bps

Interest Rates.

The war against inflation continued with the Bank of Canada (BoC) hiking 50 bps and the Federal Reserve (Fed) making a 75 bps move. As rates move further away from neutral, it makes sense for the pace of increases to slow, however, central bankers prefer to err on hiking too much rather than too little. Over-tightening can be dealt with by lowering rates, while under-tightening can lead to inflation being entrenched which can only be solved by forcing rates much higher and causing a deep recession. The markets are expecting the Bank of Canada and Federal Reserve to pause at 4.25% and 5-5.25% respectively.

Sovereign yields:

- Canadian 2y finished at 3.89% (+11 bps) and the 10y at 3.25% (+8 bps)
- US 2y finished at 4.49% (+20 bps) and the 10y at 4.05% (+22 bps)

The Funds.

Algonquin Debt Strategies Fund.

Despite having a yield over 10%, the move in spreads swamped the income earned in the month, leading to a loss of 35 bps. We continue to focus on higher-quality issuers, which offer attractive value, liquidity, and security in a slowing economy.

Portfolio Metrics:

- 10-11% yield
- IR Duration 0-1y
- 2yr average maturity
- Average credit rating: BBB+

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-0.35%	-0.09%	-0.66%	-4.76%	-5.16%	1.46%	2.59%	7.42%
F Class	-0.40%	-0.23%	-0.94%	-5.21%	-5.66%	0.77%	1.87%	NA

* As of October 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

As yields move higher, we have become more constructive on duration and increased our exposures to the under 5y part of the yield curve. We believe short-end yields offer the greatest asymmetry and performance potential.

Portfolio Metrics:

- 8-9% yield
- 3.5-4yr duration

- Average maturity: 3y
- Average credit rating: BBB+

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-0.77%	-2.82%	-2.11%	-9.06%	-8.81%	2.42%	10.53%

As of October 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.

With central banks around the world raising interest rates, the prospects for economic growth appear dimmer every day. The silver lining is that inflation appears to be moderating.

Normally, investors like to see strong employment, retail spending, and business activity reports, as they all point to stronger profits and higher stock prices. We suspect that for the next few months 'bad news' is 'good news,' as weaker growth and rising unemployment means slowing inflation and ultimately lower rates.

We continue to position our portfolios with the idea that a slowdown might be deeper and/or longer than anticipated. As such, downgrades and even defaults are likely to rise. With resilient issuers such as banks, telecom, and energy trading at historically attractive levels, we see little need to allocate much capital to lower-quality borrowers.

The current yields offered by investment-grade debt provide a tremendous cushion against price erosion stemming from wider credit spreads and/or higher interest rates. Furthermore, credit spread reversion to the mean and declining rates offer strong performance potential. In our opinion, the era of 'return-free-risk,' has ended.

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