You're Only A Day Away | November 2022

"Tomorrow is promised to no one."
Clint Eastwood

One More Sleep.

Every Canadian bond nerd has tomorrow circled in their calendar. It is the day the Bank of Canada (BoC) delivers its latest installment in what has been an aggressive series of rate increases.

So far this year, they have taken the overnight rate from 0.25% to 3.75%. And without fail, before each meeting, the debate has raged over how big a hike they would deliver. Our attitude towards this guessing game and what they did in any particular meeting was, 'who cares?'

It seemed clear that rates were going materially higher, did it matter if we hopped, skipped, or jumped to get there? The more important question was and is, when and where will they stop?

And now that it seems we are approaching the finish line, there is another important question to consider. At what point do they reverse course and start cutting?

The Base Case.

In considering how high and for how long, a natural starting point is what the bond market is currently pricing in. Based on the yield curve, we can make the following inferences about what the market is expecting.

The expectation is for the BoC to stop hiking at either 4.25% or 4.5% by March of next year. Thereafter, they are expected to quickly reverse course and start cutting rates in the summer or early fall.

Edge of Tomorrow.

As for tomorrow, the market is split between another oversized 50 bps or a more pedestrian 25 bps. We see this as a coin toss and maintain our ambivalent attitude as to the magnitude of the move.

If they go with 50 bps, is this a warning that the terminal rate is going to be higher than 4.5%? Or does it give them room to pause and the flexibility to cut earlier in the new year?

If they decide on a traditional 25 bps, could this mean a lower endpoint? Lately, the market seems to conflate slower with lower and interpret a more modest pace of hikes as meaning a reduced terminal rate. But perhaps smaller increases mean they will extend the hiking cycle.

The Path of Least Regret.

Thus, the size of the hike, in and of itself, does not provide much insight into the terminal rate nor the time frame for cuts. The clues to such future intentions can instead be found in reading the tea leaves of press conferences, speeches, and changes in forecasts.

The BoC will want to avoid the mistake of allowing high inflation to become entrenched. Therefore, we see the balance of risk as tilted to rates staying elevated for longer with cuts being pushed farther out in time. After all, reducing rates is inflationary, and cutting too early could cause the problem to run longer and deeper.

As such, we will be carefully parsing through their words for any indications that they plan to deviate from the path the bond market expects i.e., what is already priced in. So, as strange as it may be for a group of bond traders to say, we are focusing on their words rather than getting bogged down in the numbers.

The Month of November.

Credit.

With central banks slowing the pace of rate raises, fear is slowly turning to greed with investors eyeing some of the 'juiciest' bond yields in years. This allowed domestic spreads to narrow in November, despite $12 bn of new issuance, including a record-setting single-day with 5 deals totaling $4.9 bn. The new deals saw large numbers of buyers and few outtrades/sellers to fund the purchases. We conclude that fixed-income managers have the cash to put to work, which might mean a nice 'Santa Claus' rally in December.

- Canadian spreads narrowed 14 bps to 165 bps
- US spreads narrowed 25 bps to 133 bps

Interest Rates.

Signals from Chairman Powell that the Federal Reserve was slowing the pace of hikes coupled with his view that inflation was slowing prompted a sharp reduction in yields. The curve inversion grew as investors acknowledged that a few more rate lifts are still to come but still want to place bets that an easing cycle is just a few months away.

Sovereign yields:

- Canadian 2y finished at 3.87% (-2 bps) and the 10y at 2.94% (-31 bps)
- US 2y finished at 4.31% (-17 bps) and the 10y at 3.61% (-44 bps)

The Funds.

Algonquin Debt Strategies Fund.

A welcome performance from spreads coupled with the portfolio yield lead to a strong month for the fund. It is certainly a nice reminder that the high monthly interest accrual serves not only as a cushion when spreads widen, but also as a very nice tailwind when credit narrows.

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	2.05%	0.91%	2.34%	-2.81%	-2.84%	1.85%	2.91%	7.62%
F Class	2.00%	0.77%	2.05%	-3.31%	-3.38%	1.17%	2.19%	NA

* As of November 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

The fund experienced a strong month as rates and credit moved lower. On a tactical basis, we elected to shorten the duration slightly, with a view of increasing it once again when yields move back up.

Portfolio Metrics:

- 7-8% yield
- 2.5-3yr duration
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2021	2020
F Class	3.20%	1.06%	1.45%	-6.15%	-5.54%	2.42%	10.53%

As of November 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.

As the year draws to a close, the deluge of forecasts for next year is set to begin. With so many risk factors such as the war in Ukraine, China's 'zero-Covid' policy, and central bank activity, there is something for both the 'bear' and 'bull' camps.

From our perspective, the most important known variable to watch is inflation. The markets are heavily betting that it comes down very quickly. So far, predicting the path for inflation has befuddled just about everyone, and we suspect that it will continue to do so. As such, rate volatility is likely to be with us for some time.

Despite the recent narrowing of domestic investment grade spreads, we feel that they still reflect a shallow recession ahead. With high yield spreads trading at or near their 20-year median, and the large narrowing in US investment grade spreads, on a relative basis quality domestic bonds represent attractive value. Banks, telecommunications, and energy infrastructure remain our favourite sectors given the trifecta of value, liquidity, and security.

Contact

Algonquin Capital
40 King Street West, Suite 3402
Toronto, Ontario, M5H 3Y2
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 306-8401

Disclaimer

Algonquin Capital Corporation ("Algonquin") is registered with the Ontario Securities Commission as an exempt market dealer, investment fund manager, and portfolio manager. This commentary is confidential and for authorized use only. Under no circumstances are its contents to be reproduced or distributed to the public, media, or potential investors without written authorization. The information contained herein, while obtained from sources believed to be reliable, is not guaranteed as to its accuracy or completeness.

The information contained in this commentary is not investment or financial product advice and is not intended to be used as the basis for making an investment decision. This commentary by Algonquin is not, and does not constitute, an offer to sell or the solicitation, invitation, or recommendation to purchase any securities.

This commentary contains statements that constitute "forward-looking statements". Examples of these forward-looking statements include, but are not limited to, (i) statements regarding future results of operations and financial condition, (ii) statements of plans, objectives or goals and (iii) statements of assumptions underlying those statements. Words such as "may", "will", "expect", "intend", "plan", "estimate", "anticipate", "believe", "continue", "probability", "risk" and other similar words are intended to identify forward-looking statements but are not the exclusive means of identifying those statements. Forward-looking statements included herein are based on current expectations and beliefs, and Algonquin disclaims, other than as required by law, any obligation to update any forward-looking statements whether as a result of new information, results, future events, circumstances, or if Algonquin's expectations or opinions should change, or otherwise. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that such predictions, forecasts, projections, and other forward-looking statements will not be achieved. A number of important factors could cause Algonquin's actual results to differ materially from the plans, objectives, expectations, estimates, and intentions expressed in such forward-looking statements. As such, undue reliance should not be placed on any forward-looking statement.