The 2023 Forecast of Forecasts | December 2022

"An economist is an expert who will know tomorrow
why the things he predicted yesterday didn't happen today."
Evan Esar

The passage of one year into the next is marked by some interesting customs and traditions. Americans watch the ball drop, Spaniards eat twelve grapes at the stroke of midnight, and the Danes smash crockery on the doorsteps of friends and family. The Colombians run around the block with empty suitcases, while in Japan the old year is seen out by eating toshikoshi soba (year-crossing noodles).

Meanwhile, the financial markets celebrate the new year with the customary slew of annual forecasts. Economists and financial pundits polish their crystal balls and offer their outlook for the next twelve months.

Beyond entertainment value and providing insights into the consensus view, we see little utility in such soothsaying. As per Yogi Berra, 'it's tough to make predictions, especially about the future'. A task made that much harder in the current economic environment.

Fire up the flux capacitor.

To understand why macroeconomic forecasting is so difficult, one need only consider the outlooks from a year ago. This time last year there was almost uniform consensus that central banks would raise rates by a modest 1%. Furthermore, the Bank of Canada and pretty much every other economist had inflation finishing the year at 3-4%.

In real life (as the kids would say), we had a whopping 4% worth of rate hikes and CPI finished 2022 at around 7%. But this divergence between forecasts and reality has not stopped the same crowd from rolling out their predictions for the new year.

20-23 vision.

The consensus view for 2023 is that we will experience a recession, inflation will come down, and rates will peak in the next few months with cuts coming later in the year. While these predictions offer a fair base case, the only thing we can be confident in is that, barring any exogenous shocks, inflation will be the determining factor for the year ahead.

This is what makes forecasting particularly difficult this year. At the best of times, the myriad of factors influencing and impacting inflation makes it a truly random process, not amenable to being accurately forecasted. Today, we also must contend with new trends and paradigms, further complicating matters.

Inflation conflation.

There are new geo-political dynamics, with Russia being removed from Christmas card lists and China's shift to self-reliance in food, energy, and technology. We have new labour market demographics, with both the Boomers and Gen Z reluctant to work. Then there is the shift to renewable energy and the ever-present wildcard of technology and automation.

These new trends and dynamics make models based on historical data and precedents unreliable. As is often said with models, 'garbage in, garbage out', which means a fair amount of qualitative judgment needs to be applied. The problem is that so few of us have experience navigating a world of high inflation. This includes

central bankers, who have spent most of their careers worried about deflation, which increases the odds of a policy misstep.

Our hat in the ring.

The result of all these factors is an abnormally wide range of possible outcomes. And with inflation driving the bus, it is difficult to have any strong conviction on the direction of rates and markets. The dispersion of possible paths the CPI bus could take is just too large to map, even for Waze.

Although recent data suggest that inflation is cooling, history tells us that it takes many months for a trend to be established. Until such time, we recommend keeping an open mind and an even more watchful eye. As the only realistic prediction we can make is that there will be surprises in store. And anyone proclaiming to know where CPI will be a year from now is either a fool or taking you for one.

The Month of December.

Credit.

Despite a rocky month for equities, investors continue to be drawn to the attractiveness of corporate bonds, leading to a modest performance in credit spreads. While it was not the Santa Claus rally some had anticipated, it was far better than a lump of coal.

Domestic bond funds saw strong inflows, while supply was light at $8.4 bn, with all the new deals coming from financials. This took the year-end tally to $119 bn, the second-highest on record. A notable theme in the 2022 issuance was the heavy supply from banks, which comprised 57% of the total (typically around 33%).

- Canadian spreads narrowed 3 bps to 162 bps
- US spreads narrowed 3 bps to 130 bps

Interest Rates.

With most people convinced the end of the hiking is nigh, the focus has shifted to when the easing cycle will begin. In November there was some optimism that rate cuts could be delivered as early as the summer of this year. But in December, tough central bank rhetoric about the dangers of easing prematurely dampened enthusiasm, resulting in yields drifting higher.

Sovereign yields:

- Canadian 2y finished at 4.05% (+18 bps) and the 10y at 3.30% (+36bps)
- US 2y finished at 4.43% (+12 bps) and the 10y at 3.88% (+36 bps)

The Funds.

Algonquin Debt Strategies Fund.

The majority of the December return came from the portfolio yield (>10%) with some additional love from the modest narrowing of credit spreads.

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	0.97%	2.68%	3.21%	-1.86%	-1.86%	1.82%	3.01%	7.67%
F Class	0.92%	2.54%	2.92%	-2.41%	-2.41%	1.16%	2.29%	NA

* As of December 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

Throughout the month, we very actively managed the Fund's interest rate exposure. After the significant drop in yields through November and early-December, we reduced the portfolio duration. This move helped the Fund weather the year-end sell-off. We then took advantage of the move higher in rates to modestly increase duration once again.

Portfolio Metrics:

- 7-8% yield
- 3-3.5yr duration
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2021	2020
F Class	-.0.01%	2.39%	2.87%	-6.15%	-6.15%	2.42%	10.53%

As of December 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.

While 2022 was a miserable year for fixed-income, there are reasons to be optimistic about 2023. Even if central banks raise rates a bit more, the odds are low that they will deliver another 400 bps of hikes. As such, the range for interest rate moves (at least undesirable ones) is much narrower.

In addition, fixed income now has the safety cushion of higher yields, which more than doubled in 2022. This provides an investor with decent protection against rates and credit spreads moving higher. Thus after two years of disappointing returns, we think the prospects for 2023 are brighter

In particular, high-quality domestic spreads are looking attractive relative to high yield and US investment-grade credit. As such, we think they offer an attractive margin of safety, especially in our favoured sectors: banks, telecommunications, and energy infrastructure.

For now, we continue to remain focused on these higher-quality issuers and are leaving room to be nimble. As in the coming weeks and months, we expect there will be opportunities to change the composition of our portfolios, as we adapt to changes in valuations and unfolding economic data.

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

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