The Other March Madness | March 2023

"Like life, basketball is messy and unpredictable."
Phil Jackson

It seems this year, March Madness was not restricted to college basketball, with the excitement and unpredictability of the tournament spilling off the courts and into financial markets. As the NCAA's number-one seeds went down, so too did a few banks.

In a tournament with a single elimination ('win or go home') format, it is not surprising to get big upsets and Cinderella stories. Similarly, in a period of aggressive rate hikes and monetary tightening, it is only natural for there to be twists and turns, and for a few things to break along the way.

It is just particularly concerning when the cracks appear in financial institutions, with three bank runs in short order sparking 2008 flashbacks. The big questions being asked are what happened and how worried should we be?

Silicon Valley of Death.

The first number-one seed casualty of March Madness was Indiana's Purdue University. In the financial sector that honour went to Silicon Valley Bank (SVB). As the name would suggest, their clientele was heavily skewed to technology and venture firms.

With a flood of cash going into those sectors, SVB's deposits skyrocketed 220% through 2020 and 2021. They could not lend the money fast enough and invested the excess capital in the 'safest asset in the world', US treasuries.

But as we all learnt in Bond 101, when interest rates rise bond prices fall. And when SVB's clients began withdrawing their cash, the bank was forced to crystallize losses on these holdings. This began the downward spiral and given the speed at which information and money flow in the digital age, it did not take long before the institution was insolvent. SVB may have the dubious distinction of being the first bank taken down by Twitter.

John Hancock's Bank.

The failure of SVB sparked panic in the depositors of Signature Bank due to its high percentage of uninsured deposits, exposure to crypto, and a disproportionate amount of its assets in bonds. On Friday, March 10th, $10 billion was reportedly withdrawn from Signature Bank and on Sunday the regulators took possession of the company to 'protect the depositors' and the stability of the US financial system.

Suisse-stemic risk.

With financial institutions under close scrutiny, the next shoe to drop was Credit Suisse, where investors and depositors questioned the bank's viability and value. Since 2008, Credit Suisse has endured a comedy of strategic errors and was expected to suffer losses in the years to come. Investors decided they had enough of the mismanagement, and the Swiss regulators stepped in to facilitate UBS taking over its local rival.

Cuckoo Cocos.

For bond nerds, an interesting side note from the UBS takeover of Credit Suisse was the permanent write-down of their Contingent Convertible (CoCo) Bonds. Normally one would expect the shareholders to be wiped out before bondholders, but the Swiss like to be different.

The 'permanent write down' feature in the Swiss Cocos is not the norm, and other regulators (including Canada's OFSI) were quick to reassure bond investors that they ranked above common equity.

Regulators, mount up.

Although three bank runs in a month are concerning, it has been reassuring to see how fast the authorities have responded to ensure the problems do not fester. In the case of SVB and Signature, the Federal Deposit Insurance Corporation (FDIC) guaranteed all deposits, even those greater than $250k.

The Federal Reserve also initiated a Bank Term Funding Program whereby banks could swap their bond holdings at face value for a cash loan of up to a year. This prevents banks from having to realize losses on their bond portfolios, but it comes at the cost of a 4.75% interest rate. It is therefore seen not as a bail-out for unprofitable institutions but as short-term protection from a bank run.

Similarly, the Swiss government and regulators were prompt to act given Credit Suisse's status as a Global Systemically Important Bank (GSIB). The authorities worked quickly with UBS to ensure the risk of contagion was minimized.

2008, part deux?

With bank failures and rescue measures dominating headlines, it is tempting to draw parallels to The Great Financial Crisis. But we will go out on a limb and utter that ever-dangerous phrase, 'this time it's different.'

Compared to 2008, the big banks are far better capitalized and more heavily regulated. In particular, we do not see much concern for the Canadian oligopoly.

On top of the domestic giants being well diversified and capitalized, they also tend to hold fewer long bonds and hedge significant portions of their rate risk. And while mark-to-market losses on held-to-maturity investments have no impact on bank earnings, they are included in capital calculations.

Thus, while the Canadian banks have the headwinds of higher rates, a real estate slowdown, and the highly indebted consumers, we foresee these issues being contained to their earnings and income statements, and not spreading into a crisis of balance sheets or solvency.

Not all unicorns and rainbows.

This by no means implies that we are out of the woods. The US regional banks still have to deal with insecure depositors and will most certainly face stricter regulations going forward. This will pressure their profitability and inevitably lead to higher lending standards and a tightening of credit conditions.

Given the regionals play a big role in business and real estate lending, the impact of less available credit could result in a significant strain on the economy. Federal Reserve Chair Powell sees the stress in the banking sector as equivalent to a 'rate hike or perhaps more than that' in slowing growth.

So, while we are not losing much sleep over a 2008 repeat, the odds of a hard landing are higher than they were a month ago. That said, a severe recession is not a foregone conclusion. Much like March Madness, we expect many more plot twists to come.

The Month of March.

Credit.

It was all about the banks, with bonds across the capital structure losing significant value. On the domestic side bank bail-in spreads were out 17 bps, subordinated debt wider by 44 bps, and prices on LRCN/AT1 down $2-3.

As most Canadian investment-grade issuers are valued relative to bank credit, no companies were immune to the significant upward spread move. And after a couple of months of catching up to US levels, the domestic market was on the wrong end of a good 'drubbing.'

In terms of issuance, banks stayed on the sidelines (perhaps not wishing to validate current pricing) while $8 bn of energy, auto finance, and utilities came to market. Higher spreads resulted in fairly good deals, with these transactions being met with robust demand.

- Canadian spreads widened 22 bps to 167 bps
- US spreads widened 14 bps to 138 bps

Interest Rates.

The trouble in the banking sector saw investors quickly move to bet that rate cuts are coming this summer. This feels slightly optimistic to us, however, the range of outcomes remains wide and unpredictable.

With inflation fears subsiding, we suspect that the levels hit in February (i.e. CAD 10y at 3.5%) could mark this cycle's high point.

Sovereign yields:

- Canadian 2y finished at 3.73% (-47 bps) and the 10y at 2.90% (-43 bps)
- US 2y finished at 4.03% (-79 bps) and the 10y at 3.47% (-45 bps)

The Funds.

Algonquin Debt Strategies Fund.

The dramatic turn of events meant there was no room to hide as liquidity was scarce amidst all the fear. Although the fund generates an attractive yield, the monthly accrual was not enough to offset the impact of much wider spreads. With spreads now higher than where they were to start the year, we believe that investment-grade debt remains very attractive. The fund lost 1.75% in March, bringing the YTD gain to 1.44%

Portfolio Metrics:

- 9-10 % yield
- IR Duration: 0-1y
- Average maturity: 2y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-1.75%	1.44%	4.16%	1.44%	2.47%	8.26%	3.22%	7.61%
F Class	-1.82%	1.30%	3.87%	1.30%	1.90%	7.56%	2.51%	N/A

*As of March 31st, 2023

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

With the significant drop in yields, we thought it prudent to reduce duration from ~4.25y to ~2.5y, as the number of rate cuts built into the yield curve seemed very aggressive.

We remain comfortable with the credit quality of the issuers we hold. Current spread levels are attractive as they incorporate an attractive recession premium. Although we will be cautious when adding credit exposure, we expect to be more aggressive in adding duration should rates move higher.

Over the month, the portfolio yield and significant gain from interest rate exposure more than offset the loss due to wider spreads.

Portfolio Metrics:

- 7-8% yield
- IR Duration ~2.5y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	0.48%	2.77%	5.23%	2.77%	1.22%	-6.15%	2.42%	10.53%

As of March 31st, 2023

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 bonds reflecting expectations for a rapid decline in inflation, a dramatic slowing in economic growth, or both, all future economic data releases have the potential to be 'market moving.' Tight labour conditions, coupled with higher interest rates and stricter lending conditions could lead to a mix of weak and strong data, making it difficult to understand what is happening to inflation.

Barring an acceleration in oil prices, it does appear that price pressures are abating, however, worries of inflation becoming 'sticky' at some level well above 2% persist. Sadly, this means that rate volatility is likely to continue.

The debate over a 'soft' or 'hard' landing now has the additional element of looming problems in commercial real estate added to the mix. With the 'work from home' trend still strong, cracks are appearing in office space. With banks becoming more careful about whom they lend to, the potential for an increase in foreclosures is growing, raising fears over contagion to other sectors.

We have little doubt that more excitement lies ahead. As such, sticking to resilient, high-quality issuers remains the best option. With bank credit having given up the gains made earlier this year, we see this as an opportunity to reinvest at very attractive levels as we believe the domestic banks are capable of managing through a prolonged period of sub-par growth.

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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