

## The Tall Tale of Two Tails | April 2023

“The optimist proclaims that we live in the best of all possible worlds;  
and the pessimist fears this is true”  
James Branch Cabell

After 19 years of pure pain and suffering, Maple Leaf fans finally had a modicum of playoff success to celebrate. And celebrate they did. Following a series-clinching overtime goal, and after a collective sigh of relief, the city erupted onto the streets to rejoice. One might have thought we won the cup.

But this was just the first step in the long and arduous journey to Lord Stanley’s chalice. And now with their team down three games to none in the second round, Leafs Nation has returned to its natural state of paranoia and despair.

The one solace being that the Leaf faithful are accustomed to and always prepared for disappointment. Come playoff time, we fear and expect the worst, with any hint of optimism being of the most cautious variety. Such is the mindset of a scarred fan base that has endured one of the longest championship droughts in professional sports.

This pessimistic bias ingrained in Leaf fans reminds us of another group of people we are all too familiar with, bond investors. The buyers of securities with a predetermined and fixed upside, where all of one’s time and focus is on what could go wrong.

Perhaps this explains why amidst the current economic uncertainty that fixed income markets are so heavily tilted to the glass being half empty.

This pessimistic outlook is expressed through the level of inversion in the yield curve, which implies a forthcoming recession. This seems reasonable given that central bankers are trying to engineer an economic slowdown via higher interest rates. Recently we have seen evidence that tighter monetary policy is slowing the economy and is causing problems for some US regional banks.

Accordingly, the bond markets have fluctuated from expecting a mild recession to a bad one, and for the Fed and BoC to respond with rate cuts. The US market swings between 2 and 4 cuts being delivered this year, while the Canadian market oscillates between 1 or 2 cuts before year-end.

But the rhetoric from central bankers indicates they are in no rush to cut rates and do not anticipate doing so until next year. And as far as an economic outlook, equity markets seem to be painting a far more optimistic picture. At the end of April, the S&P was up 9%, the Nasdaq 17%, and the TSX 8%. Although there is the trope that the bond crowd is smarter than their equity counterparts, fixed-income investors can not ignore the other side.

After all, as Leaf fans and bond nerds, we recognize our pessimistic predilections and our tendency to lean toward one end of the spectrum. Furthermore, we acknowledge that, unlike a dog, a probability distribution has two tails. And even if the possibility of a positive outcome is remote, it still needs consideration.

For the Leafs the odds are pretty grim. Coming back after being down 3-0 in a playoff series has only been done four times. But one of those was the 1942 Leafs, and for the past two decades, this team has defied all odds with their inability to win in the playoffs. Maybe it is their turn to defy the odds the other way.

But given the probability (2%), we can understand leaning into the natural Leaf pessimism and not wasting time dreaming of a miraculous comeback. But when it comes to the potential economic outcomes, it is worthwhile considering what could make the cynical debt market wrong.

One possibility is that the current assumption for the level of the neutral interest rate (the point where monetary policy is neither stimulative nor restrictive) is wrong. At present, the range is thought to be between 2 and 3%. However, this has not always been the case.

According to the first-ever Fed dot plot in 2012, the long-term neutral rate was assumed to be around 4 to 4.5%. A range that was revised lower and lower over the last decade, in what was dubbed the ‘new normal’.

But what if the trend is reversing, and neutral is moving higher? If that is the case, then today’s rates would not be as restrictive as they are assumed to be. As a result, the economy could continue chugging along and an aggressive rate-cutting cycle would not be needed.

While we do not put a high probability on such an outcome, it can not be ruled out. Maybe the last decade was the anomaly, and we are returning to the higher interest rate regimes of the ‘old normal’. We know Leaf fans would like to believe that the last 55 years have been the anomaly, and that we will soon return to the glory days when Stanley Cup parades in Toronto were the norm.

## The Month of April.

### Credit.

After a chaotic March, financial markets were given a bit of a respite in April, with no bank failures coming till the end of the month. The more positive tone was also supported by decent corporate earnings, with almost 80% of the reporting S&P companies beating consensus estimates. This led to credit spreads tightening, and for the second month in a row, the Canadian market outperformed the US, but domestic spreads still remain materially wider/cheaper.

- Canadian spreads tightened 9 bps to 158 bps
- US spreads tightened 2 bps to 136 bps

April saw a number of domestic banks issue debt in the USD market where spreads were better from a funding perspective. This led to a mere \$4.5 bn of new domestic deals, the lightest April in a decade. The new supply was dominated by banks (75%), with a utility and REIT issuer rounding out the rest. Deal demand was light, as investors were preoccupied with rate uncertainty, earnings, recession fears, and of course, the US regional banks.

Although the large US banks (eg. JPM, WFC) saw deposit growth, the smaller regional banks are still a big concern. First Republic (FCR) reported its earnings showing large deposit outflows reigniting concerns of a financial crisis. An investor call where no questions were allowed did not help the situation, and FCR was taken over by JP Morgan on the last day of the month. We do not expect FCR to be the last regional bank to fall.

In Canada, the major news was that Rogers received approval to take over Shaw, with the credit spreads of both issuers converging. Rogers was subsequently downgraded to BBB-, which was very much expected in the market. The second major non-earnings news was that Suncor took full ownership of Fort Hills, acquiring the last 30% for some \$6b in cash. The transaction did not change Suncor’s debt rating.



## Interest Rates.

Despite bond traders changing the magnitude and timing of rate hikes all month, by the time the dust settled very little had changed. Since problems with US regional banks will not suddenly disappear, we expect to see much of the same over the next few months.

### Sovereign yields:

- Canadian 2y finished at 3.65% (-8bps) and the 10y at 2.84% (-6 bps)
- US 2y finished at 4.01% (-2 bps) and the 10y at 3.43% (-4 bps)

## The Funds.

### Algonquin Debt Strategies Fund.

On top of earning an attractive portfolio yield, the fund benefitted from the performance in credit to finish April with a gain of 1.33%.

### 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 | 1.30% | 0.35% | 5.89% | 2.76% | 5.19% | 6.91% | 3.33% | 7.70% |
| F Class | 1.33% | 0.22% | 5.67% | 2.65% | 4.68% | 6.24% | 2.64% | N/A   |

\*As of April 30<sup>th</sup>, 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 1<sup>st</sup>, 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 main drivers of performance in April were the yield earned and the narrowing of credit spreads, with interest rate duration management providing an additional lift.

### Portfolio Metrics:

- 6.5% yield
- IR Duration: 3.3y
- Average maturity: 3.1y
- Average credit rating: A-



|         | 1M    | 3M    | 6M    | YTD   | 1Y    | 2022   | 2021  | 2020   |
|---------|-------|-------|-------|-------|-------|--------|-------|--------|
| F Class | 1.41% | 1.16% | 7.54% | 4.22% | 5.27% | -6.15% | 2.42% | 10.53% |

\*As of April 30<sup>th</sup>, 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 both the Federal Reserve and Bank of Canada taking an intermission, the accumulation of growth and inflation data over the next couple of months will determine whether the hiking cycle is over. Despite central bankers claiming that it is far too early to consider cutting rates, bond traders have significantly inverted yield curves in anticipation of rate cuts later this year.

Chairman Powell may find himself like Odysseus having to decide between Scylla and Charybdis. But instead of facing a monster or a whirlpool, the Fed governor may have to choose between inflation and a bank crisis. Really bad inflation has led to bad outcomes such as the stagflation of the 70s, while a bank crisis could lead to a deep recession (savings and loans debacle) or a depression (massive bank failures of the 30s).

Investors are clearly betting on rate cuts, however, there is a possibility that US regulators utilize unorthodox tools such as guaranteeing deposits, implementing a ban on short selling of financials, or getting creative with lending facilities for regional banks to help them deal with deposit flight without having to sell assets.

It is impossible to predict what is going to happen nor to have a deep conviction about a particular outcome. The number of events colliding in the coming months could result in good or bad outcomes. Accordingly, we are preserving a high degree of flexibility within our portfolios.

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