ALGONQUIN
CAPITAL

A Star Is Born | May 2023

"Look to the stars and from them learn"
Albert Einstein

Last month, we looked at the neutral rate of interest, which is also known as the natural rate, the equilibrium rate, or in its nerdier, variable form as r*. This is the level for the overnight rate which neither stimulates nor restricts the economy and inflation.

We commented on how little consideration was being given to the possibility that neutral could be higher than the current central bank estimates of 2-3%. In which case, today's rates would not be as restrictive as many believe.

After all, in the first dot-plot of 2012, the Federal Reserve's (Fed) neutral rate projection was between 4 - 4.5%. A range that was ratcheted down over the past decade, in what became dubbed the 'new normal'. Our question was whether we could be back to the old normal or in some 'new new normal'.

Shortly after publishing our commentary, the New York Fed offered their response: "There is no evidence that the era of very low natural rates of interest has ended." Their current estimate of r* is a real rate (i.e. above inflation) of 0.5%. With a long-term CPI target of 2%, that would put neutral at the assumed level of 2.5%.

But this was not the only piece of research last month to come from the New York Fed, whose economists resurfaced the novel concept of r**.

Starry starry night.

The double-star version of r, or the financial stability rate, was unveiled by a group of NY Fed economists last autumn. The question they asked was "How large a shock to real interest rates can the financial system take before entering a crisis? Add this shock to the current level of interest rates, and you have found r**."

If the gap between r** and the actual interest rate is small or negative, then the financial system is vulnerable to rate hikes. Or more critically in today's world, if r** is lower than r*, we could experience a financial crisis long before rates reach the necessary levels to contain inflation.

Supernova.

With rising rates having taken down a few banks, without putting a dent in the labour market or bringing inflation back down to earth, these starry-eyed economists look rather prescient. Not to be outdone, their friends from the Kansas City Fed added their two cents, publishing a piece last month entitled 'Financial Stress May Do Relatively Little to Reduce Inflation."

This may sound like a hor-r-starry (groan), but it is not all doom and gloom. The measures taken by the authorities (i.e. liquidity facilities, deposit insurance) have thus far contained the crisis in the US regional banks. Furthermore, according to the Fed's latest Financial Stability Report, the leverage at broker-dealers is near historically low levels, and the systemically important banks are well capitalized.

ALGONQUIN
CAPITAL

When you wish upon a star?

Furthermore, while the 'r' and all its stars are interesting theoretical concepts, the ability to accurately estimate them is questionable and any attempts to do so should be taken with a grain of stardust. In most cases, we only know what the levels are once we have broken through them.

But being skeptical of the r* estimates and of 'geeks bearing models', does not diminish the sparkle of conceptually adding more stars to the constellation. Why can't there be a neutral rate for inflation, one for employment, and another for financial stability?

Of course, the problem with having multiple r's is that the stars need not align, making the job of steering monetary policy even more complex. Suffice it to say, in a galaxy with bank failures, high inflation, and strong employment, central bankers can not be caught star gazing.

The Month of May.

Credit.

May was a quiet month for Canadian credit, with the generic investment-grade index finishing the month unchanged, at the relatively elevated level of 158 bps. The index does mask the dispersion within the space, with short-dated spreads outperforming as investors capitalized on the inverted yield curve. On the other side of the performance coin, financials underperformed with spreads widening a few bps in sympathy over concerns within US regional banks.

Domestic new issue supply showed signs of life with a few big deals including a $2bn BMO 5yr bail-in, Canadian National Railway with a $1.75bn three-part deal (7s 10s 30s), and Enbridge doing a large $1.5bn three tranche deal. Interestingly, part of Enbridge's motivation was to reduce reliance on higher-cost commercial paper (again the inverted curve). Rounding out the domestic supply were issues from Sagan, Fortis, Smart REIT, and IPL's highly anticipated $750mm 7y deal. Overall, the deals came with minimal new issue concessions and were greeted with a medium level of demand and enthusiasm.

- Canadian spreads were unchanged at 158 bps
- US spreads widened 2 bps to 138 bps

Interest Rates.

Sticky inflation numbers solidified fears that rate cuts remain a distant dream, leading to a surge in yields. At month-end, neither yield curve priced in rate cuts this year, and the domestic market had the odds of a June hike at 40%. With the BoC delivering a 25 bps increase this week, bond traders have moved to incorporate another hike this year. As such, we feel the current level of yields offers fair value.

Sovereign yields:

- Canadian 2y finished at 4.22% (+56 bps) and the 10y at 3.19% (+35 bps)
- US 2y finished at 4.41% (+40 bps) and the 10y at 3.65% (+22 bps)

The Funds.

Algonquin Debt Strategies Fund.

With a quiet month in credit, the performance of 0.5% was comprised mainly of clipping the portfolio yield.

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	0.53%	0.05%	4.31%	3.31%	6.75%	6.39%	3.49%	7.69%
F Class	0.46%	-0.07%	4.07%	3.12%	6.21%	5.72%	2.79%	NA

*As of May 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

The aggressive move higher in rates led to losses, which were partially offset by the yield and credit trading. We did take the opportunity to add rate exposure into the sell-off in yields, increasing the duration from 3.3y to 4.4y over the month.

Portfolio Metrics:

- 7-8% yield
- IR Duration: 4.4y
- Average maturity: 3.1y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	-0.68%	1.21%	3.51%	3.52%	5.01%	-6.15%	2.42%	10.53%

*As of May 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.

As long as inflation remains well above 2%, central banks will be very reluctant to entertain lower rates. Despite no historical precedent of inflation falling to 2% without a significant rise in unemployment, we expect central bankers to optimistically forecast a soft landing.

Although there is a first time for everything, we remain skeptical. After all, monetary policy takes time to work, and just because we have not seen much evidence of a slowdown, there is no reason to believe one will not occur. And if growth and inflation remain strong, central banks could continue to hike rates and address any financial instabilities with macro-prudential tools. As such we continue to remain invested in high-quality issuers and are employing lower levels of leverage than normal.

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.