The Halftime Report | June 2023

"It's time for the never-tedious Super Bowl halftime show."
The Simpsons

At the start of the year, there was a sense of optimism amongst bond investors. It appeared the worst of the rate hikes were behind us, and we were entering the final innings of this tightening cycle.

After a dire year for fixed income, attractive opportunities were emerging in bonds, and with them a renewed enthusiasm for the asset class. While we concurred with this general sentiment, we warned clients to be prepared for wild bouts of rate volatility.

Our first assumption was that the bond market would continuously recalibrate expectations of rate increases and cuts based on the incoming economic data. Our second assumption was that the data would give people mixed signals, with signs of both economic strength and weakness. This would ultimately lead to a lot of to-and-froing on how many hikes were left in the tank and when cuts would begin.

Although this thesis has played out, the speed and magnitude of the moves have been greater than we anticipated. So far, we have seen the market swing back and forth between expecting a series of cuts to multiple hikes being delivered this year.

With so much going on, we thought it would be helpful to provide a summary of the year thus far, and how things are positioned for the second half.

The first quarter.

The new year began with the expectation that higher rates would lead to economic weakness (and lower inflation), which would enable central banks to loosen monetary policy. The expectation was for the Bank of Canada to remain on hold till the summer and then deliver a couple of cuts before year-end. Accordingly, Canadian rates moved 0.3-0.4% lower.

In February, we got the first economic data of the new year, and the numbers told a different story. With payrolls crushing expectations and inflation not decelerating fast enough, the market shifted to pricing in a couple more hikes this year. Canadian rates reversed the January rally and finished 0.4-0.5% higher.

Then March delivered the madness, with three bank runs and questions swirling around US regional banks. The market assumed the turmoil in the financial sector would force central bankers to cut rates and moved back to pricing in two cuts before year-end. The result was undoing the previous month's move, as rates declined 0.4-0.5%.

The second quarter.

The second quarter began with rates muddling along, and at the end of April, yields were relatively unchanged as the expectation remained for two cuts to come later in the year.

But in May, sticky inflation numbers erased any hope of cuts, and yields surged 0.5-0.7% higher. By month-end, neither the US nor Canadian curve had cuts built in, and the domestic market had the odds of a June hike at 40%.

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A week later, that 40% became a reality, as on June 7th the BoC raised the overnight rate by 0.25% to 4.75%. Following the announcement, bond traders moved to incorporate another hike this year. By month-end, the expectations sat at a hike in July to be followed by one more before year-end. This shift saw 2y rates finish the month 0.3% higher with more modest moves in longer maturities, as the curve inverted further.

Heading into halftime, the Canadian 10y yield was only 5 bps higher than the end of last year, the 5y up 30 bps, and the 2y (the big loser) rising 60 bps as people braced for more hikes in 2023 and for cuts to begin next summer.

The second half.

The third quarter has kicked off with the Bank of Canada hiking another 25 bps yesterday, and the Fed expected to follow suit later this month. The focus now shifts to how many more hikes are left to come.

While central banks have gone from 'pause' back to 'play', it appears that we have entered the 'tweaking' zone. Rather than a continuous series of hikes, it feels like they are cautiously trying to determine the appropriate rate level at which to engage a long pause.

Ultimately the terminal rate will depend upon inflation, which has proven impossible to predict. But it does appear that the odds are tilted toward rates being lower in a couple of years than they are today.

Even though bond nerds will debate what to expect for the rest of the year, normal people should be considering a more important question. Whether to be locking in current yields for a longer period. For example, shifting from cash and money market products to 5y bonds.

Although cash is king for now, once rate cuts begin it could lose its royal status. And on the other side, an investor could lock in an annual yield of 5.5% for 5 years by owning a boring senior Canadian bank bond. For many investors earning that type of return for the risk of an oligopoly player defaulting is a pretty good proposition.

The Month of June.

Credit.

Despite worries over higher rates, people rushed to put money to work as stocks rose 3-7%, while credit spreads narrowed. With the summer doldrums looming, issuers were busy, bringing $14bn worth of deals, making June the busiest month of the year. A wide array of borrowers ranging from financials to oil and gas names and utilities raised debt.

Although June was a heavy supply month, issuance is still running behind last year's totals, meaning portfolio managers have been forced to look for bonds in the secondary market. The likelihood of less supply over the summer, coupled with good demand, meant the new issues were easily digested leading to a tightening in spreads.

- Canadian spreads narrowed 7 bps to 151 bps
- US spreads narrowed 15 bps to 123 bps

Interest Rates.

With North American economies defying higher rates, expectations of more rate hikes and staying 'higher for longer' sent yields marching up once again. With central banks fine-tuning rates, we think investors will remain focused on when rate cuts will materialize.

Sovereign yields:

- Canadian 2y finished at 4.58% (+37 bps) and the 10y at 3.27% (+8 bps)
- US 2y finished at 4.90% (+50 bps) and the 10y at 3.84% (+19 bps)

The Funds.

Algonquin Debt Strategies Fund.

The combination of narrowing credit spreads and portfolio yield led to the fund generating a return of 79 bps. We continue to be selective in terms of new issues, as we wish to maintain our defensive position in high-quality borrowers.

Portfolio Metrics:

- 10% yield
- IR Duration: 1y
- Average maturity: 1.8y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.79%	2.64%	4.12%	4.12%	7.64%	5.14%	3.60%	7.71%
F Class	0.70%	2.5%	3.84%	3.84%	6.87%	4.46%	2.89%	NA

*As of June 30th, 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 monthly return might look like a typo, but the losses from rising rates were perfectly offset by the yield earned and performance from the credit position. The current level of rates looks very attractive, and we expect to gradually increase interest rate exposure across the yield curve. In particular, the front of the domestic curve and US 10yr bonds appear to have significant value.

Portfolio Metrics:

- 7-8% yield
- IR Duration: 4.1y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	0.00%	0.73%	3.52%	3.52%	6.49%	-6.15%	2.42%	10.53%

*As of June 30th, 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.

Thus far, the rumours of the economy's death have been greatly exaggerated forcing central banks to continue lifting rates. Although the 2% inflation goal appears elusive, CPI has subsided from the heady levels of last year, giving some reason for optimism.

After months of being defensive in credit, we think it is time to consider what conditions we need to see to increase our exposure. Now, we see two possible scenarios.

The first one would be that rate hikes succeed in dramatically slowing economic growth, leading to an increase in unemployment and bankruptcies. In such a scenario. credit spreads will likely widen. Given the amount of risk premium already built into Canadian investment grade spreads, we suspect such a widening would be relatively modest. Furthermore, a recession brings forward the prospect of monetary stimulus which would lead to tighter credit spreads. As a result, we would be a buyer of corporate bonds on such weakness.

The other scenario is one where inflation falls below 3%, opening the possibility of central bank cuts. Because spreads are wider than their historic average, there is room for them to rally in this scenario.

The market tends to move well before the facts become obvious to everyone, so we will need to be ready to act quickly, especially under the latter scenario. For now, we remain content to stay focussed on high-quality issuers and leave sufficient flexibility in our portfolios.

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