ALGONQUIN
CAPITAL

Rates: How High Is High? | August 2023

"How long is a piece of string?"

Earlier this year, in a commentary littered with bad 'star' puns, we wrote about the concept of r*, or the neutral rate. This is the level for the overnight rate which neither stimulates nor restricts the economy and leads to stable inflation.

We noted that the baseline assumption was that it had not materially changed from the decade prior to the pandemic. We questioned this assumption and considered how structural economic changes could have shifted us into a world of higher interest rates.

The possibility of a higher rate regime made it difficult for us to ascertain what constituted value in longer-dated yields (i.e., 10y). From the Great Financial Crisis to the pandemic, the 10y spent most of its time between 1% and 3%. We wondered whether the new 'new normal' could be in the range of 3% - 5%.

It appears that the bond market has been wondering the same thing, as long-dated yields have steadily climbed higher through the summer. With 10y rates the highest they have been in 15 years, is it time for investors to back up the truck?

The building blocks.

To untangle the million-dollar question, we begin by dissecting the 10y rate into its principal components: r* (the real neutral rate), inflation, and the term premium. Combining the first two elements, we get the neutral level for the overnight rate (nominal). The term premium is the compensation investors require for being locked in for ten years versus staying in cash.

Part of the difficulty in determining the value of long-term yields today is due to central bankers keeping overnight rates at restrictive levels. If instead, they maintained a neutral policy, then the only unknown variable would be the term premium. But today, if we want some clarity on where value lies further out the curve, we need to consider each of the three underlying components.

Twinkle, twinkle, little star.

As aforementioned, the consensus view was that r* in Canada and the US was still at its pre-pandemic level of 0.5% (before inflation). In the spring, the New York Fed published a paper reaffirming the view that things in the US had not shifted.

But north of the border, there have been rumblings at the Bank of Canada (BoC) that due to changes in demographics and global trade, r* might have moved a touch higher, potentially to 0.75%. The debate over increasing r* by 25 bps will make for a scintillating discussion amongst economists and academics but probably does little to affect long-term yields. Especially since there seems to be so much uncertainty about inflation.

Inflation conflation.

For now, central bankers are sticking with their 2% inflation target. But with headwinds of de-globalization (i.e., on-shoring, friend-shoring), demographic/labour dynamics, and government spending, this target might not be achievable without pushing the economy into a deep recession. Thus, one could see them compromising and living with a CPI of 2.5% while publicly talking about targeting a long-term average of 2%.

The time continuum.

If we can get clarity on r* and inflation, then we will have arrived at the neutral overnight policy rate. While this will be determined and set by the central banks, it is the market that decides the appropriate term premium to be applied to longer-dated bonds. Since the nineties, the term premium has fallen steadily from plus 250-300 bps to negative 50-75 bps.

The last decade or so, marked a long period of negative term premia as investors used long-term bonds as a hedge against deflation. The term premium was also compressed by central bank pandemic-related quantitative easing programs.

But now concerns have shifted to inflation, government deficits, and the potential for less foreign buying of long bonds from countries such as China and Japan. Furthermore, central banks are reducing balance sheets (quantitative tightening) allowing investors to determine the fair value for government bonds. Taking these factors into consideration, we think it is reasonable to expect term premia in the range of 50-150 bps in the future.

The sum of the parts.

Now, if we combine these estimates for r*, inflation, and the term premium, we get a range for the 10y rate of 3-5%. Thus, even at today's lofty levels, it isn't clear to us that is a screaming buy. As even if central bankers cut overnight rates to 2.5-3%, the term premium could leave little room for long-term rates to rally.

Of course, if we hit some economic speed bumps, 10y rates could rally, but it is unclear how much portfolio protection they will provide. Thus, while fixed-income markets are rich with opportunities, long maturity bonds might be a case of the right asset class, but the wrong place.

The Month of August.

Credit.

Credit spreads were not immune to the stench emanating from the stock market. But given that we expected some weakness ahead of September's heavy issuance schedule, the moves were on the smaller, more muted side. As anticipated, trading in August was limited as was primary issuance.

In terms of the new deals, BMO printed a $1.15 bn Tier 2 deal at +215 bps with the proceeds used to refinance a US$-denominated Tier 2 bond. With an all-in yield of over 6%, we think this deal offers compelling value. First National printed $200m 3y bonds at +300 bps, Enbridge came to market with a $350mm 30y issue at +230 bps, Desjardins printed a $500m +151 bps bail-in, and Bell brought a $1 bn 5y deal at + 140 bps.

- Canadian spreads widened 5 bps to 149 bps
- US spreads widened 6 bps to 118 bps

Interest Rates.

August saw significant volatility in rates, as more and more people are beginning to embrace the notion that yields are not likely to return to the levels that prevailed post-2008. Fortunately, the economic data was soft enough to suggest that the North American hiking cycle is drawing to a close. As a result, most of the damage was felt in long-maturity bonds, as curves steepened.

Sovereign yields:

- Canadian 2y finished at 4.64% (-3 bps) and the 10y at 3.56% (+6 bps)
- US 2y finished at 4.87% (-1 bps) and the 10y at 4.11% (+15 bps)

The Funds.

Algonquin Debt Strategies Fund.

The portfolio yield and profits from active trading were able to withstand the widening in credit spreads to finish the month with a positive return.

Portfolio Metrics:

- 10-11% yield
- IR Duration: 1.5y
- Average maturity: 1.8y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.23%	2.42%	2.48%	5.81%	7.81%	3.71%	3.73%	7.76%
F Class	0.17%	2.15%	2.08%	5.33%	7.13%	3.00%	3.01%	NA

*As of August 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

As rates sold off through the summer, we increased the portfolio duration to 5y, with exposures concentrated in the 2-5y part of the Canadian curve and positions in US 10y bonds (as a hedge). The move higher in US 10y rates and credit spreads outweighed the portfolio yield to push the return into negative territory for the month.

Portfolio Metrics:

- 8-8.5% yield
- IR Duration: 5y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	-0.27%	0.23%	1.44%	3.75%	4.85%	-6.15%	2.42%	10.53%

*As of August 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.

Fixed income is an attractive asset class, but as we often remind our clients, not all bonds are created equal. To which the most frequent reply is, 'my favourites are Sean Connery and Daniel Craig'.

With respect to the other bonds, we like higher-quality Canadian investment-grade companies, which are cheap on both a historical and relative value basis. For example, just last week TD and Rogers brought 5y deals with spreads of +155 bps and +187 bps over government bonds. The historical average for such issuers would be 110-130 bps, with current levels offering a recession or uncertainty premium.

Meanwhile, south of the border, investment-grade spreads are trading in and around their mean, and high-yield spreads have now rallied below their average. We feel the lower-quality part of the credit spectrum is susceptible to heavy issuance (from refinancing), higher borrowing costs, and of course, an economic slowdown.

In terms of rates, as already noted, we find it difficult to get excited about Canadian long-end yields when the 10y is around 3.50%. Our preferred area for rate exposure is in the 2-5y part of the curve, where we earn an attractive yield and see more room for rates to decline when cuts resurface on the horizon. With the US 10y above 4.20%, we do see some hedge value, as in a crisis, treasuries become the flight to quality trade.

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