That Time Was Different | October 2023

"The four most dangerous words in investing are: 'this time it's different'."
Sir John Templeton

It is an exciting time to be a bond nerd. After a few of the most volatile years we have ever seen, it now appears that we are in the midst of a paradigm shift in our world.

This shift is encapsulated in the 'higher-for-longer' slogan, which has sent 10y rates soaring over 1% since May and helped equities fall over 8% from their summer highs. These moves are the result of a debate unfolding in bond markets around two key questions.

The first is the future of hikes and cuts, and what the central bank has in store for their policy overnight rate. The second question is what are the appropriate levels for longer-term yields (i.e., 10y +), and what constitutes value further out on the curve?

While the nuances of these debates are fodder for us bond nerds, their ramifications will reverberate across asset classes and could alter how investors allocate going forward.

Just one night.

For most of this hiking cycle, the expectation was for central banks to reverse course and start cutting this year, eventually getting the overnight rate down to around 2.5%. But with the resilience of the economy and the stickiness of inflation, rate cuts have now been pushed into the distant future.

This is not to say that cuts are not expected eventually. As at the end of October, there were 2 or 3 priced in for the next couple of years. But the pace of the decline and the eventual landing point is being questioned.

From our perspective, unless forced to do so by an economic or financial crisis, central bankers would prefer to keep the overnight rate above 3%. This would give them the cushion to cut in case of an emergency. After all, they tried to build themselves this cushion in 2018, only to have the market throw a tantrum. Now that they have us anchored at 5%, it seems reasonable for them to use this opportunity to build in that extra protection.

The premium for term.

But even if the overnight rate is reduced to the neighborhood of 2.5%, where does that leave longer maturity rates? In other words, what is the appropriate term premium or additional yield that investors will require to buy longer-dated bonds?

From the early 90s to 2008, the 10y rate traded 1-3% above the overnight, sometimes going above or dipping below during aggressive moves from central banks or when recession fears were prevalent. But after the Great Financial Crisis (GFC), this premium compressed to 0.5% - 1.25%. The question now is what will it look like going forward.

As with all things related to the future, the eventual shape of the curve is unpredictable. But we would caution against putting too much emphasis on history lessons from the past 15 years. Times have a-changed.

The times they are a-changin.

We have gone from deflation lurking in the shadows to the boogeyman of inflation, and from Quantitative Easing (QE) to Quantitative Tightening (QT). And it is not only the central bankers whose demand for long bonds is waning.

Another feature of the post-GFC era was the rise of price-insensitive bond buyers. Wishing to avoid politically unpopular bail-outs, regulators forced commercial banks to hold much more government paper. Foreign central banks also become large buyers of US Treasuries, as these countries experienced significant growth in exports (China) and commodities (Russia.) Lastly, Japan (the poster child for deflation fears) embarked on a significant monetary easing program with negative interest rates and yield curve control (a form of QE). This meant even after hedging costs, that yields on the other side of the Pacific looked attractive to Japanese investors.

But now, these price-insensitive buyers are leaving the party. A string of bank failures (some due to holding too many long-dated Treasuries) did not result in new regulations requiring banks to hold more government bonds. If anything, they are now inclined to hold shorter-dated maturities. Meanwhile, China's growth is slowing and Japan is slowly pulling back yield curve control.

The convergence of fewer non-commercial bond buyers and significantly larger fiscal deficits has allowed the bond vigilantes to reassert their power. With profits in mind, this crowd is keeping a watchful eye on government spending and political shenanigans as they decide what yield they require to own longer-maturity government debt.

Four dangerous words.

We are not going to fall into the trap of saying the four most dangerous words in investing, however, we will be so bold as to say, 'That time was different'. In other words, the past 15 years of 'new normal' were abnormal, and we could see the bond market returning to, well, normal. In that, it is possible to see a future where we have shifted from a 1-3% range to a 3-6% world.

Unfortunately, this implies slower economic growth, higher borrowing costs, and lower profits. The tailwind of declining and ultra-low rates, which propelled equities, real estate, and other risk assets, has now become a headwind.

Fortunately, all is not lost. As Sir Darwin taught us, the key to survival is adapting. And for investors, there is the opportunity to shift from investments that perform in a low-rate environment to those that benefit from higher rates. As bond nerds, we recognize we are talking about our own books, but given the yield on these books, we think you can understand why.

The Month of October.

Credit.

This year October brought lots of tricks and few treats. The dominant focus was the worrisome and saddening developments in the Middle East. Added into the mix was more rate volatility, resulting in equity markets losing 2-3%. In comparison, credit fared reasonably well with domestic and US investment grade spreads out 5 and 8 bps respectively.

- Canadian spreads widened 5 bps to 155 bps
- US spreads widened 8 bps to 129 bps

After a heavy month of domestic issuance in September, this month was one of the lightest on record with a measly $3 bn of new deals. The biggest deal came from Enbridge, with a $1 bn three-trancher. The other issuers were primarily utilities, asset managers, and REITs.

The month did see M&A activity spring to life in the Energy sector, with major acquisitions announced in the U.S. Exxon bought Pioneer for US$60 bn and a week later Chevron announced the US$50 bn acquisition of Hess. North of the border, we had Suncor's acquisition of TotalEnergies Canada and Tourmaline's purchase of Bonavista, both around US$1.1 bn.

On the ratings front, Ford was upgraded by S&P to investment grade (BBB-). While an eventual upgrade was expected by the market, the timing was surprising. This rating action will pave the way for Ford to return to IG indices and tighten the basis to GM debt.

Interest Rates.

Yield curves continued to steepen/un-invert, but there was a distinct cross-border difference. On the domestic side, the steepening came from a rally in the short end, whereas in the States it was the long end that steadily marched higher.

Sovereign yields:

- Canadian 2y finished at 4.64% (-23 bps) and the 10y at 4.06% (+4 bps)
- US 2y finished at 5.09% (+4 bps) and the 10y at 4.93% (+36 bps)

The Funds.

Algonquin Debt Strategies Fund.

The move wider in credit spreads ate into most of the portfolio yield on the month, with the Fund getting some benefit from interest rate duration hedges.

Portfolio Metrics:

- 10-11% yield
- IR Duration: 1.9y
- Average maturity: 1.5y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.22%	1.03%	3.79%	6.65%	9.90%	3.71%	3.87%	7.70%
F Class	0.17%	0.85%	3.30%	6.04%	9.17%	2.99%	3.14%	4.63%

*As of October 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 portfolio yield and profits from Canadian interest rates were offset by the sell-off in credit and US 10y yields.

Portfolio Metrics:

- 8-8.5% yield
- IR Duration: 4.5y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	-0.05%	-1.75%	-1.92%	2.22%	5.48%	-6.15%	2.42%	10.53%

*As of October 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.

We expect new issue activity to increase after Q3 earnings but do not foresee a significant calendar. Lighter issuance would normally bode well for credit but for now, geopolitical concerns are at the forefront of the market.

Canadian banks are in 'blackout' which means no capital deals despite regulators increasing the domestic stability buffer to 3.5% as of November 1st. We expect to see this buffer increase to 4% in December. This change improves the credit quality of the banks as they are forced to increase the amount of capital on the books. Given these developments, we continue to favour senior bank paper which is trading at historically cheap levels.

The economy is starting to show signs of strain, with lower growth forecasts for 2024. Normally this would be a reason for concern. But with inflation slowly edging lower, the markets may not be as troubled by such prospects, as central banks could ease rates if there is a material slowdown.

The 'higher-for-longer' narrative means a tougher slog for most risk assets, with capital gains harder to come by. The good news is that higher rates also mean higher yields are available from quality debt. With the opportunity to earn equity-like returns with the security and certainty of bonds, fixed income is looking very attractive on an outright and relative value basis.

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