Year Of The Bond: The Sequel | December 2023

"Great success breeds a lot of things, including sequels."
Dwayne 'The Rock' Johnson

This time last year, 2023 was being touted as the 'Year of the Bond'. Elevated yields offered investors attractive income and the prognosticators were forecasting rate cuts to start in the summer.

Being good students of Yogi Berra, we understand that 'it's tough to make predictions, especially about the future', and the only forecast we felt confident making was to expect heightened volatility.

Our first assumption was that investors would react to each bit of economic data, trying to anticipate the central bankers' next move. Our second assumption was that the data would provide mixed signals, causing the bond market to swing from one extreme to the next.

In the end, we witnessed rates trading in a big 1.5% range only to finish the year pretty much where they started. The US 10y began and ended the year at the same level (3.88%), and the Canadian 10y finished 2023 a modest 20 bps lower (from 3.30% to 3.10%). This is despite the expected rate cuts not materializing, and the Bank of Canada (BoC) and the Federal Reserve (Fed) instead delivering three and four hikes respectively.

But as they say, the past is history, and markets are always looking forward. So now, everyone is wondering what fixed income has in store for 2024.

The 2024 base case.

Based on what is built into the yield curves, the expectation is for the Fed and BoC to deliver 5-6 cuts lowering the overnight rate by 1.25 - 1.5%. The cutting cycle is expected to begin in the spring and continue into 2025.

Last year, we were skeptical when rate cuts were being priced into the market, but with inflation cooling, the economy slowing, and labour easing, we feel it is reasonable for central bankers to start easing this year. The big question now is the timing and magnitude of the cuts.

The pace that is currently being reflected by rate markets would coincide with either a soft landing or a mild recession. We say either or, as we do not see a material difference between very low and slightly negative growth. The media outlets will trot out the scary 'R-word' if GDP dips below zero, but we do not foresee the markets overreacting to small negative prints.

So for now, similar to many other asset classes, the bond market is pricing in an economy that weakens without breaking, enabling the central banks to gradually reduce rates back towards more neutral levels.

The wildcards.

But as always, the future is a mystery and there are an infinite number of possible paths ahead. One potential wildcard would be if inflation reaccelerates. Inflation is a mysterious beast, and several factors could see it once again rear its ugly head. As an example, surging oil prices could re-ignite the inflationary flames, which in turn could see rate cuts taken off the table and potentially lead to further hikes.

On the other hand, if the economic landing is a hard one, central bankers could be forced to cut interest rates more aggressively than currently expected. If unemployment were to spike higher, we could see overnight rates being lowered below neutral to stimulate the economy.

The sequel.

The future might be unpredictable, but there is some good news for fixed-income investors. Current yields offer a decent cushion for a wide range of potential outcomes and possible insurance in the event of a hard landing. And with most forecasts pointing to rates being lower a year from now, perhaps 2024 will be the 'Year of the Bond Part II'.

The Month of December.

Credit.

As rates continued their march lower, so continued the rally in risk assets, including credit. Canadian investment-grade spreads made up a little bit of ground on the US, outperforming in December but still trading 33 bps cheaper.

In terms of new deals, we saw some late-in-the-year financial issuance. CIBC, National Bank, Home Equity Bank, BMO, Canada Western, and RBC all brought deals. In addition, Dream and Chartwell rounded out the month with small transactions.

- Canadian spreads tightened 10 bps to 132 bps
- US spreads tightened 5 bps to 99 bps

Interest Rates.

The rally in interest rates, which began in late October, was kicked into high gear after the dovish Federal Reserve meeting. In the end, US and Canadian yields dropped 31-46 bps across the curve.

Sovereign yields:

- Canadian 2y finished at 3.89% (-31 bps) and the 10y at 3.11% (-44 bps)
- US 2y finished at 4.25% (-43 bps) and the 10y at 3.88% (-45 bps)

The Funds.

Algonquin Debt Strategies Fund.

The Fund had another solid month to finish the year on an especially positive note. The portfolio yield gave us a strong starting point, with the performance in credit spreads, and the active credit and rates trading further adding to the return.

Portfolio Metrics:

- 9% yield

- Average credit rating: A-
- Average maturity: 1.7y
- IR Duration: 1.1y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	1.97%	4.28%	6.58%	10.97%	10.97%	3.90%	5.20%	8.03%
F Class	1.81%	3.89%	5.92%	9.98%	9.98%	3.17%	4.40%	NA

*As of December 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

On top of an attractive portfolio carry, the Fund capitalized on the rally in both rates and credit to finish the year with a phenomenal December result of 3.49% and a 2023 return of 9.75%.

Portfolio Metrics:

- 6-7% yield
- IR Duration: 4y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	3.49%	7.32%	6.02%	9.75%	9.75%	-6.15%	2.42%	10.53%

*As of December 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.

After a long period of defying higher rates, it does seem that North American economies are showing signs of slowing down (more so in Canada than the US). As such, the excitement for the next few months should focus on whether there will be a recession and the timing of the first rate cut by either central bank. Barring a surprise to the upside with inflation, it makes sense to take advantage of yield increases to extend duration.

New deal activity is generally strong in January. Net issuance in both Canada and the US is expected to be lower this year as corporations lean towards improving financial flexibility. With central banks poised to lower rates, strong demand for fixed income coupled with lower supply ought to support credit spreads. Domestic IG credit spreads remain much wider than historical averages, while US IG and high yield are trading close to the bottom end of their ranges.

Although the risk of a hard landing is greater in Canada than in the US, we continue to favour high-quality domestic corporate debt given that a reasonable risk premium has been built in.

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