How Low Will They Go? | February 2024

Shemika Campbell holds the word limbo record at an astonishing 21.59 cm (8.5 inches).
The Guinness Book

Barring a reacceleration of inflation, it seems safe to assume that we have seen the last of the interest rate hikes in this cycle. Both Governor Macklem and Chairman Powell have indicated that rates are sufficiently high, with the latter referring to Fed Funds as being at its peak.

So now the focus has firmly shifted to the hotly anticipated cutting cycle, with most of the attention centered around the Federal Reserve's (Fed) and Bank of Canada's (BoC) timing and pace. In this regard, the market has pared back its original enthusiasm and is now expecting the cuts to begin in the summer with three (i.e., 75 bps) being delivered this year.

While the debate over 'when the central banks will start' is fodder for the media outlets, we think there is a far more important question investors should be asking. How low will they go?

The neutral approach.

One approach to answering this question is to consider the neutral or natural rate of interest, the level which is neither restrictive nor accommodating. For the past 15 years, economists have thought this to be in the ballpark of 2.5%.

In previous commentaries, we stated our rationale for leaning towards neutral being higher today than in the post-2008 ('new normal') era. But even if we are right, the policy rate need not be set at neutral. It is not today nor has it been for over a decade.

The not so 'new normal'

From 2010-2020, despite neutral theoretically being 2.5%, overnight rates were much lower, averaging below 1%. During this period, inflation hovered below its 2% target, averaging 1.7%, with the spectre of deflation lurking in the shadows.

Forces such as globalism (i.e., exporting inflation to China), demographics, and automation were depressing prices. Furthermore, the recovery from the Great Financial Crisis (GFC) was much slower than anticipated. This led to central banks adopting and maintaining accommodative policies.

The result of these policies was that overnight rates (and almost all government bond yields) were at or below inflation. In other words, a negative real yield and in some cases just an outright negative yield.

The noughties.

But this was not the case from 2000-2008, from the dot com bubble to GFC. While rates were below the 'old skool' levels of the 90s, they were still above inflation and offered the bond investor a lil' sumpin' sumpin.'

Through this period, Canadian CPI averaged 2.3% and the overnight rate 3.5%. This positive real yield of over 1% was seen as critical in keeping inflation within range of the 2% target.

Keeping it real.

Today we once again find ourselves needing to apply downward pressure on inflation. Thus, it would seem logical for central banks to keep overnight rates above inflation.

As such, we anticipate that they will be very cautious about lowering rates too quickly or going too far (barring a deep recession). They have been bitten badly by inflation and do not want to repeat the mistakes of the 70's.

But as always, the only constant is change. And the factors that determine inflation are constantly moving – demographics, technological advances, global trade, consumer preferences, climate, etc. Furthermore, we have yet to see the full impact of higher rates, and the battle could shift from inflation back to deflation.

In the meantime, we think it is important to ignore the noise around what the central bankers will do this year and to focus more on where they will ultimately land. And considering overnight rates relative to inflation (i.e., real yields), and whether downward or upward pressure on CPI is necessary, provides investors with another method of thinking about how low they will go.

The Month of February.

Credit.

Supply on both sides of the border continued at a breathtaking pace. The US set a new record for February with $200 bn of issuance (YTD $395B bn), while Canada followed up a record-breaking January with another $12 bn in February, bringing the YTD total to $25 bn.

Despite the onslaught of supply, deals did not require concessions to get done nor did they lead to weakness in credit markets. Canadian investment spreads narrowed by 8 bps, while US spreads were flat. While Canadian credit made up some ground on the US, the cross-border basis remains wider than the long-term average. Accordingly, we anticipate the domestic market to outperform the US.

The spread movement in Canada was not uniform, as high-quality sectors such as banks and telcos widened marginally with BBB names outperforming. The performance of REIT bonds was a standout as several deals came with substantial negative new issue concessions and still performed well, forcing spreads on existing bonds to narrow as well. Notable real estate deals included strong showings from First Cap, H&R, Ventas, and Dream Summit. Other rarities included offerings from TMX Group and Finning. Notably, the domestic high-yield market was also open with deals from Cineplex and Cogeco.

The first couple of weeks of March should be busy as issuers pile in before the school break. We expect demand for credit to remain strong with investors continuing to allocate to the space. As such, we are taking the opportunity to add exposure to quality companies across the rating spectrum.

- Canadian spreads tightened 8 bps to 118 bps
- US spreads were flat at 96 bps

Interest Rates.

Stronger US inflation numbers lead to a re-think over how aggressive the Federal Reserve would be in cutting rates. Bond traders decided that March was far too early, which drove bond yields higher as they pushed the timing of the first cut into the summer. That same sentiment plagued the Canadian market, but to a lesser degree, as there are more signs that higher rates are restraining economic activity.

Sovereign yields:

- Canadian 2y finished at 4.18% (+21 bps) and the 10y at 3.49% (+17 bps)
- US 2y finished at 4.62% (+41 bps) and the 10y at 4.25% (+34 bps)

The Funds.

Algonquin Debt Strategies Fund.

It was another strong month for the Fund, with the performance driven by three main factors. The first was the rotation towards owning more BBB issuers, which significantly outperformed their A-rated peers. The high level of issuance activity also provided many tactical trading opportunities to generate excess returns. And finally, with the portfolio yield in the high-single digits, the Fund begins each month with a strong starting point.

Portfolio Metrics:

- 8-9% yield
- Average credit rating: A-
- Average maturity: 2y
- IR Duration: 1y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	1.41%	5.16%	8.16%	3.12%	10.84%	4.51%	5.18%	8.24%
F Class	1.29%	4.71%	7.39%	2.85%	9.62%	3.74%	4.37%	5.29%

*As of February 29th, 2024

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

Over the month, the gains from our credit positions and the portfolio yield were mainly offset by rising yields. We used the sell-off in rates to modestly increase duration. In general, we favour the under 5-year part of both the Canada and US curve, while also holding a small position in 10-year treasuries. We expect our exposure to interest rates to be higher than normal this year, however, we will do a little range trading to capitalize on the volatility.

Portfolio Metrics:

- 6-7% yield
- IR Duration: 4.6y
- Average maturity: 3y
- Average credit rating: A-

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	1M	3M	6M	YTD	1Y	2023	2022	2021	2020
F Class	0.03%	4.10%	6.40%	0.59%	7.94%	9.75%	-6.15%	2.42%	10.53%

*As of February 29th, 2024

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.

The debate over domestic investment grade supply versus demand in 2024 continues to evolve. Late last year, origination desks forecasted 'Negative Net Supply,' which meant issuance (estimated at $115 bn) would be less than the cash flow generated by coupons and maturities. The last time this occurred was 2018.

What a difference a couple of months make. So far this year, maturities and coupons are approximately $17.5 bn while total supply is roughly $27.8 bn. If the initial supply forecast is accurate the market is heading into a significant supply shortage with $87 bn of issuance compared to $111 bn of cash being generated in portfolios. Actual supply could be much higher than anticipated, but until this happens, there appears to be another powerful tailwind behind CAD IG spreads.

Barring a negative surprise, the investing landscape in credit looks favourable. We think it makes sense to steadily increase exposure to the BBB sector and will use new deals to do so. We also use any weakness or sell-offs in credit to add to our overall credit exposures.

In terms of rates, we think cuts are coming this year. In addition to the timing, we are also considering the cadence. For the most part, central banks tend to move at several meetings in a row, largely because adjusting rates tends to occur when economic conditions provide a sense of urgency. We have not seen such signals as of yet, so it is very possible that this cutting cycle could be a drawn-out affair.

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