

A Whiff of Stagflation | July 2025

'If you don't like the news, go out and make some of your own.'
Wes Nisker

After the 'liberation day' tariffs were unveiled, there was no shortage of doomsday prophecies. The assumption was that the proposed levies would raise prices, lower profits, and slow the economy.

In the days that followed, the administration's sharp policy reversals (i.e., TACO) turned fear into hope. The premise was that trade negotiations would result in more reasonable tariffs that wouldn't have a material impact on the economy. The market staged a remarkable recovery, with the bulls taking complete control and the doomsayers retreating into obscurity.

Initially, the data supported the market's optimism. Inflation was declining, the labour market remained strong, and earnings were robust. It seemed the Americans could have their apple pie and eat it, too. They could reshape global trade and collect tariff revenue to offset the extension of tax cuts without incurring negative economic consequences.

That was until the July data gave us our first whiff of stagflation.

Inflation, which had been trending lower, turned higher, suggesting that businesses were starting to pass on the costs of tariffs. At their July meeting, the FOMC held the policy rate steady, citing that inflation remained elevated and that price increases due to tariffs were only beginning to emerge. And with a balanced labour market (i.e., a low unemployment rate), most committee members felt they had the luxury of being patient with rate cuts.

Off with her head.

But less than 48 hours later, the employment report challenged the 'balanced labour market' assumption. Not only did July payrolls come in below expectations (73k vs 104k expected), but the big shock came from a 258k negative revision to the previous two months.

The average number of jobs created was revised to approximately 35k per month, well below the 75k to 100k needed to absorb new workers. Trump responded by adding another person to the job seeker category, firing the head of the Bureau of Labour Statistics shortly after the report was released.

Trend lines.

Although one set of data does not constitute a trend (you need two points to draw a line), July's numbers suggest the US economy is not as healthy as previously believed. And with tariffs of 10-50% taking effect last week, companies may start passing on or cutting costs (i.e., raising prices or implementing layoffs).

An analysis by Goldman Sachs estimated that through June, consumers absorbed 22% of the tariff costs, exporters 14%, with US companies taking the bulk of the hit. They also forecast that as companies pass on the tariff burden to consumers, core PCE will rise an additional 0.5% over the rest of the year.

If this materializes, the incoming data could heighten stagflation fears, with the doomsayers emerging from hiding. And if both inflation and unemployment trend higher, the Fed's dual mandates come into conflict at a time when the FOMC is already divided.

Central bank tug-of-war.

With the committee members disagreeing over whether to cut or not, there could be data points to support every member's view on the state of the economy. Those in 'camp cut' will point to signs of weakness, while the 'hold-steady crew' will highlight any inflationary pressures. The doves will be dovish and the hawks will be hawkish.

With FOMC members allowed to express their personal opinions publicly, we suspect that a growing stream of conflicting signals will emerge. As a result, the bond market may struggle to chart a reasonable path for monetary policy.

With mixed signals and divided central bankers, we expect traders to adjust their rate expectations with each new economic release. As a result, we expect yields, which have been trading in a narrow range, to become significantly more volatile in the months ahead.

The Month of July.

Credit.

The risk-on rally continued in July, with investment-grade credit spreads tightening 5-20 bps. In addition to the positive market sentiment and momentum, credit benefited from a technical bid. Dealer inventories are light, and with positive fund flows, portfolio managers are looking to put cash to work.

On the supply front, July was busier than usual with ~\$9bn in corporate deals. We continued to see Maple issuers coming to the domestic market, particularly from insurers issuing FABNs (Funding Agreement Backed Notes). Notable issuers in the month included Mass Mutual, Athene, Pacific Life, GA Global Funding, Heathrow, and Equitable Bank.

Investment-grade credit spreads:

- Canadian spreads tightened -12 bps to 85 bps.
- US spreads tightened -12 bps to 75 bps.

Interest Rates.

It appears the Fed Chairman prefers to be remembered as 'Too Late Powell' rather than 'Pushover Powell'. At their July meetings, both the BoC and Fed kept policy rates steady. But for the first time since 1993, there were two dissenters in the Fed ranks, as Governors Waller and Bowman favoured a cut.

At the start of the month, strong employment data and optimism around trade deals sent yields marching higher. As the month progressed, hints that the Fed and BoC were leaning towards cutting rates (at some point) reversed some of the sell-off. By month-end, bond traders were expecting one to two cuts from the Fed this year, while giving a 50% chance that the BoC would cut once.

- Canadian 2y finished at 2.77% (+18 bps) and the 10y at 3.46% (+18 bps)
- US 2y finished at 3.96% (+24 bps) and the 10y at 4.38% (+15 bps)

The Funds.

Algonquin Debt Strategies Fund.

Despite maintaining a conservative risk posture, the Fund was able to capture a substantial portion of the credit market's rally. The move higher in short-end rates partially offset some of the gains from yield, credit, and active trading.

Portfolio Metrics:

- 4-6% yield
- Average credit rating: BBB+
- Average maturity: 2.5y
- IR Duration: 1.2y

	1M	3M	6M	YTD	1Y	3Y	5Y	10y	SI
X Class	0.80%	2.43%	2.22%	2.51%	7.11%	9.64%	6.60%	7.66%	8.24%
F Class	0.71%	2.18%	1.84%	2.07%	6.17%	8.63%	5.72%	NA	NA

* As of July 31st, 2025

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

While the sell-off in interest rates was a headwind for the Fund, duration losses were more than offset by gains from credit and active trading. We utilized the move higher in yields to add some duration exposure to the portfolio.

Portfolio Metrics:

- 4-5% yield
- Average credit rating: A-
- Average maturity: 2.8y
- IR Duration: 4.2y

	1M	3M	6M	YTD	1Y	2y	3y	5y	SI
F Class	0.23%	1.40%	2.02%	2.72%	7.30%	9.10%	7.49%	4.69%	5.00%

* As of July 31st, 2025

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 start of August typically sees little corporate issuance, with activity picking up towards the end of the month as some companies get ahead of the busy fall period. Falling yields ought to provide an even greater incentive to do so this year.

So far, demand remains strong, with issuers able to bring deals at tighter levels than their secondary paper. However, the chance of a supply-led weakness can not be discounted. At this point, some widening of spreads would be a welcome opportunity to add exposure at more attractive levels.

After remaining on the sidelines for several months, it appears that both the Fed and the BoC are inching closer to resuming rate cuts. Traders are going to watch the Fed's Jackson Hole gathering for signals that Chairman Powell is ready to cut rates. Meanwhile, the domestic market is flirting with the chance of the BoC cutting next month. We believe it will take further evidence of declining inflation to make this a reality.

Despite the odds of rate cuts moving higher, we remain skeptical that long-term yields will move dramatically lower from here. Uncertainty around inflation, Fed independence, and fiscal deficits may exert upward pressure on 10y+ rates.

Overall, we are maintaining a defensive posture, awaiting better opportunities to increase exposure. In the meantime, we are focusing on actively rotating positions, exploring idiosyncratic opportunities, and short-term trading strategies.

Contact

Algonquin Capital
40 King Street West, Suite 3402
Toronto, Ontario, M5H 3Y2
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 306-8401

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