



The Great Rate Debate | March 2021

“The only function of economic forecasting is to make astrology look respectable.”
John Kenneth Galbraith

Who would have thought the market spotlight could shift from Gamestop’s Reddit Army to the mundane world of fixed-income? But with material losses in long-duration bonds and warnings of rising yields, interest rates find themselves at the center of attention and heated debate.

The story thus far has been a ‘tale of two curves’. The overnight rate remains at 0.25% where the central bank intends to keep it anchored until 2023. Meanwhile, at the other end of the curve, the Canadian 10y has risen from the August lows of 0.4% to breach 1.5%, with most of the move occurring this year.

At the risk of planting a Guns N’ Roses earworm, the big question on everyone’s mind is: Where do we go now?

To unpack this question we find it instructive to split the interest rate curve into two parts: the short-end (≤ 5 years) and the long-end (> 5 years).

The short end.

The single greatest factor influencing the short end is the central bank policy rate. This is the rate that financial institutions borrow and lend to each other in the overnight market.

In response to the pandemic, this was lowered to 0.25%. The central bankers also communicated that this was the ‘effective lower bound’, indicating their reluctance to explore negative rates.

So, if the overnight rate isn’t going lower, the question is when will the central banks hike?

According to their communications, they are on hold until 2023. Historically, the spectre of inflation above 2% would drive the banks to pre-emptively hike.

But this time, they have indicated their willingness to let inflation run hot, shifting policy towards a long-term average approach. With CPI having run below 2% for the last decade, central bankers have given it room to drift above the target level.

Our interpretation is that their focus has shifted from inflation to jobs, with the goal of reaching and maintaining full employment. Through the pandemic, around 8.5mm Americans and 800k Canadians lost their jobs. Until these people are gainfully employed, we don’t foresee any changes to the policy rate.

Accordingly, monthly payroll numbers will become increasingly important and carefully scrutinized. The expected timing of the hikes will shift forward or backward from 2023 depending on whether employment growth is stronger or weaker than forecast.

In our humble opinion, the balance of risk is tilted towards a faster job recovery, which will push both the Federal Reserve and Bank of Canada to start hiking rates in the latter half of 2022.



The long end.

The further out the maturity spectrum one goes, the less influence the overnight rate has. Once past the 5-year point, its impact is minimal. Instead, the driving forces are inflation expectations and quantitative easing programs.

Just over a year ago, the Bank of Canada and Federal Reserve unleashed quantitative easing programs that dwarfed those of 2008. This applied downward pressure on rates, which was compounded by concerns of pandemic-induced deflation. And in August 2020 the yields on Canadian and US 10y bonds hit lows of 0.42% and 0.51% respectively.

But with vaccine rollouts underway and further stimulus packages approved, the tail-risk has shifted from deflation to inflation. In some areas (i.e commodities), a surge in consumer demand is already leading to price increases. This has many forecasters predicting inflation numbers exceeding 2.5% in the coming months.

Furthermore, as the economy recovers, the need for monetary stimulus will decrease. As such, the expectation is for quantitative easing programs to be scaled back this year.

As a result, long-end interest rates moved sharply higher with the Canadian 10y currently sitting at 1.51%. This increase represents a return to the middle of the range seen over the last decade. In essence, it's the level that allows investors to wait and see how the recovery unfolds.

So what are the bond markets waiting to see?

While investors are braced for higher inflation numbers over the next few months, the nagging question is whether these surges are temporary or not. The longer CPI prints above 2% without showing signs of leveling off, the more nervous bond investors will become.

In addition to inflation, people will be monitoring the size of deficit spending and the pace at which quantitative easing is tapered. We expect the BoC to scale back its bond purchases this month from \$4 bn a week to \$3 bn. While we don't foresee any 'taper tantrums' on the horizon, this does add to the upward pressure on yields.

Our view is that if CPI persists over 2% into the fall, it will become too difficult for bond markets to ignore. Furthermore, with reductions of bond purchases by central banks looming, we suspect it will be a case of 'sell first, ask questions later.'

The long and short of it.

Unless the vaccines prove ineffective against new variants, our base case assumption is for a strong economic recovery for the balance of the year. And while we can't predict monthly payroll and CPI numbers, we feel the balance of risk is tilted towards higher yields in the months to come.

The bottom line for bond investors is that duration is not your friend. When yields are this low, stable to decreasing interest rates are required to generate positive returns from fixed-income. Even mild increases in rates will lead to net losses, which could take years to recoup.



The Fund.

Although rising yields dominated the news headlines, for credit traders, the story was all about the deluge of supply. Fears of higher borrowing costs prompted several companies to accelerate their debt issuance plans.

The result was a record-breaking March in terms of domestic issuance causing some indigestion and modest spread widening. The US experienced a similar wave of supply, but the depth of the market meant it was more easily absorbed.

Generic Investment-Grade Credit Spreads:

- Canadian spreads widened 8 bps to finish at 110 bps
- US spreads widened 1 bps to finish at 91 bps

Notable Canadian deals included “LRCN-like” hybrids from two insurers: Sagan MI (a real estate insurer, like Canada Mortgage and Housing Trust); and Intact Financial. The high yield market was also open with Parkland Corp financing \$600 mm and Kruger Products issuing \$135 mm.

The previously loved Telecom sector was rocked by the announcement that Rogers is acquiring Shaw. In response, Roger's credit spreads widened up to 20 bps (depending on maturity) and 5 bps or so for Shaw. The sector was also further pressured by future spectrum financing and new supply from Verizon doing a two-part maple deal (\$1.5 bn total) and Bell Canada and Telus issuing about \$2 bn between them.

The Fund took advantage of the temporary, supply-driven weakness to establish positions in favoured issuers at attractive prices. While trading gains and yield offset the losses from weakness in credit, the move wider in domestic spreads landed us on the wrong side of zero for the month.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-0.08%	1.25%	5.19%	1.25%	25.30%	4.99%	7.70%	9.98%
F Class	-0.11%	1.05%	4.61%	1.05%	24.31%	4.18%	NA	NA

As of March 31st, 2021

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.

Looking Ahead.

In terms of deploying capital, we believe the LRCN/hybrid market will continue to grow as more investment-grade companies consider issuing subordinated debt rather than preferred shares. As such there will be opportunities for us in both new bond issues and existing preferred shares.

We expect continued supply in both the US and Canada as treasurers look at a path of higher underlying rates and decide to lock in low all-in yields today. Although this creates a technical headwind for markets, it allows the fund to reload at higher spreads.



In terms of investor demand, rising yields and losses from fixed-income could lead to significant redemptions from bond funds. However, thus far there has been little evidence of such behaviour. If anything, higher yields are leading to modest inflows for investment-grade bond funds based on US fund flow data.

Longer-term the return of animal spirits to the C-suite may lead to more merger and acquisition activity. Aside from telecoms, we note that Brookfield is as active as ever, taking over its property subsidiary, as well as bidding for Inter Pipeline Ltd. The extent to which this M&A activity is debt-financed is of concern to credit markets, but such action also leads to interesting opportunities.

For the time being, we look at some merger-proof sectors as good credits to own as the activity unfolds: the coddled Canadian banks sector (unless they make foreign acquisitions), pre-levered REITs, and captive auto finance entities are some areas that we have focussed on. In terms of potential acquisition targets, we have selective exposures in the midstream sector.

Despite several countries reimposing lockdown measures, investor confidence in vaccine efficacy remains the dominant theme as financial markets continue to perform well. Of course, this will change in a heartbeat if the variants can best the current vaccine treatments and rage unabated. This is a potential development that we are closely monitoring.

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

Disclaimer

Algonquin Capital Corporation (“Algonquin”) is registered with the Ontario Securities Commission as an exempt market dealer, investment fund manager, and portfolio manager. This commentary is confidential and for authorized use only. Under no circumstances are its contents to be reproduced or distributed to the public, media, or potential investors without written authorization. The information contained herein, while obtained from sources believed to be reliable, is not guaranteed as to its accuracy or completeness.

The information contained in this commentary is not investment or financial product advice and is not intended to be used as the basis for making an investment decision. This commentary by Algonquin is not, and does not constitute, an offer to sell or the solicitation, invitation, or recommendation to purchase any securities.

This commentary contains statements that constitute “forward-looking statements”. Examples of these forward-looking statements include, but are not limited to, (i) statements regarding future results of operations and financial condition, (ii) statements of plans, objectives or goals and (iii) statements of assumptions underlying those statements. Words such as “may”, “will”, “expect”, “intend”, “plan”, “estimate”, “anticipate”, “believe”, “continue”, “probability”, “risk” and other similar words are intended to identify forward-looking statements but are not the exclusive means of identifying those statements. Forward-looking statements included herein are based on current expectations and beliefs, and Algonquin disclaims, other than as required by law, any obligation to update any forward-looking statements whether as a result of new information, results, future events, circumstances, or if Algonquin’s expectations or opinions should change, or otherwise. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that such predictions, forecasts, projections, and other forward-looking statements will not be achieved. A number of important factors could cause Algonquin’s actual results to differ materially from the plans, objectives, expectations, estimates, and intentions expressed in such forward-looking statements. As such, undue reliance should not be placed on any forward-looking statement.