



## Rate Expectations | February 2023

“Ask no questions, and you'll be told no lies.”  
Charles Dickens

Boring old bonds have been anything but lately. Investors that were lured back into fixed income have been treated to some wild bouts of volatility, with the pendulum swinging from one extreme to the other (and in short order).

The year began full of optimism, with bonds offering attractive yields and talk of rates declining. The consensus view was that we would see higher rates slowing the economy, causing inflation to fall, thus enabling central banks to begin easing monetary conditions.

The expectation was for the Bank of Canada (BoC) to remain on pause until the summer and then deliver two rate cuts later this year. This led to rates declining 0.30 – 0.40% in January and bond indices returning 3% to start the year.

But oh, what a difference a month makes.

### February blues.

In February we got the first set of 2023 economic data, and the numbers told a rather different story. Both US and Canadian employment crushed expectations, with US payrolls coming in at 517k (vs. 185k estimate) and Canada adding 150k jobs (vs. 15k estimate). Although CPI is coming down, the pace of the decline was less than the market had anticipated (or hoped for).

The sanguine view that inflation was under control came into question, resulting in a dramatic shift in rate expectations. Instead of anticipating a cut in Q3, the market began pricing in a hike. This led to yields reversing course and finishing February 0.4 – 0.5% higher, leading to bond funds giving up most of their January gains.

### A mixed bag.

Such wild swings can be difficult for investors to understand and endure. The bad news is we do not see anything changing soon, as the pendulum is likely to continue swinging.

The problem is that at business cycle inflection points, it is only natural to get mixed data. Signs of both economic strength and weakness.

The BoC is aware of this and is unlikely to react to one or two months' worth of numbers. They have bought themselves time to wait for a trend to be established before needing to determine their next course of action.

But in the meantime, the manic depressive that is 'the Market' is likely to react to each new report that is released. Thus, as we muddle through this uncertainty, we expect rates to sell off on strong data and rally on weak numbers.

### What does this mean?

For passive investors, this means living with the volatility. While never fun, the good news is that higher yields offer a decent cushion for the bumpy road ahead. For example, earning 5% from a 5y bank bond protects an investor from a 1% rise in yields over a one-year period.



For active investors, the volatility can be an opportunity. Our approach has been simple; add rate exposure (i.e. duration) when strong data push yields higher, and reduce risk when signs of economic weakness drive them down.

### So, is duration my friend?

For those looking for greater certainty, our apologies. Until there is more clarity on inflation it is tough to have a strong conviction on the ultimate path of interest rates. Or more simply put, duration is not the ‘no-brainer’ that some would have us believe.

That is why we prefer to focus on value rather than timing. Rates are too unpredictable to be cute around the ‘when’, which is why we prefer to focus on the ‘where’, i.e. at what level are yields attractive? Like the real estate guys always say, ‘location, location, location’.

Based on what we know today, it is hard to say at which level rates are cheap, but at least there is some guidance on what is expensive. The BoC believes the neutral level for overnight rates is somewhere around 2.5%. Barring any big paradigm shifts or economic shocks, this seems a reasonable target for them to work towards in the long run.

Although we can not tell you when to buy, we can recommend when not to. As we do not see much value in adding longer-dated bonds when the Canadian 10y is yielding less than 3%.

### Ask the bot.

For our conclusion, we did what all the cool kids are doing. We asked ChatGPT. So here is the final thought from the bot:

“Overall, the outlook for interest rates in 2023 will depend on a range of factors, including inflation trends, economic growth, and the evolving global economic and financial conditions. The Bank of Canada will continue to monitor these factors closely and adjust its policy as needed to support the Canadian economy.

Investors will need to stay informed and vigilant in order to navigate these complex and rapidly changing conditions.

Beep Bop.”

### The Month of February.

#### Credit.

In a month that saw equity and bond indices down 2-3%, Canadian credit stood out in a good way, with a modest rally in investment grade spreads. The domestic market’s performance can be chalked up to thin supply, with a mere \$4.85 bn in new deals, the lowest February tally since 2013. The banks remained on the sidelines, with autos and telcos making up the majority of the new issue supply. Despite zero or negative concessions, the new deals were met with robust demand.

- Canadian spreads narrowed 5 bps to 145 bps
- US spreads widened 7 bps to 124 bps



### Interest Rates.

The February macro data showed that while rate hikes were working, the economy remained resilient. Inflation declined but not fast enough, and the labour market was red hot. This led the market to shift from expecting two rate cuts later in the year to pricing in another hike. The result was a sharp move higher in rates across the curve.

Sovereign yields:

- Canadian 2y finished at 4.20% (+45 bps) and the 10y at 3.33% (+41 bps)
- US 2y finished at 4.82% (+62 bps) and the 10y at 3.92% (+41 bps)

### The Funds.

#### Algonquin Debt Strategies Fund.

On top of the yield earned, the Fund capitalized on the modest rally in Canadian credit spreads to finish the month +0.75%.

Portfolio Metrics:

- 9-10 % yield
- IR Duration ~1y
- Average maturity: 2y
- Average credit rating: A-/BBB+

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.83%	4.26%	5.21%	3.25%	4.07%	2.63%	3.52%	7.93%
F Class	0.75%	4.14%	4.94%	3.18%	3.51%	1.99%	2.81%	N/A

\*As of February 28<sup>th</sup>, 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 1<sup>st</sup>, 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

We continue to be very nimble and active in the management of our rate exposure. After having increased duration into year-end, we reduced it down to ~2y at the end of January. As rates moved higher in February, we added exposure to finish the month with a duration of ~4y.

These portfolio shifts have led to a solid year-to-date performance, but the magnitude of the move in rates last month meant the Fund finished February in the red.

Portfolio Metrics:

- 7-8% yield
- IR Duration ~4y



- Average maturity: 3y
- Average credit rating: A-/BBB+

	1M	3M	6M	YTD	1Y	2022	2021	2020
F Class	-0.73%	2.27%	3.36%	2.28%	-0.33%	-6.15%	2.42%	10.53%

As of February 28<sup>th</sup>, 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.

Interest rate hikes take time to work through the economy. For example, many people have not felt the impact of higher mortgage rates since their renewal date is in the future. Furthermore, expansion plans that were underway often continue to completion, even if the company realizes that future revenues might not be as rosy.

This means that the growth indicators could point to both a weak and strong economy, making it difficult to determine the trend. The BoC is well aware of this issue, so will likely remain on pause for a few more months as it assesses how things are unfolding.

The inflation fight south of the border is proving to be more challenging, with fewer signs that higher rates are having the desired effect. Perhaps because the US consumer is less indebted and due to 30-year fixed mortgages being the norm south of the border. As a result, there is a higher probability that the Federal Reserve has to move rates higher than previously believed.

A higher terminal rate increases the possibility of a hard landing. This is why we continue to favour the highest quality issuers in the Canadian investment-grade universe (i.e. banks, telcos, energy infrastructure).

On a value basis, high yield continues to look expensive, and Canadian investment-grade credit is trading ~20 bps cheaper than its US counterpart. Also, credit downgrades are beginning to outpace upgrades, a reflection of deteriorating fundamentals. These risks are particularly acute in high-yield issuers and the lower tiers of investment-grade credit. These companies are more vulnerable to increased funding costs, margin pressures, and have fewer levers to preserve cash (dividends, asset sales, secured mortgages, etc.)

This does not imply that we are calling for a hard landing. But if one were to occur, we would rather be in the higher credit echelons, particularly as the spreads of these issuers remain attractive. We just do not see the need to reach for yield when there is plenty of good opportunities in the A/BBB rated sectors. As Paul Newman once said, 'Why go out for a hamburger when you have steak at home?'



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