

Moving Targets | April 2024

‘The archer who misses his mark does not blame the target.
He stops, corrects himself, and shoots again.’
Confucius

This time last year, we expressed our view that the neutral rate of interest (i.e., the level that is neither restrictive nor accommodating) was higher post-pandemic than in the ‘new normal’ era of 2008 – 2020.

At the time, central bankers disagreed with our position. Their research indicated that neutrality had not materially changed from its pre-pandemic levels.

But recently, their tune has changed, albeit slightly, with forecasts for neutral revised higher. The Fed has moved from 2.5% to 2.6%, while north of the border, there is chatter that this could be 0.25% higher than was previously assumed.

We suspect we will see further upward revisions to the neutral rate in the coming months. But we also think there is another target that central banks need to reconsider, that of 2% inflation.

[The origin story.](#)

The origins of the 2% inflation target are credited to the Kiwis, where the Reserve Bank of New Zealand adopted it in 1989. Interestingly, this number was not the result of academic studies or economic models but originated from an offhand comment (in a television interview) by the finance minister about the ideal range being 0-1%. The Reserve Bank took that as a starting point and made an upward bias revision to arrive at the 2% target.

In 1991, Canada became the second country to adopt this target, with the Bank of Canada (BoC) and the government agreeing to reach 2% by 1995. After battling high inflation through the late 70s and 80s, a ‘low and stable’ rate was seen as necessary for the efficient functioning of the economy. As once people are confident that they know what inflation will be, they can make long-range financial plans, leading to higher growth and lower unemployment rates.

Through both monetary and fiscal policy, the BoC and government successfully got inflation to their 2% target. This period also saw strong economic growth, leading to the agreement being renewed in 1995 and several more times since then (the most recent being 2021, extending to 2026).

But, because prices are sensitive to both persistent and temporary supply/demand imbalances, inflation rarely sits at precisely 2.0%. Thus, to avoid constant interest rate adjustments to keep CPI glued to 2%, the Bank conducts monetary policy to maintain it in a 1-3% band.

This brings us to the here and now and the proverbial ‘last mile’ in our current battle with inflation.

[The last mile.](#)

While we have seen considerable progress in domestic inflation (now below 3%), progress south of the border has not only stalled but has reversed direction. Furthermore, certain structural economic changes could mean inflation gets stuck at the higher end of the preferred band (i.e., 2.5%).

The transition away from fossil fuels is putting upward pressure on energy costs, which in turn spills over into manufacturing, transportation, and food production (to name a few). We also have the restructuring of global supply chains, with onshoring (or friend-shoring) leading to increased production costs.

As for demographics, that remains a mystery. For many decades, people have pointed to Japan as the prime example of an aging population that has led to deflation. What is missing from this narrative is the impact of immigration.

Canada's population is growing quickly, and more importantly, the newcomers are arriving in their prime spending years as they find jobs, buy houses, and raise families. Meanwhile, many 'boomers' are in the 'go-go' years of retirement, where spending on leisure and travel usually rises. Thus, it isn't clear that the 'aging' population and low birth rates will exert deflationary pressures.

Thus, the downward force on prices might be left to technology and generative AI. However, how the robot revolution unfolds, and its impact on productivity remains to be seen.

The trade-off.

If the balance of these factors causes CPI to be mired somewhere between 2-3%, the BoC will have to consider an important trade-off. Restrain growth until inflation falls to 2% or accept that it will run hotter and avoid inflicting too much pain and unemployment on Canadians.

Forcing a deep recession when inflation is below 3% seems unlikely. Especially given that in December 2021, the BoC and the government made a joint statement that explicitly allows for flexibility within the 1-3% band for the Bank to maximize employment when conditions warrant.

Accordingly, we expect the BoC to cut rates; however, we see the terminal point being much higher than in the post-2008 era. With the potential for both inflation and the neutral rate to be higher, there is a genuine possibility that they will stop cutting at 3.5%.

If this is the case, the biggest impact would be felt further out the yield curve in 7y+ interest rates. Unless one believes that inverted curves are the 'new normal', long-term yields would have to rise to create an upward-sloping curve.

So, even with cuts being delivered, we could see long-end rates going higher. And investors hoping that the cutting cycle will produce strong returns from long-duration products could be sorely disappointed. Thus, as with many retail businesses, when it comes to duration, it's about location, location, location.

The Month of April.

Credit.

April was a fairly active month for corporate issuance, with a total of \$7.6 bn in domestic supply. From the auto sector we had deals from GM and BMW, while the 407 Highway decided not to bypass the market and issued long bonds. Rounding out the transportation theme, Canadian National Rail loaded up on \$1.25 bn of bonds in 5 and 30-year tranches.

We also saw some issuers come north of the border, as Wells Fargo (\$1.25 bn) and Citi (\$1 bn) tapped the maple market. And while not technically a maple, John Deere Canada issued a \$600m 5-year bond.



On the other side of cross-border issuance, RBC issued USD 1 bn of LRCNs at 7.5% and a back-end of 298 bps. These are much more attractive than the levels they would get in Canada and put a bit of a fire under C\$ LRCN. Also on the banking side, we saw several lines of preferred shares redeemed (RY and BMO), as these are being gradually replaced with more tax-efficient bonds.

With strong demand for the new deals and a generally supportive earnings season, credit spreads generically tightened a few bps.

- Canadian spreads tightened 4 bps to 116 bps
- US spreads narrowed 3 bps to 87 bps

Interest Rates.

With US inflation and employment continuing to surpass expectations, bond traders reduced their expectations for rate cuts and pushed them further into the future. Yields across both the US and Canadian curves rose, with a greater steepening bias north of the border.

Sovereign yields:

- Canadian 2y finished at 4.34% (+17 bps) and the 10y at 3.82% (+35 bps)
- US 2y finished at 5.04% (+41 bps) and the 10y at 4.68% (+48 bps)

The Funds.

Algonquin Debt Strategies Fund.

The Fund continues to benefit from the attractive portfolio yield earned every month. Returns were also bolstered through our credit positioning and tactical trading.

Portfolio Metrics:

- 7-9% yield
- Average credit rating: A-
- Average maturity: 2.3y
- IR Duration: 1.3y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.76%	2.94%	8.92%	4.68%	13.04%	4.88%	5.10%	8.27%
F Class	0.67%	2.64%	8.10%	4.22%	11.67%	4.08%	4.29%	NA

* As of April 30th, 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

The losses from the move higher in interest rates were mitigated through our active duration management, performance in credit positions, and the yield earned. However, the magnitude of the move in rates inevitably led to a negative month for the Fund.

Portfolio Metrics:

- 6-7% yield
- IR Duration: 4.2y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2023	2022	2021	2020
F Class	-0.84%	0.10%	8.07%	0.65%	6.00%	9.75%	-6.15%	2.42%	10.53%

*As of April 30th, 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.

Lately, there has been some chatter and noise around the potential for the Fed to deliver even more rate hikes. From our perspective, the bar for further increases is very high, and the next move will still be a cut. The question, of course, is when.

With US unemployment below 4%, the Fed can patiently watch the incoming data to be sure that the inflation uptick in Q1 is not a trend. But north of the border, it isn't clear that the Bank of Canada can afford to be equally patient.

With inflation within their target range, an unproductive economy, and rising unemployment, the BoC has pretty much indicated that rate cuts will start in June. How many cuts and how fast remains to be seen and is somewhat dependent on the US cycle.

We agree with some commentary that the BoC can cut twice or so before declines in the loonie manifest themselves into importing inflation. While a weaker currency is a concern, the BoC can be bolstered by the fact that goods inflation in the US is negative, and services are driving inflation. And we import a lot more goods than services.

Regarding credit, year-to-date supply continues to track well above last year. We believe corporations are taking advantage of relatively steady markets and strong fixed-income demand to issue new bonds. In doing so, they are locking in their funding and avoiding a potentially more volatile second half of the year. As such, we expect the issuance pace to slow down, which should support credit.



As for our positioning, we continue to be overweight Canadian investment-grade credit. Not only are the domestic issuers offering an additional 30 bps compared to their US peers, but we also see less interest rate risk north of the border.

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