ALGONQUIN
CAPITAL

The First Cut Is The Deepest | May 2024

"Let's enjoy the moment."
Tiff Macklem

Last week, the Bank of Canada (BoC) became the first of the G7 central banks to cut rates, lowering the overnight level from 5% to 4.75%. The decision was widely anticipated (i.e., 80%) and one we think was relatively easy for them to make.

The 5% level was proving sufficiently restrictive. Q4 GDP was 0.1%, and unemployment has risen 1% over the past year. Furthermore, inflation fell from 3.4% in December to 2.7%, and all the core measures are now below the 3% threshold.

So, with that, the BoC's cutting cycle has begun. When pressed on what to expect from their upcoming meetings, Governor Tiff Macklem responded, 'Let's enjoy the moment.'

While this first cut offers borrowers some enjoyment, we know everyone is already wondering what's next.

Let's get real.

After all, now that the journey has started, it is only natural for the attention to turn towards the final destination and the path towards it.

One approach is to consider the overnight rate in terms of the real yield (i.e., relative to inflation). In December, CPI was 3.4%, implying a real overnight rate of 1.6% (5%-3.4%). This level of restriction proved sufficient to slow the economy, increase unemployment, and reduce inflation.

Over the last several months, CPI has fallen to 2.7%. As a result, the real yield on the overnight rate rose from 1.6% to 2.3%. This effect is referred to as a passive tightening in monetary conditions, which threatens to put the economy into a protracted recession—an outcome the BoC (and all of us) would like to avoid.

Thus, in real terms, the BoC could easily cut another 50 bps just to maintain the level of restrictive policy and offset passive tightening.

Ahead of the Fed.

Some might scoff at this notion, questioning the BoC's ability to continue cutting ahead of the Fed, who seem in no rush to begin their easing campaign. The concern is that a growing differential in interest rates could lead to the loonie getting slammed.

While there are certainly limits to the amount of policy divergence, as Governor Macklem stated, we are 'not close to those limits.' We interpret this as him saying that the FX rate will not influence the Bank's decisions in the near term but could ultimately impact the terminal rate (i.e., how low they go).

In theory, a weaker currency compounds the effect of rate cuts, as it also supports growth (via exports) and puts upward pressure on inflation (via imports). Thus, a weaker loonie could imply less heavy lifting from the BoC and a higher terminal rate.

The bottom line.

In the meantime, it seems the Bank of Canada has a clear path to reducing the overnight rate to 4%. Beyond that, the picture gets murkier as the debate shifts to the much more difficult question of the Bank's final destination.

The Month of May.

Credit.

For math nerds, in absolute terms, the Canadian and US credit markets moved equally, just in opposite directions. Canadian investment grade spreads sold off 2 bps, while south of the border, they tightened 2 bps.

The underperformance in domestic credit can be chalked up to supply. Not only did we see $12.3 bn of new issues, but the market also prepared itself for a $7 bn deal from Coastal Gas (the biggest in Canadian history).

Notable new issues in May:

- Bell Canada with $1.5 bn of 10y and 30y bonds.
- EDF brought a maple deal, also across 10s and 30s.
- McDonald's issued $1 bn of McMaples.
- Reliance LP brought $400 mm of 7y paper.
- Ford brought its third deal of the year, printing $ 1bn of 4y and 7y bonds.
- Subordinated transactions were also popular, with Desjardins ($1 bn 10nc5) and Sun Life ($750 mm 12nc7) issuing Tier 2 bonds.
- In the high-yield market, Capital Power issued a $450 mm 30nc10 hybrid with an 8.125% coupon, and CES Energy Solutions came to market with a small $200 mm 5nc2 deal at 6.875%.
- An interesting structure that came to market for the first time was Intact Financial issuing a 10nc5 senior (not subordinated) note.

Bank results were mixed, with solid capital market earnings offset by higher loan loss provisions. From a credit perspective, capital remained strong across the six banks.

- RBC reported its first results after closing the acquisition of HSBC Bank Canada and came out with stronger-than-expected capital levels (12.8% CET1).
- TD Bank's AML fines and problems are causing underperformance, although TD went into these issues with very high capital levels.

With banks in blackout for most of the month and opting to issue in foreign markets (at more favourable levels), there was limited domestic supply. This led to the sector tightening over the month, in contrast to the broader market moves.

In company-specific news, Videotron was upgraded from high-yield to investment grade. We anticipate strong performance in this credit, as entering the index will result in new buyers emerging (similar to Ford's upgrade earlier this year).

Investment grade credit spreads:

- Canadian spreads widened 2 bps to 118 bps
- US spreads narrowed 2 bps to 85 bps

Interest Rates.

May started with robust domestic employment data, which cast doubts over a June cut. However, softer-than-expected inflation and GDP data reinvigorated optimism that the Bank of Canada would begin lowering rates in June. This time around, the market (and we) got it right.

South of the border, the economy continues to confound nearly everyone as it performs better than expected, although the economic numbers are beginning to lean toward moderation. And while 'fed-speak' tilted towards caution over cutting rates too soon, it certainly appears that the bar for further rate hikes is very high. As a result, US yields drifted lower.

Sovereign yields:

- Canadian 2y finished at 4.18% (-16 bps) and the 10y at 3.63% (-19 bps)
- US 2y finished at 4.87% (-16 bps) and the 10y at 4.50% (-18 bps)

The Funds.

Algonquin Debt Strategies Fund.

Despite weakness in domestic credit markets, the Fund posted another month of solid gains. The performance was driven by three main factors: the yield earned, the outperformance of our credit positions, and tactical rate trading.

Portfolio Metrics:

- 7-9% yield
- Average credit rating: A-
- Average maturity: 2.8y
- IR Duration: 1.3y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.93%	2.46%	7.74%	5.66%	13.50%	5.05%	5.27%	8.30%
F Class	0.84%	2.19%	7.00%	5.10%	12.09%	4.24%	4.44%	NA

* As of May 31st, 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 Fund benefitted from the additional rate exposure we added in April when yields sold off 20-50 bps. The remainder of the gain is attributed to the yield earned, credit positioning, and active trading.

Portfolio Metrics:

- 6-7% yield
- Average credit rating: A-
- Average maturity: 3.4y
- IR Duration: 4.3y

	1M	3M	6M	YTD	1Y	2023	2022	2021	2020
F Class	1.38%	1.45%	5.60%	2.04%	8.19%	9.75%	-6.15%	2.42%	10.53%

*As of May 31st, 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.

Now that the cutting cycle has begun, investors need to consider two critical questions: How low will they go, and what will yield curves look like?

At some point, we expect an upward-sloping interest rate curve; however, whether this occurs because 2-year yields drop below 10-year yields or because the 10-year rate moves higher is unclear. Our bottom line is that investing in long-duration bonds is not worth the 'brain damage' accompanying the position. As such, we prefer to concentrate our rate exposure on the short end of the curve and will use any back-up in yields to add to our positions.

In terms of credit, the BoC's easing cycle adds another significant tailwind to the mix of favourabe factors. We have considerable coupon payments in June, which will need to be invested. Now that the $7 bn Coastal Gas deal and June Fed meeting are in the rearview mirror, and with bank debt being cheaper to issue in the US, domestic supply should lighten. As a result, we could see Canadian spreads closing some of the 33 bps gap to the US market. Accordingly, we are increasing our Canadian IG exposure to take advantage of the potential move.

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