ALGONQUIN
CAPITAL

Shifting Battlegrounds | August 2024

"Cry havoc, and let slip the dogs of war."
Marc Anthony (Shakespeare)

Every war has costs: the casualties of battle, the broken eggs required to make an omelette. Leaders must weigh these against the potential benefits and price of inaction. And once the war is waged, this cost/benefit analysis must be continuously recalibrated.

In their fight against inflation, central bankers aggressively hiked rates, knowing this would have negative consequences, intended and unintended. They were counting on restrictive policy inevitably leading to a weaker economy and labour market.

These costs were deemed necessary evils in pursuing low and stable inflation. But now, with CPI under 3%, the battleground appears to have shifted.

The costs of war.

So far, the costs of the war on inflation have been slower economic growth and a rise in unemployment. Over the past 18 months, the unemployment rates in Canada and the US have gone from 5% and 3.4% to 6.4% and 4.3%, respectively.

Central banks accepted this trade-off to avoid the perils of price increases getting ingrained. After all, persistently high inflation threatens economic stability and living standards for all.

Simply put, 6% inflation impacts almost everyone, whereas 6% unemployment affects around 6% of people. For the Trekkies, it is like Mr. Spock sacrificing himself because 'the needs of the many outweigh the needs of the few.'

Assessing the damage.

But now that inflation is within striking distance of the 2% target, central bankers have the latitude to assess the fallout wrought by higher rates. Some of the damage is in the form of lower disposable cash for people and businesses, but a more significant concern is the fall in employment.

Current levels are not overly alarming, but the downward trend in job creation is causing concern. There is evidence that sharp increases in unemployment are a harbinger of recessions. Accordingly, central bankers seem to be shifting their focus from inflation to avoiding a hard landing.

The next battle.

At the recent Jackson Hole symposium, Federal Reserve (Fed) Chairman Powell acknowledged this shift, signalling that priorities have shifted from fighting inflation to protecting jobs. He went so far as to say that further cooling in the labour market would be 'unwelcome.'

Thus, unless inflation reaccelerates and central bankers have to wage a war on two fronts, employment and economic growth will determine the path of the cutting cycle. As such, labour data will likely be the dominant driver of market volatility for the remainder of this year and into the next.

The Month of August

Credit.

Typically, August sees very little activity in corporate bonds. That was not the case this year. Several companies came to market with domestic issuance totalling an August record of $8.7 bn.

- Enbridge ($1.8 bn) and SouthBow ($1.45 bn) did three tranche deals.
- Hydro One, Capital Power, Telus, Smart Centres, Canadian Western Bank, Primaris, HomeEquity Bank, Volkswagon and Manulife rounded out the investment grade names.
- A few high-yield issuers also tapped the market, as Chemtrade ($250 mm), ATS ($400 mm), and Surge Energy ($175 mm) completed successful transactions.

Demand remains robust for the new deals, but the supply volume and market volatility saw domestic credit spreads push modestly wider.

In other news, there was the potential acquisition of Seven Eleven by Couche Tard. If completed, this would lead to a significant increase in leverage and potential rating downgrade. Despite this, Couche Tard's spread only widened 10 bps. From our perspective, this muted reaction underprices the downside risk in the credit.

Lastly, the long-awaited downgrade of Bell Canada to BBB-mid had no meaningful spread impact.

Investment grade credit spreads:

- Canadian spreads widened 3 bps to 123 bps
- US spreads were unchanged at 93 bps

Interest Rates.

After several months of speculation, the Fed acknowledged it was time to adjust interest rate policy, fueling a nice drop in yields. US treasuries are priced for 100 bps of rate cuts over the next three meetings, meaning investors expect at least one 50 bps move.

Although the Bank of Canada has already embarked on its rate-cutting cycle, the potential for aggressive moves south of the border prompted domestic bond traders to push short-end yields slightly lower.

Sovereign yields:

- Canadian 2y finished at 3.33% (-12 bps), and the 10y at 3.16% (unchanged)
- US 2y finished at 3.92% (-34 bps), and the 10y at 3.90% (-13 bps)

The Funds.

Algonquin Debt Strategies Fund.

The widening in domestic credit spreads was more than offset by the carry and active trading, leading to a slight gain over the month.

Portfolio Metrics:

- 6-8% yield
- Average credit rating: A-
- Average maturity: 3y
- IR Duration: 1y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.09%	2.04%	4.54%	7.81%	13.07%	5.64%	5.48%	8.30%
F Class	0.05%	1.76%	3.99%	6.95%	11.67%	4.78%	4.64%	NA

* As of August 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 returns earned through portfolio yield and rate positioning were enough to compensate for the sell-off in Canadian credit, leading to a monthly gain of 0.50%.

Portfolio Metrics:

- 6-7% yield
- Average credit rating: A-
- Average maturity: 3.5y
- IR Duration: 2.6y

	1M	3M	6M	YTD	1Y	2023	2022	2021	2020
F Class	0.50%	3.57%	5.07%	5.68%	10.93%	9.75%	-6.15%	2.42%	10.53%

* As of August 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.

Corporate issuance has been robust so far this year. Fortunately, the tailwind of a cutting cycle has fueled a steady demand for bonds, allowing spreads to remain well contained. The window for issuance in the fall is a little smaller than usual, as we suspect most companies would prefer to avoid the period around the US election.

As such, September ought to be quite busy. The wild card is domestic supply from the banks, as raising debt in the US or Europe is cheaper. Given how much supply has already come, we expect new issue activity to be muted for the rest of the year. The lack of new deals should be another factor limiting how far credit spreads can widen.

Bond markets are now priced for the BoC to cut rates to 2.5-2.75% in 2025 and for the Fed to lower its policy rate to around 3%. While we cannot rule this out, there is scope for disappointment should economic growth accelerate and labour conditions improve.

Overall, we remain comfortable with the value in domestic credit spreads, but given the optimism in rate cuts, we are cautious with duration exposure.

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.