Choose Your Own Adventure | September 2024

"You are responsible because *you* choose!
Think carefully before you make a move! One mistake may be your last."
The Choose Your Own Adventure Warning

Over the past five years, the bond market story has read like a choose-your-own-adventure novel, jumping from one plot line to another. We had the emergency response to the pandemic, followed shortly thereafter by aggressive rate hikes in the fight against inflation.

Once again, the page has flipped to a new storyline: the rate-cutting cycle. With the Fed bringing a 'jumbo' cut to the party, the latest adventure is officially underway.

Skipping ahead.

Most authors will have readers stop at each central bank meeting to make a choice: 25 bps, 50bps, or pause. We find that too long and tedious and prefer to skip to the end of this act.

After all, we all know the direction this story is taking. The real question is, where does this journey end?

The consensus plotline.

The wisdom of the crowd (i.e., futures pricing and yield curves) sees this storyline ending next year with policy rates of 2.5%- 2.75% in Canada and 2.75%- 3% in the US. Based on their latest dot plot (September), the Fed agrees with the market's endpoint but forecasts a slower pace to get there.

If you disagree with the consensus and think cuts will be deeper, proceed to the next section. If, instead, you believe the central banks will stop higher, skip ahead to 'they stop higher'.

They go lower.

'Ouch', you have landed in a dark (hard) place. A world of high unemployment and negative growth has forced central bankers to drop rates to around 1% to stimulate the economy.

They stop higher.

In this scenario, the economy is resilient, and unemployment is contained, allowing central bankers to stop cutting rates. After all, why would they cut more than they have to? Maintaining a higher policy rate gives them room to respond should a crisis emerge later in the story.

The bottom line.

Ultimately, how this story unfolds is still too uncertain to predict. But there are two things we can be sure of: there will be plot twists, and overnight rates will be lower a year from now.

Sadly, for King Cash and his royal court of GICs and discount bonds, this means an abrupt end to their reign. With yields on these instruments steadily falling, investors are fleeing their kingdom in search of better returns.

The next act.

Where investors rotate their cash will depend on their objectives. As always, we are happy to discuss suitable ideas based on your and your client's needs.

Lastly, for those readers curious about what happens after the cuts are done, flip to next month's commentary.

The Month of September.

Credit.

The big news in September was the Fed kicking off its easing campaign with a 50-bps cut. This powered a rally across risk assets and increased demand for corporate debt. Portfolio managers scrambled to lock in reasonable coupons as government rates tumbled. And any sell-offs in yields spurred further buying of credit.

The new issue market saw robust demand, with deals heavily oversubscribed and repricing secondary curves tighter. With supply frontloaded this year, issuance is expected to slow down ahead of the US election.

Notable new issues:

- The REIT sector saw a resurgence of fundraising, with strong deals from Sienna, RioCan, and Allied Properties.
- Other interesting deals included a very successful inaugural deal from Stella-Jones and supply from WSP Global, CGI, Penske, and various financials and utilities.

Investment grade credit spreads:

- Canadian spreads tightened 7 bps to 116 bps.
- US spreads tightened 4 bps to 89 bps.

Interest Rates.

With the cutting cycle officially underway on both sides of the border, rates rallied, and yield curves steepened. Interestingly, at the end of Q3, US and Canadian 10y rates were only 10-15 bps lower than at the start of the year. Meanwhile, 2y yields fell almost 1% in Canada and 61 bps in the US.

Sovereign yields:

- Canadian 2y finished at 2.91% (-42 bps), and the 10y at 2.96% (-20 bps)
- US 2y finished at 3.64% (-28 bps), and the 10y at 3.78% (-12 bps)

The Funds.

Algonquin Debt Strategies Fund.

The Fund significantly outperformed the broader credit markets with a monthly return of 1.60%. The outperformance was driven by sector selection and active trading.

Portfolio Metrics:

- 6-8% yield
- Average credit rating: BBB+
- Average maturity: 3y

- IR Duration: 0.5y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	1.74%	3.30%	5.58%	9.69%	14.38%	6.03%	5.63%	8.42%
F Class	1.60%	2.95%	4.96%	8.66%	12.88%	5.14%	4.78%	5.60%

* As of September 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 Fund continued its run of solid performance with a strong return of 2.05% in September. While we reduced the portfolio duration, the Fund benefited from having the rate exposure concentrated in short-end yields. Outperformance from our credit positions further enhanced the returns.

Portfolio Metrics:

- 5-7% yield
- Average credit rating: A-
- Average maturity: 3.4y
- IR Duration: 2.5y

	1M	3M	6M	YTD	1Y	2023	2022	2021	2020
F Class	2.05%	4.68%	6.25%	7.85%	15.74%	9.75%	-6.15%	2.42%	10.53%

* As of September 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.

Being a central banker can be extremely difficult at times (e.g., the last few years). Fortunately, for the Bank of Canada, the next few months will be much easier than usual. Whenever they have to opine on policy rates, the only decision is whether to cut 25 bps or 50 bps.

The decision for Chairman Powell and his merry crew is not quite as simple. For the Fed, skipping a meeting might merit a few seconds of discussion. However, they, too, will enjoy a relatively straightforward process.

Unfortunately for investors, life is not so simple. Yields have already moved to incorporate the market's view on the terminal policy rate for this cycle. This means you can no longer simply ride the trend. We think duration management now is about 'trading the range.' We expect the market to overreact to each economic data release and are positioned to capitalize on the volatility.

As for credit, the path of least resistance for spreads seems to be tighter. Demand for fixed income continues to be strong and could grow more robust as people rotate out of cash and money markets. Meanwhile, we suspect new deals were frontloaded this year to avoid the US election and to capitalize on receptive buyers. So, the expectation is for supply to slow down.

Against the supportive technical picture, we have a backdrop of economic uncertainty, the US election, and geopolitical risks. As such, we continue to monitor and adapt our hedging strategies and maintain flexibility in the portfolios should markets sell-off.

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