ALGONQUIN
CAPITAL

Fast & Furious XI: Tariff Wars | February 2025

‘I live my life a quarter mile at a time.’
Dominic Toretto

It seems the Trump administration has taken a page out of one of Hollywood’s most successful franchises, *The Fast & The Furious*. The policy blitz since inauguration has been as frantic and dizzying as the car chases that made the movies so popular. And like the drivers in pursuit of the elusive Dominic Toretto (Vin Diesel), governments, businesses, and markets are struggling to keep up with the barrage of executive orders.

Sticking to the Hollywood script, while Trump is moving fast, one move in particular is making Canadians furious: tariffs. As fellow Canadians, we hope this crisis does not go to waste and that we emerge as a stronger nation with a more diversified economy. In the meantime, we are focused on the economic fallout and how the Bank of Canada (BoC) will respond.

The disclaimer.

Having traded for decades, we profoundly respect how unpredictable the future is. But these days, uncertainty has gone to a whole new level, where 180° turns can occur with the stroke of a pen or a tweet (or whatever they are called on X).

Nonetheless, we will humbly attempt to unpack tariffs and the potential monetary response from the BoC, beginning with what we kind of, sort of know today.

The ‘sort of, kinda’ knowns.

If 10% levies on energy and 25% on everything else are actually implemented, Canada would likely slip into a recession. Assuming the tariffs remain in place for the rest of the year, the estimated hit to GDP is 1.5%- 2.5%, and unemployment is expected to rise to 7.5%- 8%.

The proposed counter-tariffs on US goods would put upward pressure on inflation, potentially pushing CPI from 2% to 2.5%-2.7%. This stagflation scenario would put the BoC in a difficult position.

Rock and a hard place.

The BoC’s sole mandate is to keep inflation within a 1%- 3% band. Thus, on the surface, CPI pushing toward the upper limit would imply that they hold rates steady or even prepare to hike.

However, the BoC tends to look 12-18 months into the future, and with declining growth and rising unemployment, a wage and inflation spiral is unlikely. Accordingly, if this scenario played out, we think they will continue cutting rates, with the overnight rate potentially dropping to 2% or lower. But for now, this is all theoretical conjecture, as there are still far too many unknowns.

The unknowns.

Unfortunately, the list of unknowns keeps growing and is ever-changing. How long will tariffs last, will the rates change, and will there be carve-outs (e.g., autos, USMCA)? How will the Loonie respond, and what fiscal stimulus will the federal and provincial governments deliver? What other non-tariff policies could materially impact the economy?

The BoC playbook.

Ultimately, these unknowns will determine the pace and magnitude of the BoC's cuts. In the meantime, it seems reasonable to expect lower growth in Canada and for them to cut 25 bps at their next meeting. After all, another cut does little harm and gets us to the middle of the range for the neutral rate.

We also expect them to provide little (if any) forward guidance this month. The governors will likely wait until April when they are due to provide updated economic forecasts. At least at that point, they should have more clarity on the proposed reciprocal tariffs and potential carve-outs. We could also be in the middle of a federal election, and the various parties will have announced their plans to deal with the tariff war.

In the meantime, perhaps the BoC will take a page out of the book of Dominic Toretto and take it a quarter of a percent at a time.

The Month of February.

Credit.

Tariff concerns and policy uncertainty led to a sell-off in credit on both sides of the border. Despite the tone, the domestic market saw $11.2 bn of new issuance across several issuers, with companies taking advantage of the tariffs being kicked out a month.

New issue notables:

- Largest monthly supply of FRNs with $900mm across three deals. These notes outperformed the new fixed-rate bonds that came to market.
- Enbridge and TC Energy came with big deals of $2.8 bn and $1 bn, respectively.
- REITs were busy with new issues from Primaris, Allied, Dream Summit, and an inaugural deal from Northwest Health.
- Despite the negative sentiment in the auto sector, GM came with an odd-sized $450mm 5y deal. The bond came at a healthy discount to secondaries and initially performed before being knocked back by auto tariff threats.

Investment grade credit spreads:

- Canadian spreads widened 6 bps to 109 bps.
- US spreads widened 8 bps to 87 bps.

Demand for credit remains robust, with strong inflows into investment-grade and high-yield funds. Against this, supply is expected to slow down. While these technicals support credit, macroeconomic uncertainty will be the dominant theme and driver of spreads.

Interest Rates.

Although trade wars push inflation higher and growth lower, bond traders chose to focus on the latter and moved to price additional rate cuts from both the Federal Reserve and Bank of Canada. As we type, the market has priced 2-3 more cuts from the BoC and the Fed to lower rates 75 bps later this year.

These odds change several times a day, so it is difficult to draw much from the price action other than to say that bond investors are becoming more concerned that growth is slowing.

Sovereign yields:

- Canadian 2y finished at 2.57% (-8 bps), and the 10y at 2.90% (-17 bps)
- US 2y finished at 3.99% (-21 bps), and the 10y at 4.21% (-33 bps)

The Funds.

Algonquin Debt Strategies Fund.

Despite the sell-off in credit, the Fund managed to generate a small positive return (F Class + 2 bps). The main factors impacting performance in February:

- Having significantly reduced credit exposures (50-60% of what we ran in 2024), the losses from the credit spread widening were mitigated and offset by the yield earned.
- The losses from credit were further offset by credit hedges (short positions) and gains from tactical rate trading

Portfolio Metrics:

- 5-7% yield
- Average credit rating: BBB+
- Average maturity: 2.8y
- IR Duration: 0.7y

	1M	3M	6M	YTD	1Y	3Y	5Y	10y	SI
X Class	0.06%	0.95%	4.75%	0.34%	9.51%	8.10%	5.58%	8.20%	8.37%
F Class	0.02%	0.78%	4.22%	0.24%	8.38%	7.14%	4.73%	NA	NA

* As of February 28th, 2025

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

With credit and rate risk at the lower end of our ranges, the main driver of the returns was the active management of interest rate exposures within a duration band of 2y-3.5y.

Portfolio Metrics:

- 4-6% yield
- Average credit rating: BBB+
- Average maturity: 3y
- IR Duration: 2.3y

	1M	3M	6M	YTD	1Y	2y	3y	5y	SI
F Class	0.44%	1.75%	5.10%	1.13%	10.43%	9.17%	5.91%	4.90%	5.10%

* As of February 28th, 2025

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.

The Austrian-British philosopher Sir Karl Popper is best known for his work on the scientific method, but it is his political musings that seem particularly relevant today. Writing during the rise of authoritarian regimes in Europe, he saw the risks of leaders making wholesale changes in pursuit of their vision. He believed their great error was neglecting the human factor: that institutions and societies are made up of individuals whose behaviour cannot be predicted or controlled.

"The greater the holistic changes attempted, the greater are their unintended and largely unexpected repercussions, forcing on the holistic engineer the expedient of piecemeal improvisation" or the "notorious phenomenon of unplanned planning." (The Poverty of Historicism).

Piecemeal improvisation and unplanned planning seem to be Trump's modus operandi. The administration's implementation of the 'American Exceptionalism' agenda has created upheaval in government agencies, global trade, immigration, and foreign policy. The ensuing turmoil has widened the breadth of economic outcomes and increased the odds of unintended consequences.

Accordingly, we will continue to maintain a defensive posture until risk premiums widen sufficiently or risks diminish. In the meantime, we are finding tactical trading opportunities in both credit and rates that allow us to hit a few singles.

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