The Immaculate Disinflation | January 2024

"It's a riddle wrapped in a mystery inside an enigma."
Winston Churchill

We have long maintained that inflation is a complex and mysterious beast. With so many moving parts, it is nearly impossible to model and predict.

A task made even more difficult these past few years, with new dynamics emerging from the pandemic, extreme monetary and fiscal policies, and conflicts in Ukraine and the Middle East.

Thanks to these and other factors, CPI soared to 8-9% before dropping down to current levels of around 3.5%. Unexpectedly, this dramatic decline has occurred without the expected economic weakness or unemployment.

Even with the benefit of hindsight, understanding the spike in inflation and the 'immaculate disinflation' is murky. There are just so many factors at play, leaving the causes open to interpretation, where the data can be made to fit different theories.

One such theory that has resurfaced from the depths of ridicule is that of inflation being transitory.

Some economists, including Nobel laureate Joseph E. Stiglitz, claim that team transitory was right all along. They argue that the surge in inflation was not driven by excessive aggregate demand, but instead by supply chain disruptions and shifts in consumption patterns.

Accordingly, this camp attributes the disinflation to improved supply chains and lower energy prices and not restrictive monetary policy. In fact, they argue that CPI has not come down due to central bank action but despite it. The argument is that rate hikes have elevated shelter costs, as higher rates restrict construction and thus housing supply and higher mortgage costs force more people into rentals thus pushing up rents.

Following this logic, restrictive rates were and are unnecessary in the battle against inflation. This implies that central banks can start easing without fears of CPI reaccelerating and thus avoid the risks of leaving rates too high for too long.

The obvious difficulty with this line of thinking is that we will never know what would have happened had the central banks not responded so aggressively. Those in the 'permanent' team argue that without the rate hikes, inflation would be much higher today.

While this camp acknowledges that some of the inflationary factors were indeed transient, they also point out the more long-lasting elements of labour shortages, wage growth, inflation expectations, and of course, the excess demand resulting from the flood of pandemic stimulus and increase in the money supply. To get these entrenched factors under control, central banks needed to take aggressive action.

In an attempt to dissect the factors causing the drop in US inflation, Allianz Research attributed an almost equal weighting to improved supply chains and actions taken by the Federal Reserve (Fed). Where the Fed's contribution came from both higher rates squeezing demand and their signaling helping to re-anchor inflation expectations.

Based on this analysis and the facts thus far, both sides can cherry-pick evidence and claim theoretical superiority. But until we have completed the 'last mile' in the battle against inflation, it seems premature for either team to be doing victory laps.

For now, we will file this mystery as unsolved, and wait to see which theory is more right (or less wrong). At this stage, the only thing we can be certain of is that the case of 'immaculate disinflation' will be the subject of innumerable Ph.D. dissertations and occupy economic theory wonks for years to come.

The Month of January.

Credit.

The strong demand for investment-grade credit continued in January with lower rate volatility, strong equity markets, and a continued belief in the soft landing scenario. New issuance set a record at almost $13 bn in Canada and a whopping $240 bn south of the border.

Normally this volume of supply causes a bit of indigestion resulting in a temporary widening of spreads, but not this time. Despite virtually no price concessions, deals were well over-subscribed, forcing investors to search for paper in secondary markets. As a result, spreads narrowed during the month.

Banks, auto financing, midstream energy, and REITS were featured issuers. Canadian banks tapped both the domestic and US markets. TD issued covered bonds, BNS did a 5yr bail-in bond, Canadian Western Bank and CIBC sold NVCC securities, and RBC brought an institutional preferred (AT1) to bolster capital ahead of closing the HSBC Canada acquisition. Perhaps the most interesting activity was in the REIT space, where the prospects of a soft landing and lower rates motivated buyers to move into a potentially undervalued sector.

- Canadian spreads tightened 6 bps to 126 bps
- US spreads tightened 3 bps to 96 bps

Interest Rates.

After two months of indiscriminate buying, investors used January to reassess where value lies on the yield curve. While central bankers acknowledged that the peak of the hiking cycle has been reached, they sought to temper expectations for a rapid cutting cycle.

Relative to the volatility we have gotten accustomed to, January was a more sanguine month. With rate hikes off the table, the market is now jockeying between the timing and pace of the cutting cycle.

Sovereign yields:

- Canadian 2y finished at 3.97% (+8 bps) and the 10y at 3.32% (+21 bps)
- US 2y finished at 4.21% (-4 bps) and the 10y at 3.91% (+3 bps)

The Funds.

Algonquin Debt Strategies Fund.

Two main factors led to the Fund outperforming the broader credit markets. Late last year we increased exposure to higher-beta securities (i.e., bank NVCC), and last month the spreads on these bonds experienced greater compression. The other factor was our concentration in shorter-dated paper which was in hot demand.

Portfolio Metrics:

- 8-9% yield
- Average credit rating: A-
- Average maturity: 2y
- IR Duration: 1y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	1.69%	5.80%	6.89%	1.69%	10.20%	4.14%	5.13%	8.16%
F Class	1.54%	5.32%	6.21%	1.54%	9.04%	3.39%	4.32%	5.18%

*As of January 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 move higher in rates was a headwind for the Fund, but the outperformance from our credit positions and the yield earned over the month more than compensated for the rise in yields.

Portfolio Metrics:

- 6-7% yield
- IR Duration: 4.5y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2023	2022	2021	2020
F Class	0.55%	7.97%	6.08%	0.55%	7.12%	9.75%	-6.15%	2.42%	10.53%

*As of January 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.

We think that both the Federal Reserve and the Bank of Canada will embark on a rate-cutting cycle later this year. Until then, yields will likely wax and wane as traders fixate on the date of the first cut and the number of cuts to come in 2024.

In our opinion, the start date is of little importance. As long as cuts begin, markets ought to be well supported, as the probability of a soft landing increases.

The nightmare scenario is one where inflation reaccelerates forcing central banks to pivot back to raising rates. To be clear, this is not our base case, but we remain cognizant that many outcomes remain possible, including a hard landing and the need for an aggressive cutting cycle.

In terms of what the market is expecting, we have been wary of the enthusiasm for spring rate cuts and the potential for disappointment. However, strong corporate earnings, robust fixed income demand, and resilient economic numbers paint a healthy picture for credit. We expect any corrections in investment-grade credit to be bought by investors. Thus, while we took profits in some shorter-dated holdings and trimmed positions to ensure plenty of dry powder, we continue to maintain a medium risk posture.

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