Anchors Aweigh | June 2024

"60 percent of the time, it works every time."
Brian Fantana in *Anchorman*

Of the many cognitive biases, the 'anchoring effect' is often cited as one of the most important and common. It is our tendency to overemphasize a reference point or initial piece of information we receive, even if they are otherwise irrelevant. There are countless examples of it in everyday life, and its robustness has been proven through numerous academic studies and experiments.

One of the most famous experiments was conducted by the dynamic duo of Tversky and Kahneman. In their study, participants began by spinning a 'wheel of fortune' rigged to stop at 10 or 65. The subjects were then asked if the percentage of African nations among U.N. members was larger or smaller than the number they spun.

The follow-up question was their best guess of the percentage of African countries in the U.N. The average estimate for those who spun 10 was 25%, whereas for those who landed on 65, the average guess was 45%. Even though spinning the wheel was completely arbitrary and provided no useful information, it materially affected the estimates. (Side note: the correct answer is 28%).

This phenomenon of psychological anchors is not confined to research laboratories but also exists in the real world. Perhaps the most common example comes from the most abused four-letter word, 'sale.'

Consider shopping for a new jacket and finding one marked down from $1000 to $600. Even if you only intended to spend $400, the significant discount from the original price could prove too tempting.

In both examples, the original anchors influence our judgment, even if they should not. This is the power of the 'anchoring effect' and something central bankers should not ignore as they embark on interest rate-cutting cycles.

The old, rusty anchor.

Following the GFC of 2008, central banks adopted a zero interest rate policy or 'ZIRP'. For the better part of a decade, the Federal Reserve (Fed) maintained the target overnight rate at 0-0.25%.

In December 2015, they began a slow return to normalcy by gradually hiking rates in 25 bps increments. In 2018, they delivered four such hikes, raising the overnight rate to 2.25- 2.50% and paving the path to 3%.

That was until the market had a tantrum, with equities dropping almost 20%. After being anchored at 0% for so long, investors perceived 3% as too high and restrictive.

The following year, the Fed had to backtrack and make a mid-cycle adjustment, cutting rates by 75 bps to a 'more reasonable' 1.5-1.75%. Unfortunately, this left them little room to respond to the pandemic with rate cuts, forcing them to unleash massive amounts of Quantitative Easing (Q.E.).

The shiny, new anchor.

Fast-forward to today, sprinkle in some recency bias, and we find ourselves anchored at around 5%. A couple of years ago, rates this high were unfathomable. Such a restrictive policy could only be accompanied by a severe recession.

But so far, the world has not ended. This has allowed central bankers to be patient when easing policy. If we continue to avoid a serious downturn, they could also leverage the new 5% anchor to their advantage. They can build the cushion they wanted in 2018 and have the room to cut in an emergency.

In the current environment, 3% overnight rates would be welcomed with open arms. They would be seen as a relief rather than a burden. In 2018, hiking to 3% took something away from us and invoked fears of loss. Today, cutting from our current anchors to 3% gives us something. Thus, giving the central bankers another psychological weapon should they wish to keep rates towards the higher end.

The Month of June.

Credit.

June saw a massive amount of new issue supply hit the domestic market. The $21 bn printed set a June record and was the second-highest of any month (next to March 2022).

A few highlights from this record-breaking supply month,

- $7 bn from Coastal Gas Link (the largest Canadian deal ever).
- $1 bn from Videotron (recently upgraded to investment grade).
- $3 bn in Tier 2 NVCCs from CIBC, BNS, and BMO (to replace maturing bonds)
- $1.3 bn from North West Redwater (after a 3-year absence).

The predictable consequence of such a flood of supply was widening credit spreads. The Canadian investment-grade index was +4 bps on the month. Given the amount of supply, the widening was modest. We attribute this to the strong demand for fixed income now that the Bank of Canada (BoC) has launched its long-awaited easing cycle.

Another notable development was the proposed acquisition of Canadian Western Bank by National Bank (CWB spreads outperformed as a result). The deal is expected to close by the end of 2025.

South of the border, the record-breaking pace of new issues continues. The first half of the year has seen the second most issuance on record (after 2020). With the market feeling supply fatigue and demanding larger concessions on new deals, spreads widened 9 bps.

Investment grade credit spreads:

- Canadian spreads widened 4 bps to 122 bps
- U.S. spreads widened 9 bps to 94 bps

Interest Rates.

The Bank of Canada (BoC) announced the start of a cutting cycle with a 25 bps cut in June. This immediately sparked a rally in short-maturity bonds as investors anticipated at least two more cuts this year. A more significant move was tempered by uncertainty about when the Federal Reserve (Fed) would join the party.

The U.S. economic outlook is coming into more balance. After several months of unambiguously strong data, we are seeing some pockets of weakness emerge as higher rates impose a drag. As a result, treasury yields drifted lower in hopes that the Fed would cut rates at least once this year.

Sovereign yields:

- Canadian 2y finished at 3.99% (-19 bps) and the 10y at 3.50% (-13 bps)
- U.S. 2y finished at 4.76% (-12 bps) and the 10y at 4.40% (-10 bps)

The Funds.

Algonquin Debt Strategies Fund.

Despite another month of spreads widening, the Fund posted another solid gain. The performance was driven by three main factors: the yield earned, tactical rate positioning, and credit trading.

Portfolio Metrics:

- 7-9% yield
- Average credit rating: A-
- Average maturity: 2.9y
- I.R. Duration: 1.2y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.50%	2.20%	6.18%	6.18%	13.17%	5.13%	5.15%	8.28%
F Class	0.43%	1.95%	5.55%	5.55%	11.79%	4.31%	4.34%	N.A.

* As of June 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 benefitted from the drop in yields over the month. We took the opportunity to reduce exposure to the 7and 10-year parts of the yield curve. 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: 3.6y
- I.R. Duration: 3.7y

	1M	3M	6M	YTD	1Y	2023	2022	2021	2020
F Class	0.96%	1.50%	3.02%	3.02%	9.08%	9.75%	-6.15%	2.42%	10.53%

*As of June 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.

History has taught us that supply-driven backups in credit spreads should be bought, especially as we move into the typically slower summer holiday period. With issuers on hiatus and portfolio managers still needing to put cash to work, spreads often grind tighter. Furthermore, this year, there has been a massive frontloading of corporate bond supply. By some estimates, 78% of the expected new issues for 2024 has already come to market.

We are prepared for adverse macro developments, but based on the supply forecast and the BoC cutting cycle, we feel a healthy long position is warranted.

With the BoC firmly in the cutting camp and the Fed inching closer to making an initial move, yields (at least for shorter maturities) ought to be contained from moving materially higher. Determining whether 10-year-plus yields offer value is a far trickier proposition. There are many variables to consider, such as the size of fiscal deficits, whether inflation will be sticky, etc. It does not appear to be worth the brain damage assessing value in the long end when the outlook is much more transparent in the short end.

Later this month, we will receive announcements from the BoC and Fed. Whether they cut depends on incoming data; however, we are confident that both banks will retain a dovish bias.

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