The Bucket List Revisited | March 2024

'I haven't been everywhere, but it's on my list.'
Susan Sontag

As bond nerds, we are constantly engaged in discussions with allocators and investors about their fixed-income portfolios. Three years ago, when interest rates were close to zero, these conversations were filled with a sense of frustration (and in some cases, another f-word).

In an attempt to address this discontent, we began asking folks what they wanted from their fixed-income investments. The answers varied from person to person, but over the hundreds of discussions we had, three common themes emerged: safety, hedging, and income.

Our approach was to split each of these desires into separate buckets and to look at the products that fit into each. We then evaluated the pros and cons of various fixed-income offerings according to the function and purpose they fulfilled.

While many investors found the 'three bucket method' useful, given where rates were when we published the commentary in 2021, the product evaluations tilted a little heavier on the cons side.

But three years and an aggressive hiking cycle later, a lot has changed in Bond Land. That is, except for the needs and desires of investors. In the conversations we are having today, people are still looking for the same three things; safety, hedging, and income.

Accordingly, we decided to dust off that analysis and update the fixed income bucket list for today's brave new rate world.

Safety.

The first bucket, safety, comprises cash and cash equivalents, where the preferred products are high-interest savings accounts, GICs, and money market funds. Today, we have also seen short-dated discount bonds added to this list, with their attractive blend of capital gains and income.

The purpose of these products is to meet specific cash needs or as savings vehicles for short-term investment objectives (eg. a downpayment on a home). They offer the investor capital preservation, minimal volatility, and a high degree of liquidity.

For many years, the problem with the safety bucket was the yield available was barely above 1%. But with the overnight rate at 5%, today an investor can earn a decent return with minimal to no risk.

While this is an attractive proposition, the issue with over-allocating to 'cash' is that there is no upside beyond the yield that you earn. And with rate cuts expected in the coming months, one is left with the prospect of earning less and less over time.

Hedging.

The second of our buckets addresses fixed income's role as a hedge against drawdowns in equities. This is achieved through exposure to interest rates, usually via government bonds.

Three years ago we expressed our skepticism about duration acting as portfolio insurance and declared that the 'Fed put was kaput'. We even warned investors about the potential one-two punch of higher rates leading to losses in both stocks and bonds, as was the case in 2022.

But now with policy rates deep into restrictive territory, central banks can break the glass in case of emergency, and respond to a crisis with aggressive cuts. While smaller moves in yields could still see positive correlations between fixed income and equities, in the event of a bad economic outcome, rate duration could dull the pain from losses in stocks.

Or more simply put, given where rates are today, the central bank put has been put back in place (sorry, we had to).

Income.

This brings us to the third and final bucket on our list; income. This one is the least straightforward, as it covers such a broad range of products. On the vanilla side of things, we have investment-grade debt yielding 4.5-5.5%. A few years ago, to earn that type of income investors had to venture into the high-yield market, where today bonds in that space are offering 7-8%.

For those seeking even more income, there is a plethora of options from emerging markets and private debt to all sorts of niche alternatives. These options span the risk/return spectrum, each with different levels of security, liquidity, and transparency.

Thus, when it comes to this bucket, investors must balance their needs and desires with their risk tolerance. For as with lunch, there is no such thing as free yield. So extra work is required to understand the risks one is eating.

Balancing the buckets.

Separating the products into buckets is the easy part. The more difficult step is balancing the pros and cons, as each bucket comes with a trade-off. Fortunately, the higher rate environment has made these trade-offs more palatable.

If you need safety, you can still earn a respectable return but will have little to gain if interest rates fall. If you hedge equities with duration, you have to deal with the volatility and potential losses from rising rates, but thanks to higher yields, you have a greater margin of safety. If you fancy more income, you need to take on more risk, however, for many investors, their income needs can be met with higher-quality bonds.

Thus, while higher interest rates are causing problems in many different areas, they have certainly made investing in fixed income much more attractive and the 'three bucket method' much easier to apply.

The Month of March.

Credit.

March saw a reversal of the previous month's moves in credit, with Canadian spreads underperforming the US. Over the month, domestic investment-grade spreads generically widened by 2 bps while US credit tightened 6 bps.

Supply on both sides of the border remained heavy, but investors managed to digest the new issues reasonably well. Q1 domestic issuance was one of the largest on record. While banks and finance companies made up the largest portion, the strong demand for corporate debt has enticed a wide array of borrowers to enter the fray. March saw approximately $12 bn of issuance, including 3 high yield offerings. We also saw NextEra Energy successfully complete an inaugural Maple deal, and REITs continued to be active with Crombie and RioCan tapping the market.

In rating news, Moody's and S&P placed BCE on a negative outlook after earnings were released. Despite a continued sell-off in BCE equity, its credit spreads have been stable.

Despite a slight widening this month due to supply, credit spreads traded well as money continued to pour into bond funds. At this point, we see little that ought to change the ongoing interest in bonds, which should be supportive of credit markets.

- Canadian spreads widened 2 bps to 120 bps
- US spreads narrowed 6 bps to 90 bps

Interest Rates.

Mixed signals on inflation and growth provided little direction for yields. Further progress in the fight against inflation or much weaker employment is needed before central bankers can provide greater clarity on their intentions. Until then, rates ought to remain fairly contained.

Sovereign yields:

- Canadian 2y finished at 4.18% (unchanged) and the 10y at 3.47% (-2 bps)
- US 2y finished at 4.62% (unchanged) and the 10y at 4.20% (-5 bps)

The Funds.

Algonquin Debt Strategies Fund.

Despite domestic credit spreads moving wider in March, the Fund was able to post a solid return for the month thanks to the yield earned, the active management, and the outperformance in our positions in banks and insurers.

Portfolio Metrics:

- 8-9% yield
- Average credit rating: A-
- Average maturity: 2.3y
- IR Duration: 1.3y

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.75%	3.89%	8.34%	3.89%	13.65%	4.80%	5.27%	8.25%
F Class	0.66%	3.53%	7.55%	3.53%	12.40%	4.01%	4.44%	5.32%

*As of March 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

With only modest moves in rates, the March performance was driven by the portfolio yield and the active management of our credit portfolio.

Portfolio Metrics:

- 6-7% yield
- IR Duration: 4.2y
- Average maturity: 3y
- Average credit rating: A-

	1M	3M	6M	YTD	1Y	2023	2022	2021	2020
F Class	0.91%	1.50%	8.93%	1.50%	8.40%	9.75%	-6.15%	2.42%	10.53%

*As of March 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.

Prospects for the Canadian and US economy continue to diverge. On the domestic front, higher rates are having the desired outcome of lowering inflation. But south of the border, the story is rather different. Progress on lowering inflation is at a virtual standstill, while economic growth remains strong.

The Fed has been talking about lowering rates for several months, but the economic data is not giving them much cover to do so. Accordingly, the treasury market has adjusted its expectations, with yields slowly moving higher, as rate cuts are pushed further into the future.

This could put the Bank of Canada (BoC) in the unenviable position of lowering rates, without much certainty that the Federal Reserve (Fed) will be following suit. Being too far ahead of the Fed puts downward pressure on the currency which in turn sends import prices higher (i.e., importing inflation).

We think the BoC could get away with 50 bps of cuts before the Fed, but delivering 100 bps without the Fed cutting seems unlikely. In the meantime, rate volatility is likely to increase, as each new data point reshapes the market's expectations of cuts.

On the credit, issuers have been very active, with US Q1 supply amounting to approximately 38% of last year's total, while domestic companies have already issued an eye-popping 69% of 2023 issuance. Attractive all-in yields coupled with the potential for lower rates means bond funds continue to attract capital, allowing for the incredible volume to be easily digested.

We think many domestic issuers have front-loaded their deals and will not have much more to do in the coming months. It is hard to see where a sudden urge to borrow more money is going to arise within the corporate sector. Limited prospective supply and steady inflows into fixed income should mean that portfolio managers are lined up to aggressively buy weakness.

In light of the positive technical picture, we have increased our credit exposure to medium-high.

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