# MONTHLY BOND LETTER

AlphaFixe Capital

OCTOBER 2016

## ECONOMIC EVENTS

- Canadian Finance Minister, Bill Morneau, announced measures to better supervise the real estate market. Going forward, only Canadian residents will benefit from the capital gains exception on the sale of a primary residence. Moreover, since October 17th, all borrowers are subject to a stress test to ensure that home buyers can still afford the mortgage in a rising interest rate environment. Instead of the current market rate, lenders will use the Bank of Canada rate, currently at 4.64%. In addition, starting on November 30th, insured mortgages with a down payment of more than 20 % will be subject to the same eligibility criteria as those with a lower down payment.

*The Federal Government wants to share the mortgage credit risk with financial institutions. Currently, mortgage insurance is directly or indirectly guaranteed by the CMHC. It is quite possible that our banks pass on the risk to customers in the form of higher mortgage rates. Why a national program to fight a real estate frenzy focused on two cities?*

- U.S. economic growth accelerated in the third quarter to an annualized rate of 2.9 %, compared to 1.4 % in the second quarter. Net exports contributed to this growth, as well as an inventory replenishment, following 5 consecutive quarters of reduction. On the other hand, consumer spending grew at (+ 2.1 %) half the rate of the previous quarter (+ 4.3 %).

*We should not worry about the decrease in household spending. Up by 2.1 %, consumption is growing at the potential growth rate. Over the past three years, households have increased their spending by 3.0 % annually compared to 1.7% for the previous three years.*

- The United Kingdom's economy grew at an annualized rate of 2 % during the three months following the Brexit vote. It is a decrease from the second quarter (2.8 %), but a nice surprise if one compares with the Bank of England's gloomy forecast. The service sector grew by 3.2 %, while manufacturing and construction have been decreasing.

*For the moment, the British economy appears resilient to the uncertainty surrounding the Brexit vote. The risk is not immediate, but should materialize in the long term when the separation terms will be negotiated.*

## RATE TRENDS

- Bank of Canada has decided to maintain its overnight rate at its last meeting, but has revised its growth profile downward on the back of an expected housing market downturn and weaken foreign trade. The Bank estimates that the new mortgage rules should curb residential investment in the coming quarters. With a softened stance, the Bank leaves the door open for further rate cuts.

*Now that the Federal Government tightened rules to mitigate real estate risk, the Bank seems more at ease to stimulate the economy. However, the uptake of a more accommodating speech depreciates the currency, which could make the Canadian assets more attractive to foreigners, including real estate.*

- The Bank of England kept its key rate at 0.25 % while increasing its forecasts for growth and inflation. The Monetary Authority has eliminated its bias in favor of an expansionary monetary policy given the current economic status and now perceives inflation as a risk in the long term. The country is a net importer and the post Brexit currency depreciation should propel the prices beyond the 2 % target rate of the Bank.

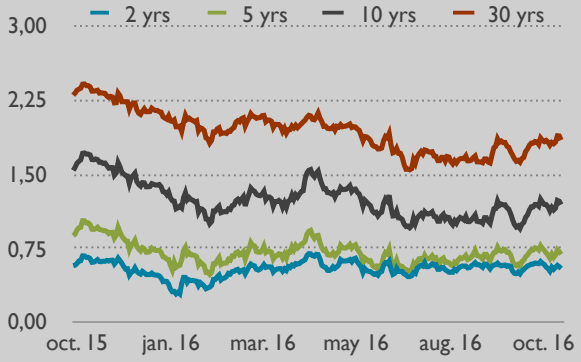
*It is a turnaround that could have been avoided. Why put in place a quantitative easing program which would depreciate the currency and thereafter worry about the inflationary effects of the decline in the currency?*

## BOND RATES

| Oct. 31 2016 | | Monthly Change | Change 2016 | | Monthly Change | Change 2016 |
|---|---|---|---|---|---|---|
| Key Interest Rate | 0,50 % | 0,00 % | 0,00 % | 0,50 % | 0,00 % | 0,00 % |
| 3 months | 0,48 % | -0,06 % | -0,04 % | 0,30 % | 0,03 % | 0,14 % |
| 2 years | 0,55 % | 0,03 % | 0,07 % | 0,84 % | 0,08 % | -0,21 % |
| 5 years | 0,69 % | 0,07 % | -0,04 % | 1,31 % | 0,16 % | -0,45 % |
| 10 years | 1,20 % | 0,20 % | -0,20 % | 1,83 % | 0,23 % | -0,44 % |
| 30 years | 1,85 % | 0,19 % | -0,30 % | 2,58 % | 0,26 % | -0,44 % |
| RRB 30 years | 0,23 % | 0,05 % | -0,41 % | | | |

Source: Bloomberg

## CANADIAN RATE TRENDS

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## CREDIT BOND RISK PREMIUMS

| ISSUER | Credit rating DBRS | Credit rating S&P | Spread 5 yrs | Spread 10 yrs | Spread 30 yrs | Change 5 yrs month | Change 5 yrs 2016 | Change 10 yrs month | Change 10 yrs 2016 | Change 30 yrs month | Change 30 yrs 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Royal Bank, deposit notes | AA | AA- | 95 | 110 | 155 | -5 | -40 | -10 | -45 | -5 | -35 |
| Manulife, Senior debt | A high | A+ | 115 | 140 | 190 | -5 | -30 | -5 | -30 | 0 | -20 |
| Fortis Inc. | BBB high | BBB+ | 135 | 185 | 240 | -5 | 0 | 0 | 20 | -5 | 25 |
| Hydro One | A high | A | 85 | 115 | 160 | 0 | -25 | -5 | -20 | 0 | -25 |
| Enbridge Inc | BBB high | BBB+ | 150 | 205 | 265 | -10 | -110 | -10 | -110 | -20 | -80 |
| Encana Corp | BBB low | BBB | 285 | 355 | 415 | -35 | -115 | -35 | -120 | -35 | -135 |
| GTAA | --- | A+ | 75 | 105 | 140 | 0 | -15 | 0 | -15 | -5 | -25 |
| Bell Canada | BBB high | BBB+ | 130 | 180 | 235 | -5 | -40 | -5 | -40 | 0 | -45 |
| Rogers Communications | BBB | BBB+ | 130 | 180 | 240 | -5 | -50 | -5 | -50 | -5 | -55 |
| Loblaw | BBB | BBB | 130 | 180 | 230 | -5 | -35 | -5 | -30 | -5 | -35 |
| Canadian Tire | BBB high | BBB+ | 135 | 185 | 235 | -5 | -25 | -5 | -20 | -5 | -25 |
| Province of Québec | A high | A+ | 60 | 86 | 101 | -3 | -8 | -1 | -11 | -2 | -9 |
| Province of Ontario | AA low | A+ | 60 | 85 | 97 | -3 | -8 | 0 | -11 | -1 | -9 |
| CMHC | AAA | AAA | 40 | 51 | --- | -4 | -9 | -2 | -8 | | |

Source: National Bank Financial

## CREDIT MARKET

- Canadian corporate bond new issuance reached $ 5 billion in the month of October, down $ 2 billion from the previous month and $1 billion less than in October 2015. Since the beginning of the year, corporate issuance reached $ 69.1 billion, or 11,8 % less than at the same date last year. The decline of new issues resulted in the tightening of spreads. According to the FTSE-TMX universe Index, corporate risk premium is at 144 bps at the end of October, down 4 bps in a month and 17 bps since the beginning of the year. New issuers include Kingston Solar, an entity that operates a 100 megawatt solar panel facility located in the city of Kingston and in the Loyalist region of Ontario. The facility is connected to Hydro One's electrical network and the issuer sells all the electricity generated to Ontario's Energy Board in accordance with a 20 year fixed-price purchase price agreement. The issuer's activities are in line with the Principles for Responsible Investment.

- Quebec's Finance Minister published an economic update reporting a larger budget surplus of $ 2.2 billion in the fiscal year 2015-16 on the back of higher than expected revenues. This surplus excludes $1.4 billion that will be deposited to the Generation Fund which is used to pay down debt. At March 31st, the level of gross debt has been reduced by $ 610 million to $ 203.3 billion, a first decrease since 1959. The gross debt to GDP ratio fell from 55.1 % to 53.8 %. Quebec will reinvest $ 288 million of the surplus in the current fiscal year and a total of $ 2.4 billion by 2020. The majority of these expenditures will be made in health, education and infrastructure.

- In early November, National Bank announced that it issued its first «panda» bond in China, which is a debt denominated in yuan (Chinese currency) by a foreign issuer. The chinese issue totalling 3.5 billion yuan ($ 690 million) is a first for a North American financial institution, but the second Canadian entity after the province of British Colombia. In addition to diversifying its sources of financing, the Bank said that this issue will benefit its Canadian customers who have business development goals in China.

## FTSE TMX INDEX PERFORMANCE

| Sector | Weight | october-16 | 2016 |
|---|---|---|---|
| Universe | 100 % | -0.91 | 4.33 |
| Short Term | 43,8 % | 0.03 | 1.55 |
| Mid Term | 24,1 % | -0.70 | 4.15 |
| Long Term | 32,2 % | -2.31 | 8.27 |
| Federal | 36,6 % | -0.79 | 2.56 |
| Provincial | 34,3 % | -1.42 | 5.43 |
| Corporates | 27,1 % | -0.40 | 5.23 |
| RRB | | -0.31 | 7.47 |

Source: ftse.com

*Quebec's budget has greatly improved, but risk concerns persist, namely export weakness and real estate uncertainty based on new mortgage rules. Therefore, the provincial budget cushion could be deployed to ensure economic stability.*

*We can draw two conclusions from this news. First, the Chinese corporate bond market seems to be developing, which reduces the risks to the shadow banking system. Second, our banking system continues to be well perceived among foreigners.*

## STRATEGIC POSITIONNING

Although the Bank of the Canada has maintained its monetary policy in October, Governor Poloz appears to have become more open to the idea of introducing further easing measures. The Monetary Authority was previously been caught between a rock and a hard place, how to improve the situation of Canadian exporters using monetary policy and currency depreciation without adding fuel to the real estate market in certain regions. Now that the Federal Government has implemented new mortgage rules to stabilize the housing market and mitigate vulnerabilities to households, the Bank can now focus on supporting foreign trade indirectly through currency depreciation. As shown in our research paper entitled "Pouvons-nous miser sur les exportations?", much of the manufacturing industry was destroyed to the benefit of the energy industry. Although the currency must remain at a low level for some time to rebuild factories, using monetary policy also brings some risk. If the currency depreciates further to reach its low point of the year (0,6859 US$), Canadian real estate will become attractive again to foreigners, which could neutralize the effect of the federal measures. If the Federal Reserve raises its key rate in December, the Bank of Canada will have a period of relief to reassess its strategy.