# MONTHLY BOND LETTER

AlphaFixe Capital

DECEMBER 2021

## ECONOMIC EVENTS

- The Canadian economy added 153,700 jobs in November, bringing the unemployment rate to 6.0%, the lowest since February. With this gain, employment is 186,000 above its pre-pandemic level. Job creation is fairly well balanced with 79,900 full-time and 73,800 part-time positions. No one industry stands out, in fact 11 of the 16 industries listed recorded gains. However, the jobs were not evenly distributed across the provinces. Ontario added 68,100 mostly full-time jobs while 45,500 new workers found employment in Quebec, mostly part-time. Alberta came in third with a gain of 15,400 jobs.

It should be noted that the impact of the flooding in British Columbia is not considered in this survey as it occurred after the survey date. All in all, this is confirmation that the labour market was robust at year-end, before Omicron spoiled the holiday season for everyone, especially for restaurant workers.

- The Consumer Price Index (CPI) in the United States reached 6.8% YoY in November and 4.9% if we remove food and energy. This is the fastest pace since 1982 for the CPI. Upward pressure on prices is becoming more widespread, not just concentrated in a few items. Energy costs showed the largest gain (33.3% year-over-year), especially gasoline (58.1%). Inflation also rose for housing (3.8%), food (6.1%), new vehicles (11.1%), used cars and trucks (31.4%), and clothing (5%).

After 9 consecutive months of inflation above 2%, the Federal Reserve had to reassess its temporary assessment of inflation and decided to accelerate its tapering of asset purchases. On the other hand, employment still remains below its pre-pandemic level, which provides the Fed with some leeway before raising its policy rate. Omicron could also delay things a bit, but the tolerance for inflation is getting thinner.

- In an effort to cushion the fall of the Turkish lira, President Erdogan announced a new program to protect people's bank deposits from currency fluctuations. Thus, if the depreciation of the currency eliminates the interest gain offered by banks on deposits of more than 3 months, the government will protect the deposit capital. For example, if banks are paying 15% for deposits in lira, but the currency depreciates by 20%, the Treasury would pay the difference to deposit holders.

It is therefore a disguised rate hike where taxpayers have to pay to protect the deposits of the richest. A tax that stems from the monetary policy mistakes orchestrated by Erdogan himself. Despite galloping inflation (36% in December), he stubbornly decided to cut the key rate.

## RATE TRENDS

- After several weeks of juggling with the idea, the Bank of England finally raised its policy rate by 0.15% to 0.25%. This was somewhat of a surprise on the back of ramping Omicron variant cases. However, the most recent inflation reading (5.1% YoY) weighed more heavily. Upward pressure on prices continues, as does pressure on wages.
- Rising inflation has forced the Federal Reserve to accelerate its tapering of asset purchases. The committee decided to reduce the monthly pace of its net asset purchases by $30 billion, twice as much as before. As a result, the quantitative easing program will end in March. The Fed also added a rate hike to its 2022 forecast, bringing the total to three in 2022 and three in 2023.

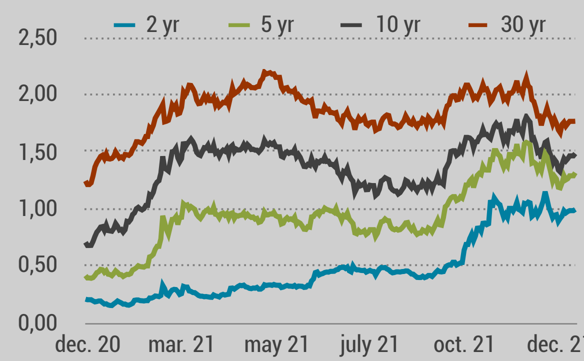
After being on the sidelines all year long calling inflation temporary, central banks are realizing that rising prices are more persistent than expected. Omicron could, however, delay the monetary tightening that is underway. However, financial markets do not seem to agree with the Fed's policy rate projection, considering it too aggressive and potentially damaging to the recovery. Even the tapering in the asset purchases is more aggressive today than last time. In 2014, the Fed took 9 months to wind down its $85 billion program. Today, it wants to end the $120 billion program in 4 months.

## BOND RATES

| Dec. 31 2021 | Canada | Monthly Change | Change 2021 | United States | Monthly Change | Change 2021 |
|---|---|---|---|---|---|---|
| Key Interest Rate | 0,25 % | 0,00 % | 0,00 % | 0,25 % | 0,00 % | 0,00 % |
| 3 months | 0,18 % | 0,10 % | 0,10 % | 0,03 % | -0,02 % | -0,03 % |
| 2 years | 0,95 % | -0,03 % | 0,75 % | 0,73 % | 0,17 % | 0,61 % |
| 5 years | 1,26 % | -0,14 % | 0,87 % | 1,26 % | 0,10 % | 0,90 % |
| 10 years | 1,43 % | -0,14 % | 0,75 % | 1,51 % | 0,07 % | 0,60 % |
| 30 years | 1,68 % | -0,21 % | 0,47 % | 1,90 % | 0,11 % | 0,26 % |
| RRB 30 years | -0,12 % | -0,17 % | 0,17 % | | | |

Source: Bloomberg

## CANADIAN RATE TRENDS

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## CREDIT BOND RISK PREMIUMS

| Issuers | Credit Rating DBRS | Spread 5 yrs | Spread 10 yrs | Spread 30 yrs | Change 5 yrs month | Change 5 yrs 2021 | Change 10 yrs month | Change 10 yrs 2021 | Change 30 yrs month | Change 30 yrs 2021 |
|---|---|---|---|---|---|---|---|---|---|---|
| Royal Bank, Bail-in-debt | AA | 85 | 115 | 155 | 0 | 20 | 0 | 10 | -5 | 0 |
| Royal Bank, NVCC | A | 110 | 150 | 200 | -5 | 10 | -5 | 10 | -5 | 5 |
| Sun Life, subordinated debt | A | 100 | 140 | 190 | -5 | 10 | -5 | 10 | -5 | 5 |
| Hydro One | A high | 65 | 100 | 135 | 0 | 15 | 0 | 15 | 0 | 5 |
| Enbridge Inc | BBB high | 110 | 155 | 230 | 0 | 15 | 0 | 5 | -5 | -5 |
| Altalink LP | A | 65 | 100 | 135 | 0 | 15 | 5 | 20 | 5 | 10 |
| GTAA | A high | 70 | 100 | 130 | 5 | 20 | 0 | 15 | -5 | 0 |
| Bell Canada | BBB high | 100 | 145 | 205 | 5 | 20 | 5 | 15 | -5 | 5 |
| Rogers Communications | BBB high | 130 | 175 | 235 | 5 | 50 | 5 | 45 | -5 | 35 |
| Loblaw | BBB high | 90 | 135 | 190 | 0 | 15 | 0 | 10 | 0 | -5 |
| Canadian Tire | BBB | 95 | 145 | 230 | 0 | 0 | 0 | -10 | 0 | -25 |
| Province Québec | AA low | 33 | 56 | 74 | 3 | 3 | 0 | -1 | 1 | -5 |
| Province Ontario | AA low | 37 | 61 | 78 | 3 | 2 | 0 | -1 | 1 | -3 |
| CMHC | AAA | 31 | 41 | --- | 4 | 10 | 1 | 9 | | |

Source: National Bank Financial

## CREDIT MARKET

- The sum of new domestic corporate bond issuance reached $7 billion in December, down $6.9 billion from the previous month, but $1.1 billion more than in December 2020. For the year 2021, bond financings totaled a record $119 billion, 10% higher than the previous mark set last year. A portion of this growth is attributable to new issuance in the industrial sector, which totaled $21.6 billion in 2021, up 87% year-over-year. In fact, there were six new issues over $1 billion, which is a first for this sector. Of particular note were two issues totaling $2.2 billion from CP Railway that were used to finance the acquisition of Kansas City Southern.

- Bank of Montreal, through its U.S. subsidiary BMO Harris Bank, announced the acquisition of Bank of the West, a U.S. entity owned by BNP Paribas. The transaction, valued at US$16.3 billion, will strengthen BMO's presence in the Western United States, including California, which accounts for 70% of bank deposits. The transaction will give Bank of Montreal a presence in 32 states with the addition of 514 branches and 1.8 million customers. Bank of Montreal intends to finance the acquisition with its excess capital. At the beginning of the pandemic, the Office of the Superintendent of Financial Institutions restricted Canadian banks from increasing dividends or buying back shares. These restrictions were recently lifted and Bank of Montreal decided to deploy the capital raised to expand its operations.

- The performance of provincial bonds in 2021 was -3.28%, despite a tightening of credit spreads. Indeed, long-term spreads closed the year at 79 bps, down 9 bps over 12 months. However, the performance is not homogeneous. The rise in oil prices during the year strengthened Alberta's public finances, whose long-term bond spreads narrowed by 17 bps over a 12-month period. Bonds in other provinces such as New Brunswick, Manitoba and Saskatchewan also narrowed by more than 10 bps during the year. In contrast, spread tightening was smaller in Quebec (-5 bps) and Ontario (-3 bps).

### FTSE TMX INDEX PERFORMANCE

| Sector | Weight | Dec. 2021 | 2021 |
|---|---|---|---|
| Universe | 100 % | 1,67 % | -2,54 % |
| Short Term | 39,2 % | 0,36 % | -0,93 % |
| Mid Term | 26,9 % | 1,14 % | -2,69 % |
| Long Term | 33,8 % | 3,65 % | -4,52 % |
| Federal | 34,0 % | 1,19 % | -2,62 % |
| Provincial | 37,4 % | 2,22 % | -3,28 % |
| Corporates | 26,4 % | 1,50 % | -1,34 % |
| RRB | | 3,64 % | 1,84 % |

Source: ftse.com

This is a strategic acquisition for Bank of Montreal because of the lack of overlap with its existing operations located mainly in the Midwest. Finally, we prefer a bank that favors investing its excess capital for the long term instead of paying a special dividend to shareholders that is only profitable in the short term.

While the fiscal situation has improved in 2021, Omicron will lead to additional spending and an economic slowdown that will hurt public finances. Since the provinces borrow primarily on a long-term basis, how will investors react if long-term rates rise in line with inflation and the withdrawal of the Bank of Canada's federal bond purchase program?

## STRATEGIC POSITIONNING

Scarcity, inflation and transitory. These are the three words I would use to describe the economy and financial markets in 2021. For investors in risky assets, central banks have been a strong ally, continuing to stimulate the economy and inject liquidity even in the face of rising and persistent inflation. Next year, central banks will no longer play this ally role, withdrawing monetary injections while beginning to normalize rates. Inflation has become public enemy number one for central banks around the world, despite the presence of Omicron. Withdrawing extraordinary monetary support carries its own set of risks for investors. Orchestrating a soft landing of the economy to contain inflation in the midst of a pandemic, with declining government support, supply problems and a stock market that has recorded 3 consecutive years of 20%+ gains will be a balancing act worthy of the Cirque du Soleil. Tightening too quickly would dampen inflation, but could disrupt the stock market. On the other hand, slower rate hikes might please shareholders, but risks failing to control inflation, pushing long-term rates higher. The Federal Reserve has never been able to initiate monetary tightening without creating economic or financial disruption. It is hard to believe that 2022 will be any different. Please fasten your seat belts, we could be in for a bumpy ride.