MONTHLY BOND LETTER

AlphaFixe Capital

AUGUST 2022

ECONOMIC EVENTS

- After a 3.1% annualized gain in the first quarter, the Canadian economy grew by 3.3% in the second. Supported by a robust job market and a deep savings account, households increased their spending by an annualized 9.5%, propelled by spending on travel, restaurants and clothing. Business investment also contributed, up 13.9%, but could not offset the drop (-27.8%) in residential investment. Business inventory accumulation was the largest contributor to growth in the second quarter, adding 5.9% to GDP. The ratio of inventories to sales is now similar to the pre-pandemic level, suggesting a relief from shortages of certain goods. In nominal terms, GDP grew by 17.9% due to a 14% increase in the GDP price index, the highest since 1974.

With such strong nominal growth, it is not surprising that the federal government recorded a budget surplus of $10.2 billion between April and June. Provincial tax revenues will also be boosted by inflation and rising wages. Unfortunately, these higher revenues will encourage governments to hand out cheques to taxpayers to help them cope with inflation, again fuelling price increases. The lifting of health restrictions released a pent-up demand that is not expected to be repeated, growth may therefore be slower in the second half of the year.

- The U.S. economy added 315,000 workers in August, bringing the sum of new jobs created in 2022 to over 3.5 million. However, the unemployment rate rose from 3.5% in July to 3.7% last month. This increase is due to an increase in the labor force. Some workers are returning to the labor market and looking for work. In fact, the number of people in the labor force (164.7 million) who are either working, unemployed or looking for work has finally surpassed the pre-pandemic level (164.6 million). Nevertheless, the participation rate (the number of people in the labor force as a proportion of the working-age population) remains lower (62.4%) than in February 2020 (63.4%).

If, by some miracle, the participation rate were to return to its pre-pandemic level, the U.S. economy could have 2.6 million additional workers. If these workers are added to the 6 million unemployed, there are still 2.6 million employees needed to fill all the vacancies in the economy (11.2 million). As a result, the worker shortages will not correct by itself any time soon and wage pressures are expected to continue. In the past year, the average hourly wage is up 5.2% , still below the level of inflation.

- Inflation in Europe rose 0.5% in August and 9.1% in the past year, a new high. Although the explosion in energy prices (38.3% year-on-year) was a major contributor, inflation is becoming more widespread. Prices also rose faster for food (10.6%), services (3.8%) and non-energy industrial goods (5%). Excluding energy, food, alcohol and tobacco, core inflation rose from 4.0% to 4.3%, more than double the European Central Bank's (ECB) target.

Inflation is higher than in Canada and the United States, while the policy rate is only 0.75%, so they have a lot of catching up to do if they want to contain price increases. On the other hand, the risk of stagflation is high, which limits the level where the policy rate can be raised without causing serious economic turmoil.

RATE TRENDS

- Speaking at the annual Jackson Hole symposium, Jerome Powell indicated that the fight against inflation will come at the cost of slower growth, a weakening labor market, causing pain to households and businesses. To restore price stability, a tight monetary policy for some time will be necessary. Jerome Powell was not alone in taking a tougher stance on inflation. Isabel Schnabel, a member of the European Central Bank's board of directors, said that "even if we enter a recession, we have little choice but to continue down the path of normalization," because "if inflation expectations were to take hold, the effect on the economy would be even worse."

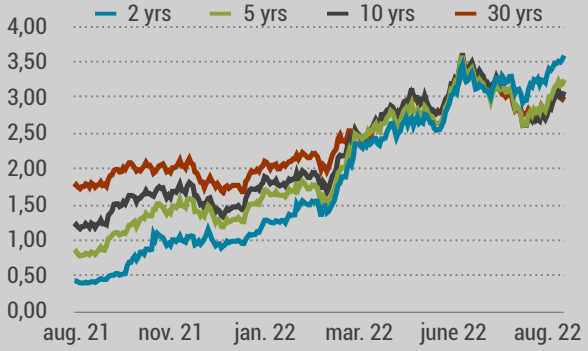
Therefore, the Fed's president dismissed any expectations that the policy rate would be cut in the second half of next year to stimulate a recessionary economy. Central banks have thus hardened their tone by indicating that the risk of a recession would not cause them to deviate from their goal of controlling inflation. However, the Fed has not been known lately for the accuracy of its forecasts. At this symposium last year, Jerome Powell defended the thesis of transitory inflation. History has proven him wrong.

BOND RATES

Aug. 31, 2022		Monthly Change	Change 2022		Monthly Change	Change 2022
Key Interest Rate	2,50 %	0,00 %	2,25 %	2,50 %	0,00 %	2,25 %
3 months	3,25 %	0,58 %	3,07 %	2,90 %	0,58 %	2,87 %
2 years	3,65 %	0,69 %	2,70 %	3,49 %	0,61 %	2,76 %
5 years	3,29 %	0,67 %	2,03 %	3,35 %	0,67 %	2,09 %
10 years	3,12 %	0,51 %	1,69 %	3,19 %	0,54 %	1,68 %
30 years	3,03 %	0,26 %	1,35 %	3,29 %	0,28 %	1,39 %
RRB 30 years	1,26 %	0,31 %	1,38 %			

Source: Bloomberg

CANADIAN RATE TRENDS



1800 Ave. McGill College | Suite 2420 | Montréal (PQ) | H3A 3J6 514-861-3493 www.alphafixe.com info@alphafixe.com

CREDIT BOND RISK PREMIUMS

Issuers	Credit Rating DBRS	Spread 5 yrs	Spread 10 yrs	Spread 30 yrs	Change 5 yrs month	Change 5 yrs 2022	Change 10 yrs month	Change 10 yrs 2022	Change 30 yrs month	Change 30 yrs 2022
Royal Bank, Bail-in-debt	AA	160	195	225	0	75	0	80	5	70
Royal Bank, NVCC	A	215	260	295	0	105	-5	110	-10	95
Sun Life, subordinated debt	A	190	235	275	5	90	5	95	5	85
Hydro One	A high	100	130	155	0	35	-5	30	-5	20
Enbridge Inc	BBB high	170	210	265	0	60	-5	55	-5	35
Altalink LP	A	95	125	150	0	30	-5	25	-5	15
GTAA	A high	100	125	150	0	30	-10	25	-10	20
Bell Canada	BBB high	160	195	235	5	60	0	50	0	30
Rogers Communications	BBB high	175	215	275	5	45	0	40	0	40
Loblaw	BBB high	155	190	225	5	65	0	55	5	35
Canadian Tire	BBB	165	205	255	5	70	0	60	-15	25
Province Québec	AA low	48	74	93	2	15	2	18	-1	19
Province Ontario	AA low	50	77	96	1	13	0	16	0	18
CMHC	AAA	35	47	---	0	4	3	6		

Source: National Bank Financial

CREDIT MARKET

- Canadian corporate bond new issuance totaled $6.2 billion in August, up $1.3 billion from the previous month and $2.4 billion more than in August 2021. Year-to-date, bond financings totaled $76.8 billion, down 1.2% from this time last year. Issuers during the month included a new issue of a Limited Recourse Capital Notes (LRCN) from National Bank, rated BB. This below investment grade rating contrasts with the other banks for the same debt structure due to the institution's lower credit rating compared to the other 5 Canadian banks.

- The six major Canadian banks reported their third quarter financial results. They reported earnings of $13.2 billion collectively, down 13% from the same period last year. Mortgages at the six banks were up nearly 10% in the quarter from a year earlier, while commercial loans jumped 16%, according to the financial statements. Nevertheless, revenues are now weakened by lower investment banking fees and lower revenues from assets under management in the wealth management division. With economic uncertainty looming, banks have increased loan loss provisions as rising interest rates and inflation squeeze household and business budgets.

- The province of Alberta has revised its budget forecast for the 2022-23 fiscal year. The Minister of Finance is now forecasting a surplus of $13.1 billion (2.9% of GDP), a significant increase from the forecast announced in February ($511 million). This revision comes essentially from an increase of $13.3 billion in additional revenues, mainly from oil royalties. When the budget was announced in February, the province was expecting WTI oil to trade around US$70. Oil forecast is now at US$92.50. Tax revenues have also increased, but investment income has acted as a counterbalance. Expenditures have also increased, but only by $635 million. As a result, the province's financing needs have evaporated from the $2.2 billion it started the year with.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	Aug. 2022	2022
Universe	100 %	-2,74 %	-11,31 %
Short Term	43,3 %	-1,44 %	-4,62 %
Mid Term	26,1 %	-3,45 %	-10,44 %
Long Term	30,6 %	-3,94 %	-19,77 %
Federal	37,1 %	-2,62 %	-9,07 %
Provincial	34,7 %	-3,44 %	-14,30 %
Corporates	26,1 %	-1,95 %	-9,88 %
RRB		-4,31 %	-14,56 %

Source: ftse.com

Recent rate increases are slowing down real estate activity, but there should be no concerns about the viability of Canadian banks. They have a high capitalization ratio and the rate hikes are only affecting those who are renegotiating their fixed rate mortgages or those with variable rate mortgages and payments, which is the equivalent of almost 10% of mortgage borrowers.

Last February we said that the province's oil forecast was conservative and that there was room for improvement in the surplus. Today, the opposite could be said. With oil at $92.50, there is little room to manoeuvre to reach the announced target, especially in a volatile geopolitical environment and economic uncertainty.

STRATEGIC POSITIONNING

With very high inflation rates, governments are looking to blame central banks. The Australian government has already announced a review of the conduct of monetary policy and the new U.K. Prime Minister, Liz Truss, also made such a promise during her run for the Conservative Party leadership. While central banks waited too long to normalize policy rates, government large spending during the pandemic also contributed to the price spike. Nevertheless, monetary authorities still seem to be using inflation projection models developed over the past few decades without much thought as to their relevance in today's world. The banks hope that inflation will return to the 2% target as quickly as it has risen over the past two years. However, their monetary policy only affects demand in the economy, it cannot correct disruptions in global chains, rejuvenate the population that contributes to labor shortages, reverse global warming or even restore trade links broken by various geopolitical tensions. Cyclical inflation may ease as policy rates are raised, but new structural forces could keep the price structure high. These factors must now be taken seriously.