# MONTHLY BOND LETTER

AlphaFixe Capital

NOVEMBER 2018

## ECONOMIC EVENTS

- The Canadian economy grew at an annualized rate of 2.0% in the third quarter, a slower pace from previous quarter (2.9%). Household spending growth went from 2.3% in the second quarter to 1.2% in the third, mainly due to declining sales in durable goods, such as cars (-6.2%). Uncertainty related to international trade negatively affected business investments in the summer. Exports rose slightly while imports contracted sharply so that international trade contributed to growth but for different reasons than the previous quarter, when exports had increased.

*Although 2% is a slower pace, it is still in line with Canada's potential growth rate. However, we should expect household spending to have a smaller contribution to future growth since we are already at full employment. Growth will be more dependent on corporate investments. In this regard, the USMCA and the new federal measures of accelerated investments amortization should help.*

- Recent US housing market indicators point to a slowdown this year. After six consecutive months of declines, existing home sales in the United States rose by 70,000 to reach 5.2 million on an annualized basis. In contrast, new home sales reached their lowest level since March 2016 at 544,000 units on an annual basis. In addition, the National Association of Home Builders' confidence index reached its lowest level in 2 years. Some investors point to the 1.0% increase in 30-year mortgage rates this year as the source of the slowdown.

*Although the real estate market is going through a rough patch, the fundamentals remain solid. Employment is robust, the ratio of household debt to disposable income had been at its lowest level in years, as well as the mortgage debt service ratio. In addition, the inventory of available homes is low as is the vacancy rate. Therefore, none of these indicators point to a real estate crisis.*

- Japan's economy contracted in the third quarter due to a series of natural disasters (typhoons, torrential rain and earthquakes) that hit the region in the summer. As a result, household spending, business investments and exports were all affected. On the other hand, the residential real estate sector recovered after 4 consecutive quarters of decline.

*The reconstruction process will allow growth to pick up in the fourth quarter. On the other hand, the succession from the natural disasters doesn't allow us to measure whether global trade conflicts have had an impact on companies' investment intentions.*

## RATE TRENDS

- The Bank of Canada maintained its policy rate at 1.75% at their December 5th meeting, stating that the Canadian oil sector would be significantly weaker than expected as a result of the decline in oil prices. While the Bank still believes that the policy rate will have to be increased to reach a neutral rate and to contain inflation, they are concerned that historical GDP revised figures will show an output gap. International trade and investment developments are also a concern for the Bank.

*While the sharp decline in Canadian oil prices is troubling, the negative impact of the industry's slowdown on the Canadian economy will be less than in 2016. Moreover, it is not necessary to analyse GDP to observe that the output gap is closed as indicated by the generalized labour shortage.*

- In November, Federal Reserve Chairman Jerome Powell said that the U.S. policy rate was just below the equilibrium level range. This is in contrast to his speech back in October when he said that monetary policy was far from neutral.

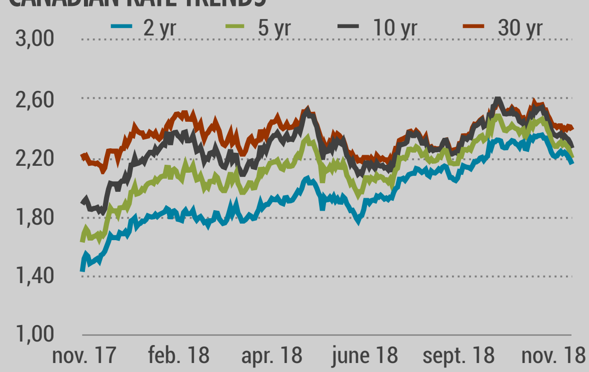
*Openly and strongly criticized by Trump, Jerome Powell used different words but did not change his message. The neutral rate range has always been 2.5% to 3.5%. At the current level of 2.25%, we are close to the range, but perhaps far from the neutral rate they measure.*

## BOND RATES

| Nov. 30 2018 | Canada | Monthly Change | Change 2018 | United States | Monthly Change | Change 2018 |
|---|---|---|---|---|---|---|
| Key Interest Rate | 1,75 % | 0,00 % | 0,75 % | 2,25 % | 0,00 % | 0,75 % |
| 3 months | 1,70 % | -0,04 % | 0,64 % | 2,34 % | 0,02 % | 0,97 % |
| 2 years | 2,16 % | -0,18 % | 0,47 % | 2,79 % | -0,08 % | 0,90 % |
| 5 years | 2,20 % | -0,23 % | 0,34 % | 2,81 % | -0,16 % | 0,61 % |
| 10 years | 2,27 % | -0,23 % | 0,22 % | 2,99 % | -0,16 % | 0,58 % |
| 30 years | 2,39 % | -0,14 % | 0,12 % | 3,29 % | -0,10 % | 0,55 % |
| RRB 30 years | 0,83 % | 0,01 % | 0,25 % | | | |

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

| ISSUER | Credit rating DBRS | Credit rating S&P | Spread 5 yrs | Spread 10 yrs | Spread 30 yrs | Change 5 yrs month | Change 5 yrs 2018 | Change 10 yrs month | Change 10 yrs 2018 | Change 30 yrs month | Change 30 yrs 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Royal Bank, deposit notes | AA | AA- | 90 | 110 | 150 | 10 | 15 | 10 | 20 | 10 | 20 |
| Manulife, Senior debt | A high | A+ | 115 | 140 | 180 | 10 | 25 | 10 | 25 | 10 | 15 |
| Fortis Inc. | BBB high | BBB+ | 125 | 170 | 220 | 15 | 35 | 15 | 35 | 15 | 55 |
| Hydro One | A high | A- | 100 | 125 | 165 | 10 | 35 | 10 | 40 | 10 | 35 |
| Enbridge Inc | BBB high | BBB+ | 150 | 200 | 265 | 20 | 35 | 30 | 35 | 30 | 40 |
| Encana Corp | BBB low | BBB- | 185 | 250 | 305 | 30 | 55 | 35 | 60 | 35 | 40 |
| GTAA | --- | A+ | 75 | 95 | 125 | 10 | 25 | 10 | 25 | 10 | 40 |
| Bell Canada | BBB high | BBB+ | 140 | 185 | 245 | 20 | 45 | 20 | 40 | 20 | 45 |
| Rogers Communications | BBB | BBB+ | 135 | 180 | 245 | 20 | 45 | 20 | 40 | 20 | 45 |
| Loblaw | BBB | BBB | 155 | 210 | 260 | 30 | 60 | 40 | 65 | 40 | 60 |
| Canadian Tire | BBB high | BBB+ | 145 | 205 | 260 | 25 | 45 | 40 | 55 | 30 | 55 |
| Province of Québec | A high | A+ | 46 | 69 | 81 | 6 | 10 | 9 | 14 | 5 | 16 |
| Province of Ontario | AA low | A+ | 49 | 73 | 84 | 6 | 11 | 9 | 14 | 4 | 17 |
| CMHC | AAA | AAA | 34 | 46 | --- | 5 | 7 | 8 | 11 | | |

Source: National Bank Financial

## CREDIT MARKET

- Canadian corporate bond new issuance reached $ 5.2 billion in November, an increase of $1.5 billion over the month but $7.9 billion lower than in November 2017. Since the beginning of the year, corporate bond issuance amounted to $79.7 billion, or 20.5% lower than at the same date last year. Turbulence in financial markets during the month finally had an impact on the credit market, as corporate bond spreads widened by 13 bps in November according to the FTSE Canada Index. The provincial sector has not been spared in this environment with long term spreads widening by 7 bps.

- The new Québec government has presented an economic update showing an increase in the budget surplus from $1.8 billion to $2.6 billion in the fiscal year ending March 2018. This surplus is mainly due to lower-than-expected expenses. For the current fiscal year, the combination of stronger than expected economic growth and higher federal transfers will allow the government to post a surplus of $1.7 billion, compared to the balance budget initially forecasted. The government has also announced a measure to accelerate debt repayment. In total, $10 billion will be withdrawn from the Generations Fund to be applied to the debt by 2019-20. The government therefore expects to reach its target of 45% of debt as a proportion of GDP in 2020-21, five years earlier than expected.

- The Province of Alberta also released a quarterly update of its finances, which now projects a $7.5 billion deficit for the current year, an improvement of $245 million from the previous quarter. This slight improvement is due to higher oil prices in the first half of the year. Since then, oil prices have declined sharply, forcing the province to revise its growth forecast from 2.5% to 2.0% for this year. The update also provides for a more conservative spread between the Texas oil price (WTI) and the Alberta price, $29.25 compared to $22.40 previously. In order to restore Canadian oil prices and to have the lowest possible differential with WTI prices, the government announced a production reduction of 325,000 barrels per day starting in January 2019.

### FTSE TMX INDEX PERFORMANCE

| Sector | Weight | Nov. 2018 | 2018 |
|---|---|---|---|
| Universe | 100 % | 1,02 % | 0,05 % |
| Short Term | 45,6 % | 0,59 % | 1,03 % |
| Mid Term | 21,5 % | 1,18 % | 0,30 % |
| Long Term | 32,9 % | 1,53 % | -1,53 % |
| Federal | 36,0 % | 1,19 % | 0,70 % |
| Provincial | 34,3 % | 1,32 % | -0,61 % |
| Corporates | 27,7 % | 0,43 % | 0,04 % |
| RRB | | -0,51 % | -1,48 % |

Source: ftse.com

*This reimbursement will reduce debt service expenditures in the next few years. In addition, it is prudent to profit a portion of the Generations Fund's return before the next recession begins. Therefore, the government will have more financial flexibility in darker days.*

*The impact of oil production reduction on public finances is mixed. On the one hand, the economy is expected to grow at a slower pace, reducing tax revenues, but the higher oil prices will boost revenues. This drop in production and train purchases by the province for oil transport are fairly left-wing thinking for a province like Alberta.*

## STRATEGIC POSITIONNING

The jury is currently deliberating to identify the source of turbulence in the financial markets. Several culprits have been identified: the slowdown of the global economy from an accelerated pace to a more normal level, the restrictive rhetoric of US monetary policy, the sharp decline in oil prices and trade tensions between the United States and China. Among these elements, trade disputes seem to attract the greatest number of suspicions. Generally, a body in motion will stay in motion unless an opposite force changes its trajectory. This inertia principle also applies to the economy, which will normally continue to expand unless the Fed significantly restricts credit causing damage to the financial system or the world order is politically disrupted. With a policy rate of 2.25%, some may say that the Fed is reducing a patient's drug dosage, but it seems difficult to believe that this rate is economically restrictive. On the other hand, protectionism and the modification of globally integrated production chains are major changes in the economic arena. Investors are more focused on Trump's tweets than on reading the fundamentals. However, the president knows that a strong economy is essential to his re-election, and he wants to be strong in front of his opponents, even if it means signing an agreement similar to the one already in place. We are experiencing the volatility at the end of the cycle, but this cycle is not yet over.