# MONTHLY BOND LETTER

AlphaFixe Capital

## ECONOMIC EVENTS

OCTOBER 2019

- The Québec economy grew by 0.4% in real terms in July according to the «Institut de la statistique du Québec», a tenth consecutive monthly gain, a record since 1997. Goods and services industries posted gains while residential construction declined. Since October 2018, the Québec economy grew by 3.4%, a rate well above Canada's. The non-mining primary sector (15.5%), wholesale trade (9.1%) and mining (6.0%) round out the podium for annual growth over the last 10 months.

Although there was a slight decline in residential construction in July, growth over the past 10 months was 4.4%. The drop in mortgage rates over the summer, combined with job market strength, should help boost real estate and construction in Québec in the coming quarters.

- The US economy grew by 1.9% in annualised terms in the third quarter, compared to 2% in the previous quarter. This slowdown is attributable to a decline in business investments (-3.0%), particularly in fixed assets (-15.3%). In contrast, household spending remained robust (2.9%) while residential real estate jumped (5.1%) influenced by mortgage rate cuts. This is the first gain in 7 quarters for this business segment. Government spending also contributed to growth (2.0%).

Faced with the uncertainty of trade disputes, American companies have put some investment projects on hold. A conflict resolution could resolve a repressed demand from companies waiting to learn about the new rules in the supply chain.

- The Chinese economy grew by 6.0% in the third quarter following increases of 6.2% and 6.4% during the first two quarters of the year. This is the lowest rate since 1992. However, the economy improved in September as industrial production grew by 5.8% annually, compared to 4.4% in August. Retail sales also accelerated, rising from 7.5% on an annual basis in August to 7.8% in September.

Many question the validity of China's GDP. The Li Keqiang index is therefore an excellent alternative. It measures economic activity through the growth of bank lending, rail freight and power generation. In September, the index rose 7.5% year-on-year, compared with 6.3% in August.

## RATE TRENDS

- The Bank of Canada has maintained its policy rate at 1.75%, but is increasingly concerned about the contagion effects due to trade disputes. The Bank is concerned that the slowdown in investments and exports resulting from trade tensions is being passed on to households. Currently, the Canadian economy is showing signs of resilience with strong consumer spending and a strengthening housing market. The Bank recognizes an « insurance » rate cut would increase financial vulnerabilities in Canada.

The Bank's concern about trade tensions comes at a strange time as discussions between China and the United States have improved with a potential phase 1 agreement. However, the Bank believes that monetary policy is still expansionary and that a rate reduction could further harm the economy given inflation is already above target and elevated consumer debt.

- The Federal Reserve announced a third cut in the key policy rate this year to 1.75%. The Fed used the same pretexts as before, namely geopolitical uncertainty and the absence of inflationary pressure. As for Canada, household spending and employment remain strong, but investments and exports are weakening. After three decreases, the Fed removed the fact that it would act appropriately to support the expansion. Two committee members opposed, preferring the status quo.

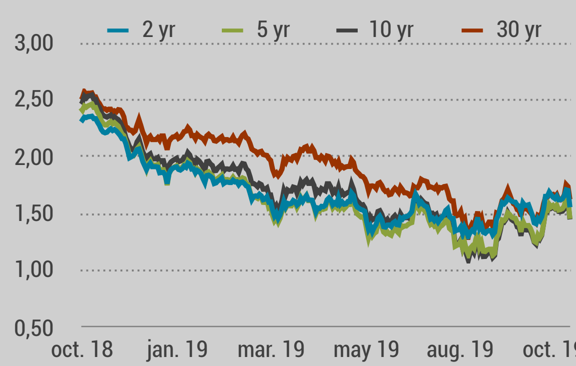
By no longer promising to support expansion, the Fed is opening the door to a possible break in monetary easing after three consecutive declines. The Fed is also more optimistic about a resolution of the trade dispute with China, in contrast with the Bank of Canada, which, on the same day, expressed growing concern.

## BOND RATES

| Oct 31 2019 | Canada | Monthly Change | Change 2019 | United States | Monthly Change | Change 2019 |
|---|---|---|---|---|---|---|
| Key Interest Rate | 1,75 % | 0,00 % | 0,00 % | 1,75 % | -0,25 % | -0,75 % |
| 3 months | 1,66 % | 0,01 % | 0,01 % | 1,52 % | -0,28 % | -0,83 % |
| 2 years | 1,52 % | -0,06 % | -0,35 % | 1,52 % | -0,10 % | -0,96 % |
| 5 years | 1,42 % | 0,02 % | -0,47 % | 1,52 % | -0,02 % | -0,99 % |
| 10 years | 1,41 % | 0,05 % | -0,56 % | 1,69 % | 0,03 % | -0,99 % |
| 30 years | 1,58 % | 0,05 % | -0,61 % | 2,18 % | 0,07 % | -0,84 % |
| RRB 30 years | 0,34 % | 0,08 % | -0,43 % | | | |

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 SPREADS

| ISSUER | Credit rating DBRS | Spread 5 yrs | Spread 10 yrs | Spread 30 yrs | CHANGE 5 yrs month | CHANGE 5 yrs 2019 | CHANGE 10 yrs month | CHANGE 10 yrs 2019 | CHANGE 30 yrs month | CHANGE 30 yrs 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| Royal Bank, bail-in debt | AA | 100 | 135 | 175 | 0 | -35 | 0 | -25 | 0 | -25 |
| Royal Bank, sub debt NVCC | A | 145 | 195 | 235 | 5 | -40 | 5 | -25 | 5 | -25 |
| Fortis Inc. | BBB high | 100 | 140 | 205 | 5 | -40 | 0 | -45 | 5 | -30 |
| Hydro One | A high | 80 | 110 | 155 | 5 | -35 | 0 | -30 | 0 | -25 |
| Enbridge Inc | BBB high | 120 | 170 | 240 | 0 | -40 | 0 | -40 | 5 | -35 |
| Encana Corp | BBB | 185 | 245 | 315 | -5 | -20 | -5 | -25 | -5 | -10 |
| GTAA | --- | 65 | 90 | 120 | 0 | -20 | 0 | -15 | 0 | -20 |
| Bell Canada | BBB high | 110 | 160 | 225 | 0 | -45 | -5 | -40 | -5 | -35 |
| Rogers Communications | BBB | 105 | 155 | 225 | 0 | -45 | -5 | -40 | 0 | -35 |
| Loblaw | BBB | 115 | 165 | 225 | 0 | -50 | -5 | -50 | 0 | -45 |
| Canadian Tire | BBB high | 110 | 160 | 220 | 0 | -50 | -5 | -50 | 0 | -50 |
| Province of Québec | A high | 43 | 66 | 78 | 2 | -16 | 2 | -18 | 1 | -18 |
| Province of Ontario | AA low | 44 | 70 | 82 | 1 | -19 | 1 | -19 | 1 | -19 |
| CMHC | AAA | 31 | 41 | --- | 0 | -12 | 1 | -15 | | |

Source: National Bank Financial

## CREDIT MARKET

- Canadian corporate bond new issuance reached 8.8 billion in October, a decrease of $5.6 billion compared to the previous month but $5.1 billion more than in October 2018. Since the beginning of the year, total bond financings totalled $82.6 billion, up 11% compared to the same date last year. Silver Arrow Canada issued over $500 million of automotive asset-backed securities from Mercedes-Benz Canada. Classes A1, A2 and A3 received a rating of AAA due to the loan pool's credit quality and the high level of subordination associated with these securities.

- Alberta's new Conservative government has released its budget, which shows an $8.7 billion deficit for the fiscal year 2019-20 (2.4% of GDP), up by $2 billion compared to the previous year. This deficit increase is due to the carbon tax elimination, a $1.5 billion provision to exit the rail oil transportation program and 680 million for contingencies. The corporate tax rate has already been reduced by 12% to 11%, but will reach 8% in 2022. For next year, the Finance Minister expects a deficit of $5.9 billion and a balanced budget is expected in 2022-23. To achieve this, the government will reduce spending on 2.4% and expects oil prices to rise to $63 (WTI).

- The S&P rating agency reviewed several automotive credit ratings during the month of October. It lowered Renault's rating to BBB- while placing Nissan Motor's rating (A-) under review. The more difficult global environment in the second half of the year led to lower sales, operating margins and cash-flow for the French automaker. As for Nissan, the company needs to stabilize its corporate structure and rebuild its relationships with its French partner Renault. Ford also had its credit rating downgraded by S&P to BBB- taking into account that the recent underperformance of the car manufacturer would make it difficult to achieve long term profitability in China and Europe. Recall that Moody's had also downgraded Ford's investment grade rating (Ba1) last September.

### FTSE TMX INDEX PERFORMANCE

| Sector | Weight | Oct. 2019 | 2019 |
|---|---|---|---|
| Universe | 100 % | -0,17 % | 7,60 % |
| Short Term | 43,1 % | 0,22 % | 3,18 % |
| Mid Term | 22,8 % | -0,12 % | 6,78 % |
| Long Term | 34,1 % | -0,70 % | 14,12 % |
| Federal | 35,0 % | -0,07 % | 4,80 % |
| Provincial | 35,5 % | -0,37 % | 10,12 % |
| Corporates | 27,4 % | -0,04 % | 7,94 % |
| RRB | | -0,94 % | 10,22 % |

Source: ftse.com

Despite difficult economic conditions, Alberta has demonstrated a strong commitment to rebalancing the budget by reducing spending and making reasonable assumptions about oil prices. Companies will pay less taxes and citizens will receive fewer services. If the economy does not strengthen, this balance will be difficult to maintain politically.

Trade disputes have financial consequences for companies. However, the automotive sector is also facing major structural changes and rising costs to meet stricter environmental standards. Manufacturers lagging behind in electric vehicles are now paying the price.

## STRATEGIC POSITIONNING

The sources of growth in the Canadian economy are similar to those of the United States. Consumer household consumption spending remains strong, but trade tensions are forcing companies to put some investment projects on hold, seeking to know the new rules of the global supply chains before investing. In this respect, the partial agreement between the United States and China, which should be ratified by the end of the year, could unlock latent business demand and stimulate global economic growth. The scarcity of manpower also encourages companies to invest in automating certain tasks. Lower mortgage rates will also stimulate real estate next year. All in all, the resolution of the trade dispute combined with key interest rate cuts by some 20 central banks this year should produce a more favourable global economic environment next year. In this context, both the Bank of Canada and the Federal Reserve are expected to keep their monetary policy unchanged for some time to come. A monetary stimulus combined with full employment could create upward pressure on wages and possibly on consumer prices. In the absence of central banks in the fight against inflation, bond investors will want to protect themselves with higher bond yields.