# MONTHLY BOND LETTER

AlphaFixe Capital

## ECONOMIC EVENTS

JUNE 2018

- The Canadian economy cut 7,500 jobs in May, a second month of decline. Since the beginning of the year, employment has fallen by 48,900, mainly part-time jobs (-124,600), while full-time jobs continue to grow (75,800). The unemployment rate remained unchanged for a fourth straight month at 5.8%, a record low. Downsizing in the construction and manufacturing industries continued in May, bringing job losses to -28,500 and -43,100 respectively since the beginning of the year. Nevertheless, wages recorded a strong jump, rising 3.9% annually in May, against 3.6% the previous month.

*Although the Canadian job market is declining, the increase of full-time positions is reassuring, as well as the rise in wages reflecting favorable conditions for workers. On the other hand, two industries seem destabilized, one by the new mortgage rules and the other by the emerging trade disputes with the United States.*

- The Trump administration will put its threat into effect by imposing, from July 6, 25 % tariffs on $ 50 billion worth of Chinese imports. China has responded with import tariffs equivalent to US imports. Judging the retaliation unacceptable and China's lack of progress in the intellectual property dispute, Trump summoned his Commerce secretary to identify $ 200 billion worth of Chinese goods for additional tariffs of 10 %. If China retaliates, it will impose another $ 200 billion, amounting to $ 450 billion, or nearly 90 % of goods imported from China.

*Since US exports to China amounted to $ 130 billion in 2017, Trump knows that China can't have an equivalent retaliation if there is a second wave of tariffs. However, China will not want to lose face and could act differently. It can tax imports at a higher rate, devalue its currency heavily, or even sell Treasury bonds to send a strong message to the United States.*

- Japan's economy contracted at an annualized rate of 0.6 % in the first quarter. This is a first decline since December 2015, ending the longest expansion in 28 years. This decline is in part attributable to household consumer spending. The severe winter conditions led to higher food prices at the beginning of the year, thereby reducing consumers' purchasing power.

*Trade conflict risks could also disrupt the Japanese economy by slowing exports (17 % of GDP). Facing uncertainty, companies could also delay some investment projects (16 % of GDP).*

## RATE TRENDS

- The Federal Reserve raised its key rate by 0.25 % to 2.00 %, which is 0.20 % above the Fed's core inflation rate. The real Fed Funds rate is therefore positive for the first time since March 2008. The Fed has described growth as robust, propelled by an accelerating consumer spending and a sharp increase in corporate investments. Faced with this favorable conditions, the Fed announces two other rate hikes by the end of the year, one more than what was expected last March.

*The Fed's leaders believe that the neutral Fed Funds rate would be close to 3 %, leaving 4 additional rate hikes before removing the monetary stimulus still in place. The Fed would therefore be in a restrictive mode only at the end of next year, unless inflation or protectionism intensifies with their diametrically opposite effects on the direction of rates.*

- The European Central Bank has announced that it will end its bond buyback program at the end of this year, but does not plan to raise its key rate before the end of summer 2019. However, the ECB will I adopt a patient and gradual approach when raising rates.

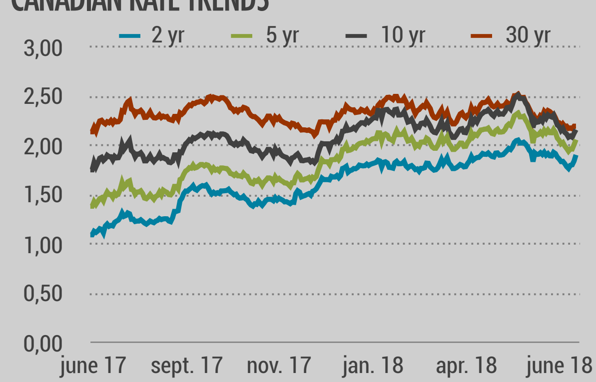
*Although Mr. Draghi wants to end the program, he is open to extending it, especially if the trade conflict with the United States intensifies. The old continent is highly dependent on exports (48 % of GDP).*

## BOND RATES

| June 30 2018 | Canada | Monthly Change | Change 2018 | United States | Monthly Change | Change 2018 |
|---|---|---|---|---|---|---|
| Key Interest Rate | 1,25 % | 0,00 % | 0,25 % | 2,00 % | 0,25 % | 0,50 % |
| 3 months | 1,26 % | -0,03 % | 0,20 % | 1,91 % | 0,02 % | 0,54 % |
| 2 years | 1,91 % | -0,00 % | 0,23 % | 2,52 % | 0,10 % | 0,64 % |
| 5 years | 2,07 % | -0,04 % | 0,20 % | 2,73 % | 0,03 % | 0,52 % |
| 10 years | 2,17 % | -0,07 % | 0,13 % | 2,85 % | -0,01 % | 0,45 % |
| 30 years | 2,21 % | -0,06 % | -0,06 % | 2,98 % | -0,04 % | 0,24 % |
| RRB 30 years | 0,47 % | -0,05 % | -0,11 % | | | |

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 2018 | Change 10 yrs month | Change 10 yrs 2018 | Change 30 yrs month | Change 30 yrs 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Royal Bank, deposit notes | AA | AA- | 85 | 105 | 145 | 0 | 10 | 0 | 15 | 0 | 15 |
| Manulife, Senior debt | A high | A+ | 95 | 120 | 170 | -5 | 5 | -5 | 5 | 0 | 5 |
| Fortis Inc. | BBB high | BBB+ | 110 | 150 | 185 | 10 | 20 | 10 | 15 | 5 | 20 |
| Hydro One | A high | A | 80 | 105 | 140 | 10 | 15 | 10 | 20 | 5 | 10 |
| Enbridge Inc | BBB high | BBB+ | 125 | 175 | 240 | 5 | 10 | 5 | 10 | 10 | 15 |
| Encana Corp | BBB low | BBB- | 140 | 190 | 260 | 5 | 10 | 5 | 0 | 5 | -5 |
| GTAA | --- | A+ | 65 | 85 | 110 | 5 | 15 | 0 | 15 | -5 | 25 |
| Bell Canada | BBB high | BBB+ | 110 | 155 | 215 | 5 | 15 | 5 | 10 | 5 | 15 |
| Rogers Communications | BBB | BBB+ | 105 | 145 | 215 | 5 | 15 | 5 | 5 | 5 | 15 |
| Loblaw | BBB | BBB | 110 | 160 | 215 | 5 | 15 | 5 | 15 | 5 | 15 |
| Canadian Tire | BBB high | BBB+ | 105 | 155 | 215 | 0 | 5 | 0 | 5 | 0 | 10 |
| Province of Québec | A high | A+ | 42 | 64 | 75 | 2 | 6 | 2 | 9 | 3 | 10 |
| Province of Ontario | AA low | A+ | 45 | 69 | 80 | 2 | 7 | 2 | 10 | 3 | 13 |
| CMHC | AAA | AAA | 30 | 40 | --- | -2 | 3 | 0 | 5 | | |

Source: National Bank Financial

## CREDIT MARKET

- Canadian corporate bond new issuance reached $ 11.1 billion in June, up $ 800 million from the previous month and $ 2.1 billion from June 2017. Since the beginning of the year, corporate bond issuance totaled $ 50.0 billion, down 5.1% from the same period last year. Among borrowers, Ontario Power Generation (OPG) made its first green bond issue. The proceeds of this debenture will be used to fund hydropower projects using renewable, clean and low carbon energy. Previously in June, the Canada Pension Plan Investment Board issued a 10-year green bond totaling $ 1.5 billion. This is of historic size for a green bond in Canada and a world first for a pension fund.
- Moody's downgraded Hydro One's credit rating from A3 to Baa1. The agency had announced a negative outlook on the credit rating last July following the acquisition of the US energy company Avista. According to the agency, this acquisition reduces the likelihood of government support since it would benefit stakeholders outside the regulated public service in Ontario. The announcement came as the acquisition recently obtained various approvals in the United States. For its part, S&P placed the credit rating (A) under watch with negative implication, also due to obtaining approvals for endorsing transactions.
- Fitch has changed the Province of Ontario's outlook from stable to negative (AA-) on the grounds that the 2018-19 budget will see a return on deficits despite the Conservative Party election. Although Doug Ford's party has not tabled a concrete budget plan in the last election, he expects to see a deficit in the first two years of his term. The theme of his election platform was to lower taxes for the middle class and businesses, as well as lower taxes on gasoline. All tax relief measures ($ 3.5 billion annually) should be offset by cost reductions that are not yet detailed. An economic update is expected shortly.

## FTSE TMX INDEX PERFORMANCE

| Sector | Weight | June 2018 | 2018 |
|---|---|---|---|
| Universe | 100 % | 0,57 % | 0,61 % |
| Short Term | 45,3 % | 0,23 % | 0,53 % |
| Mid Term | 22,1 % | 0,65 % | 0,26 % |
| Long Term | 32,6 % | 1,00 % | 0,92 % |
| Federal | 35,6 % | 0,46 % | 0,67 % |
| Provincial | 34,0 % | 0,82 % | 0,49 % |
| Corporates | 28,5 % | 0,41 % | 0,70 % |
| RRB | | 1,09 % | 3,36 % |

Source: ftse.com

*Now that Ontario holds only 47 % of Hydro One's shares, it would be politically difficult for the government to orchestrate a bailout for US assets and jobs. A governmental financial support has value only if it is explicitly stipulated in a contract.*

*The action plan for returning to a balanced budget is important for the agencies and must focus more on controlling spending rather than expected growth. This could be reduced by trade conflict with the United States. Ontario's exports to the United States represent 26 % of its GDP, above the Canadian average (22 %).*

## STRATEGIC POSITIONNING

Trade tensions between the United States and a multitude of partners affected the financial market outlook at the end of the quarter despite favorable economic conditions. Initially, Trump's tariff announcements affected only a small portion of global trade, but recent retaliations against China and the auto industry in Canada and Europe changed the game. Trump doesn't accept that his partners are retaliating and believes that he has a strong hand in negotiations, since the United States imports more than they export. He therefore uses a of maximum pressure strategy knowing that he is able to tax more than his partners. Although the majority of the trade deficit is with China (66 %), this figure needs to be put into perspective. The production line is globally integrated and China assembles the final product. The OECD estimates that about a third of Chinese exports comes from abroad. For example, the cost of producing an iPhone X assembled in China is about $ 370, but the Chinese portion is only $ 50-60 according to IHS Markit. However, the total cost is used in the calculation of the trade deficit. Trump seeks to force trade renegotiation, because if he absolutely wanted to have protectionism, the tariffs would have been applied a long time ago without any delay. China's abuse in intellectual property had to be addressed, but the means used by Trump can be challenged.