MONTHLY BOND LETTER

AlphaFixe Capital

MAY 2019

ECONOMIC EVENTS

- The Canadian economy grew at an annualized rate of 0.4 % in the first quarter, the same rate as in the previous quarter. Net exports were a major drag to growth while domestic demand had a solid contribution. Household spending increased by 3.5 % while business investment rebounded (+13.5 %) after three consecutive quarters of decline. The new Federal government program for accelerated depreciation of capital investments partly explains this increase. Companies have also replenished their stocks, thus contributing to growth. On the other hand, residential investment remained subdued, contracting for a fifth consecutive quarter.

GDP components show a stronger economy than the headline suggests. The labour market strength, particularly with a record 106,500 new jobs last April, continues to support consumer spending. The accelerated depreciation program should also promote investments. The only shadow, as on the global economy, remains international trade, courtesy of Donald Trump.

- The U.S. goods trade deficit reached ($ 72.1 billion) in April, the highest level this year. Exports fell 4.2 % during the month ($134.6 billion) while imports fell by 2.7 % ($216.7 billion). For 2018, the U.S. trade balance stood at (-$ 622 billion), mainly due to the goods trade deficit (-$ 891 billion) as Americans post a surplus with the rest of the world in services ($ 269 billion). Last year's trade deficit was an all-time record, despite the Trump tariffs on US major trading partners.

Trump's tariffs will not solve the United States' trade deficit. If Americans import more than they export, it is because they consume much more than they can produce. This reality will not change with the tariffs; it will just move away from China to another country. However, he's using tariffs force China to stop their unfair trade practices.

- The German economy grew at an annualized rate of 1.6 % in the first quarter after stalling in the previous quarter. This rebound is attributable to a rebound in construction, an unexpected increase in exports, but mainly due to a sharp rise in household consumption, the highest in 8 years (4.9 %). The combined growth of the 19 nations eurozone also reached 1.6 % in the first quarter.

Germany's economic ties with China are strong. As a result, China's stimulus programs implemented in the beginning of the year could have a positive effect on Germany's manufacturing sector.

RATE TRENDS

- The status quo in Canadian monetary policy persists. The Bank of Canada has been more enthusiastic about the Canadian economy, describing the slowdown in the last two quarters as temporary and counting on a recovery in the second quarter, fuelled by strong employment, investment spending and a stable housing market. On the other hand, the escalation in the trade dispute between China and the United States is forcing the Bank to be patient and to maintain some degree of monetary stimulus.

The Bank's commentary is in line with first quarter GDP growth. Domestic demand is strong, but international trade is harmful. Real estate is expected to stabilize and reduce vulnerability to the financial system. On the other hand, climate change is now on the Bank's financial risk factors list.

- Jerome Powell mentioned that the Federal Reserve is closely monitoring the impact of trade negotiations on economic outlook and that they could take appropriate measures to support the expansion. These comments are in addition to those of Richard Clarida, Fed Vice-President, who mentioned that monetary policy is currently appropriate unless the economic oultook weakens or data shows a persistent shortfall in inflation.

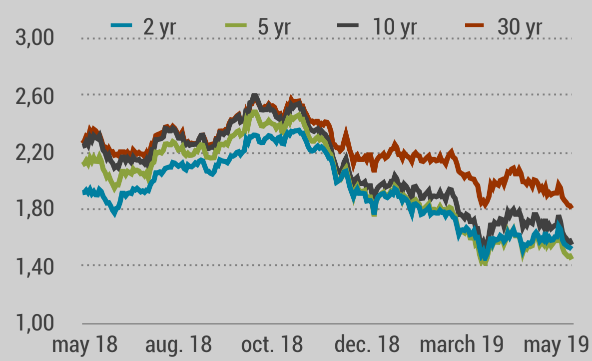
Nothing new under the sun. The Fed has often indicated that it would act to support the economy if the trade dispute with China were to put a brake on growth. The bond market seems to be forcing the Fed to lower its rate to avoid a recession. On the other hand, the bullish stock market seems to disagree.

BOND RATES

May 31 2019	Canada	Monthly Change	Change 2019	United States	Monthly Change	Change 2019
Key Interest Rate	1,75 %	0,00 %	0,00 %	2,50 %	0,00 %	0,00 %
3 months	1,68 %	0,00 %	0,03 %	2,34 %	-0,07 %	-0,01 %
2 years	1,43 %	-0,13 %	-0,43 %	1,92 %	-0,34 %	-0,57 %
5 years	1,37 %	-0,18 %	-0,52 %	1,91 %	-0,37 %	-0,60 %
10 years	1,49 %	-0,22 %	-0,48 %	2,12 %	-0,38 %	-0,56 %
30 years	1,77 %	-0,22 %	-0,42 %	2,57 %	-0,36 %	-0,45 %
RRB 30 years	0,39 %	-0,10 %	-0,37 %			

Source: Bloomberg

CANADIAN RATE TRENDS



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CREDIT BOND RISK PREMIUMS

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 low	110	145	185	10	-25	10	-15	10	-15
Manulife, sub debt NVCC	A low	155	200	240	10	-30	10	-20	10	-20
Fortis Inc.	BBB high	115	155	205	5	-25	5	-30	5	-30
Hydro One	A high	90	130	165	0	-25	0	-10	0	-15
Enbridge Inc	BBB high	125	175	250	5	-35	5	-35	20	-25
Encana Corp	BBB	170	235	290	10	-35	10	-35	10	-35
GTAA	---	75	100	125	5	-10	5	-5	5	-15
Bell Canada	BBB high	115	165	230	0	-40	10	-35	10	-30
Rogers Communications	BBB	110	160	225	0	-40	10	-35	5	-35
Loblaw	BBB	120	170	230	0	-45	0	-45	5	-40
Canadian Tire	BBB high	115	165	225	0	-45	0	-45	-5	-45
Province of Québec	A high	47	72	81	3	-12	3	-12	0	-15
Province of Ontario	AA low	49	76	85	1	-14	2	-13	0	-16
CMHC	AAA	36	45	---	3	-7	-1	-11		

Source: National Bank Financial

CREDIT MARKET

FTSE CANADA INDEX PERFORMANCE

Sector	Weight	May 2019	2019
Universe	100 %	1,69 %	5,56 %
Short Term	42,3 %	0,51 %	2,53 %
Mid Term	22,8 %	1,38 %	5,36 %
Long Term	34,9 %	3,37 %	9,74 %
Federal	35,1 %	1,36 %	3,69 %
Provincial	35,6 %	2,29 %	7,31 %
Corporates	27,3 %	1,31 %	5,70 %
RRB		1,91 %	7,33 %

Source: ftse.com

- Canadian corporate bond new issues reached $6.0 billion in May, a decrease of $1.1 billion from the previous month and $4.3 billion less than in May 2018. Since the beginning of the year, corporate bond financing amounted to $35.3 billion, a 9.5% decrease, compared with last year. Among the issuers, we should outlined Kruger Packaging Holding, a Quebec paper company rated BB (high) by DBRS. The $125 million issue maturing in 2026 carries a coupon rate of 6%, a spread of 4.41% higher than a federal bond. Despite financial market uncertainties in May, the issue was three times oversubscribed with a total of 32 investors.

- TD Bank's credit rating has been upgraded to AA (high) by DBRS. This upgrade reflects TD's sound risk management and financial profile, including higher earnings in the United States, while still maintaining strong performance in Canada. The Bank's strategy continues to focus on retail banking, which reduces funding risk in the capital markets and improves earnings stability. Personal banking in Canada and the United States accounts for more than 80% of TD's earnings. This involves a certain degree of risk, since the bank is also more exposed to a Canadian economic slowdown where households are heavily indebted.

Given its very high rating, there is little or no room for improvement in the future. In addition, Trump's tax relief measures allowed TD to increase its earnings by $240 million last year, a contribution that will fade over time. The Bank's risk management will be tested when the next recession affects Canadian households.

- DBRS also announced that the Province of Quebec's credit rating outlook (A high) has changed from stable to positive. According to DBRS, «Québec's credit profile has steadily improved in recent years with the commitment of successive governments to addressing budget imbalances, reducing the debt burden and improving the Province's economic potential.» If the Province's financial management remains consistent with the agency's expectations, DBRS could upgrade the rating to AA (low) within the next 12 months, the same as the Province of Ontario. Nevertheless, global trade tensions and uncertainties surrounding commodity prices and the outlook for monetary policy could worsen economic conditions, undermine public finances and delay the rating upgrade.

This announcement had very little impact on credit spreads, as DBRS lags behind other agencies, all of which have an AA rating for the province. It is still interesting to see that the province's rating is 3 notches below TD's despite its taxing power and sound financial management.

STRATEGIC POSITIONNING

Trade tensions increased considerably in May, particularly with China. Seeking allies in its trade struggle, Trump decided to postpone tariffs on European car imports by 6 months and to cancel the tariffs on aluminum and steel imposed on Canada and Mexico, thus opening the door to ratification of the USMCA. These reconciliations illustrate the seriousness of the U.S. in its confrontation with China, thereby accentuating fears in the financial market. However, it was the decision to impose tariffs on Mexican products in retaliation for illegal immigration that caused confusion and distress among investors. Tariffs are now a weapon in geopolitical conflicts. Who will want an agreement with the United States knowing that they can turn their backs on you? Powerless in front of these tariffs, investors are trying to force the Fed to lend a hand. Two-year bond yields declined by 34 bps in May, the steepest one-month drop since November 2008. During the financial crisis, rate cuts were essential to the banking system survival, but this is not the case today. Falling rates raise recession fears, but also stimulate the economy, particularly the real estate sector, with 30-year mortgage rates falling by 75 bps since the beginning of the year. If Trump's strategy is to weaken the economy to get a rate cut, this is a dangerous game that could hurt his re-election.