# MONTHLY BOND LETTER

AlphaFixe Capital

OCTOBER 2017

## ECONOMIC EVENTS

- Canadian retail sales fell 0.3 % in August, following a 0.4 % gain in the previous month. Excluding cars and gasoline, sales fell 1.3 %, the worst drop this year. Sales declined in 8 of the 11 sectors during the month, which accounted for 57 % of retail trade. Grocery stores (-2.5 %), home furnishings (-2.4 %) and home improvement stores (-1.9 %) posted the largest declines following a few months of consecutive gains. Despite the decline in August, sales were still up 4.2 % in 2017.

*This decline in sales is not a concern because it comes following a few months of strong gains. The job market remains robust with a creation of 264,400 jobs in the first 10 months, its best performance in 10 years.*

- Despite damages following the hurricanes in the third quarter, the US economy still grew at an annualized rate of 3.0 %, just 0.1 % lower than the previous quarter. GDP was driven by household consumption, business investment in equipment, inventory replenishment and foreign trade. Hurricanes Harvey and Irma disrupted residential and non-residential construction, but there was an increase car sales to replace damaged ones.

*Construction in hurricane-affected areas is expected to contribute to growth by the end of the year, and companies should continue their investment cycles that began three quarters ago. All in all, the US economy is resilient and supported by a robust labor market that boosts household consumption.*

- Britain's consumer price index increased 3.0 % annually in September, its highest growth rate since April 2012. The rise in the cost of living is partly attributable to increasing transportation and food costs, and occurs while the economy grows by only 1.5 % annually. The 10.7 % depreciation of the pound sterling since the Brexit vote has also boosted import prices and inflation.

*In order to contain inflation, the Bank of England raised its key rate from 0.25 % to 0.50 % at the beginning of November while announcing two more hikes in the next three years. The Bank had to soften its speech, as the currency's inflationary effect fades, while the Brexit's political uncertainty is already hurting the economy.*

## RATE TRENDS

- The Bank of Canada was cautious and kept its key rate at 1.0 % with the release of the Monetary Policy Report listing certain risk factors. Although job creation has been robust for over a year, the labor market has not reached its full potential, according to the Bank, justifying moderate inflation. The Bank is also concerned that the tightening is occurring at historic household debt level. NAFTA renegotiations and the currency's strength were also mentioned as risk factors to the economy.

*The Bank lists the same elements since September to justify being on hold, but not a complete stop of the monetary tightening. Policy rate changes have economic consequences and it is wise to analyze them before acting again. However, if the Fed increases in December, the bank would follow shortly thereafter.*

- The European Central Bank (ECB) has also renewed its policy rate to zero and only plans to increase it well after the end of the asset buyback program. Nevertheless, it has announced a reduction in the pace of asset purchases from € 60 billion to € 30 billion per month starting next January, until September 2018. The ECB, however, has said it is ready to increase this amount again if economic outlook were to weaken.

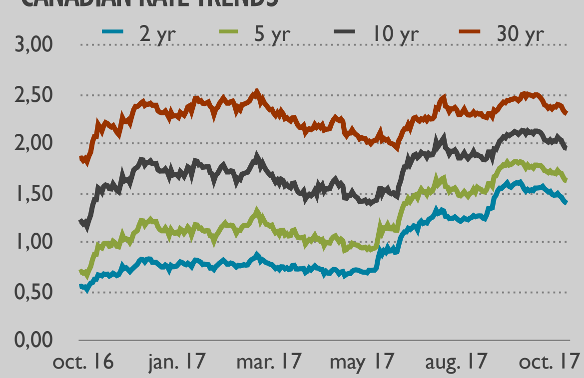
*The ECB adopts the same line of thought as other central bankers, reducing the stimulus in place. Aside from the absence of inflation in the unified zone, the ECB must also juggle with the political situation in Spain and the Italian elections in March 2018 which could bring its share of instability.*

## BOND RATES

| Oct. 31 2017 | | Monthly Change | Change 2017 | | Monthly Change | Change 2017 |
|---|---|---|---|---|---|---|
| Key Interest Rate | 1,00 % | 0,00 % | 0,50 % | 1,25 % | 0,00 % | 0,50 % |
| 3 months | 0,88 % | -0,13 % | 0,42 % | 1,13 % | 0,09 % | 0,63 % |
| 2 years | 1,39 % | -0,12 % | 0,65 % | 1,60 % | 0,12 % | 0,41 % |
| 5 years | 1,62 % | -0,13 % | 0,51 % | 2,02 % | 0,08 % | 0,09 % |
| 10 years | 1,95 % | -0,15 % | 0,23 % | 2,38 % | 0,05 % | -0,06 % |
| 30 years | 2,30 % | -0,17 % | -0,01 % | 2,88 % | 0,02 % | -0,19 % |
| RRB 30 years | 0,69 % | -0,16 % | 0,19 % | | | |

Source: Bloomberg

## CANADIAN RATE TRENDS

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## CREDIT BOND RISK PREMIUMS

| ISSUER | Credit rating | | Spread | | | Change: 5 yrs | | Change: 10 yrs | | Change: 30 yrs | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | DBRS | S&P | 5 yrs | 10 yrs | 30 yrs | month | 2016 | month | 2016 | month | 2016 |
| Royal Bank, deposit notes | AA | AA- | 70 | 90 | 130 | -5 | -25 | -5 | -20 | -10 | -25 |
| Manulife, Senior debt | A high | A+ | 85 | 115 | 160 | -5 | -30 | -10 | -20 | -10 | -25 |
| Fortis Inc. | BBB high | BBB+ | 90 | 135 | 170 | -10 | -30 | -10 | -30 | -10 | -55 |
| Hydro One | A high | A | 65 | 85 | 130 | -5 | -15 | -5 | -20 | -10 | -20 |
| Enbridge Inc | BBB high | BBB+ | 120 | 170 | 235 | 0 | -10 | 0 | -10 | 0 | -5 |
| Encana Corp | BBB low | BBB | 145 | 210 | 295 | -10 | -70 | 0 | -75 | 0 | -50 |
| GTAA | --- | A+ | 50 | 70 | 90 | 0 | -20 | -5 | -25 | 0 | -45 |
| Bell Canada | BBB high | BBB+ | 95 | 145 | 205 | -5 | -20 | -5 | -20 | -5 | -20 |
| Rogers Communications | BBB | BBB+ | 90 | 140 | 205 | -5 | -25 | -5 | -25 | -5 | -30 |
| Loblaw | BBB | BBB | 105 | 155 | 210 | 0 | -15 | 0 | -15 | -5 | -15 |
| Canadian Tire | BBB high | BBB+ | 105 | 160 | 215 | 0 | -20 | 0 | -15 | 0 | -15 |
| Province of Québec | A high | A+ | 45 | 66 | 77 | -2 | -10 | -2 | -12 | -3 | -15 |
| Province of Ontario | AA low | A+ | 47 | 68 | 77 | -2 | -9 | -1 | -11 | -3 | -12 |
| CMHC | AAA | AAA | 34 | 45 | --- | -1 | -4 | -1 | -3 | | |

Source: National Bank Financial

## CREDIT MARKET

- Canadian corporate bond new issuance reached $ 7.8 billion in October, down $ 5.7 billion from the previous month, but $ 2.5 billion more than in October 2016. Since the beginning of the year, corporate bond issuance reached $ 87.1 billion, up 25.3% from the same period last year. Among borrowers, there was an abundance of issues from the automotive industry. Manufacturers, Toyota, Nissan, Ford and GM issued bonds totalling $ 1,724 million in several tranches ranging from one to five years. Ford and GM issued asset backed securities on auto loan receivables, while Nissan Finance and Toyota Credit borrowed from senior unsecured bonds.

- Rating agency Fitch reaffirmed the credit ratings of the 7 largest Canadian banks despite persistent risks in the Canadian real estate market. According to the agency, their ratings are among the highest in Fitch's global bank universe due to their strong fundamentals and consistent earnings performance across credit cycles. Nonetheless, Fitch downgraded CIBC's outlook due to its exposure in mortgage financing and consumer spending, which is a concern in this over-indebtedness environment. Mortgage loans and lines of credit represent more than 62% of CIBC's total loans, compared to an average of 49% for other Canadian banks.

- As the fourth round of NAFTA negotiations will begin in November, a favorable outcome for Canada is less likely. Certainly, if the agreement is repealed, the Canadian economy will be significantly disrupted, but which provinces will be affected the most? According to Bank of Montreal, Ontario is the most at risk since its economy is the most integrated with the United States with well-established supply chains, particularly in the automotive industry. In fact, close to 83% of their exports go to the United States, which represents 26% of GDP. In contrast, British Columbia exports only 8.1% of its GDP to our neighbours and 14.5% for Quebec in the form of aluminum, electricity and transportation equipment.

### FTSE TMX INDEX PERFORMANCE

| Sector | Weight | Oct. 2017 | 2016 |
|---|---|---|---|
| Universe | 100 % | 1,64 % | 2,13 % |
| Short Term | 45,0 % | 0,61 % | 0,40 % |
| Mid Term | 23,4 % | 1,40 % | 1,24 % |
| Long Term | 31,7 % | 3,33 % | 5,12 % |
| Federal | 37,2 % | 1,07 % | 0,33 % |
| Provincial | 34,0 % | 2,33 % | 3,27 % |
| Corporates | 26,9 % | 1,55 % | 3,06 % |
| RRB | | 2,26 % | -0,76 % |

Source: ftse.com

*Unless there is an aggressive monetary tightening, mortgage affordability should be restricted without causing a collapse in the real estate market. The latter will encounter some obstacles in 2018. In fact, buyers who do not subscribe to mortgage insurance will now have to prove that they will be able to pay an extra 2 % on a mortgage rate.*

*Canada recorded a $ 11 billion trade surplus with the United States last year, just 1.4% of the total US deficit in goods ( $ 752 billion). However, China's shortfall was $ 347 billion. Because he needs China's help with North Korea, Trump wants to please its manufacturing voters by accusing Canada of wrongdoing*

## STRATEGIC POSITIONNING

The devastation left behind by hurricanes Harvey and Irma did not halt the momentum of the US economy. After a momentarily spike following the hurricanes, jobless claims have fallen to a historic level not seen since the 1960's while the consumer confidence index in October reached a 17 years high. Consumers and corporations should also get tax boost which would propel the economy further at a time when the unemployment rate is at 4.1 %. The labor market continues to strengthen. The Fed is seeing labor shortages in some industries and a growing use of premiums or other non-wage incentives to attract and retain workers. The appointment of Jerome Powell as head of the Fed beginning February 2018 is a continuation and should not derail the expansion in place. As an active member of the Fed, he voted alongside Janet Yellen. As a former banker, he should have a less academic approach and be more oriented towards financial markets and the business world. As long as central bankers remain accommodative, risky assets should continue to rise as long as inflation does not change the landscape and forces monetary tightening. Using a baseball analogy, we are in the eighth inning, the game is a drawing to a close, but can also go into overtime.