MONTHLY BOND LETTER

AlphaFixe Capital

SEPTEMBER 2016

ECONOMIC EVENTS

- Canadian economic growth resumed in June (+0.6 % monthly) and continued in July with a 0.5 % gain. More than half of this growth is attributable to increased production in the mining, oil and gas industry as a result of the forest fires in Fort McMurray, which paralyzed the region back in May. Of the eleven industries listed, only construction and public sectors showed a decrease in output. The construction sector has experienced a fourth consecutive monthly decline because of setbacks in residential construction and engineering work.

Production from oil and mining industry has returned to the March level, thus erasing the disturbance from the Alberta fires. Therefore, we can expect a lower contribution from this industry going forward despite increases in oil prices. Crude oil prices remain below the canadian industry break-even level ($65-75), delaying new investments and expansion of this industry.

- The Commerce Department announced that U.S. retailers have experienced a 0,3 % decline in sales in August after a slight increase of 0.1 % in July. However, sales are still up 1.9 % on a year over year basis. Car dealers reported a 0,9 % decline in sales while lower prices at the pump have also reduced the bill at the gas stations. Notwithstanding the automobile industry, sales fell by 0.1 % from July, reflecting the extent of the decline across industries.

Retail sales should still be supported by job creation and wage increases. On the other hand, we should not expect a continued growth in auto sales, they are already at levels last seen before the financial crisis.

- Against all expectations, OPEC announced a possible reduction in production of 500,000 to 1 million barrels a day, its largest decline since the 2008 crisis. Deprived of a portion of its oil revenues, Saudi Arabia decided to reduce Ministers salaries by 20 %. The Kingdom had already announced cuts in government subsidies a few months ago.

Saudi Arabia can no longer maintain this strategy of overproduction due to its coming large deficit (14% of GDP). It is important to replenish state revenues, otherwise the Kingdom will have to slash in the public sector representing 2/3 of the jobs in the country, which could lead to social unrest.

RATE TRENDS

- The Bank of Japan announced that it was maintaining its policy rate at -0.10 % and the size of its annual asset purchases at 80 000 billion yen, but these will be used to target 10-year bond rates at 0 %. The Monetary Authority is always looking to obtain a 2 % inflation rate, but also mentioned that the QE program will continue even after this target is reached.

Despite a massive monetary injection program, the Japanese economy grew at a pace of 0.6 % annually since the election of Shinzo Abe in December 2012, or 0.3 % less than the average of the last 20 years. The problem is not monetary, it's structural.

- The Federal Reserve has kept its monetary policy unchanged at its last meeting while solidifying its rhetoric for an increase by the end of the year. According to the FOMC, economic evidence supporting an increase in Fed Funds strengthened, which brought three members of the Committee to dissent from the decision, calling for an immediate increase. The odds of a rate hike points to the December meeting, following the presidential election.

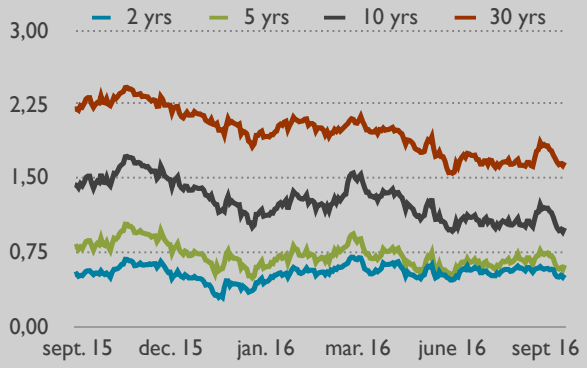
Still a great opportunity missed by the Federal Reserve to restore its credibility with investors. The Fed is too dependent on current economic data in setting its monetary policy, but appears unable to point to specific data to justify its inaction.

BOND RATES

Sept. 30 2016		Monthly Change	Change 2016		Monthly Change	Change 2016
Key Interest Rate	0,50 %	0,00 %	0,00 %	0,50 %	0,00 %	0,00 %
3 months	0,53 %	0,01 %	0,02 %	0,27 %	-0,06 %	0,11 %
2 years	0,52 %	-0,05 %	0,04 %	0,76 %	-0,04 %	-0,29 %
5 years	0,62 %	-0,05 %	-0,11 %	1,15 %	-0,05 %	-0,61 %
10 years	1,00 %	-0,03 %	-0,40 %	1,59 %	0,01 %	-0,68 %
30 years	1,66 %	0,03 %	-0,49 %	2,32 %	0,08 %	-0,70 %
RRB 30 years	0,18 %	-0,05 %	-0,46 %			

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 2016	Change 10 yrs month	Change 10 yrs 2016	Change 30 yrs month	Change 30 yrs 2016
Royal Bank, deposit notes	AA	AA-/A+	100	120	160	0	-35	5	-35	5	-30
Manulife, senior debt	A high	A+	120	145	190	0	-25	5	-25	5	-20
Fortis Inc.	A low	BBB+	140	185	245	0	5	0	20	5	30
Hydro One	A high	A	85	120	160	0	-25	0	-15	0	-25
Enbridge Inc	BBB high	BBB+	160	215	285	-20	-100	-25	-100	-10	-60
Encana Corp	BBB	BBB	320	390	450	-40	-80	-25	-85	-25	-100
GTAA	A	A+	75	105	145	0	-15	0	-15	0	-20
Bell Canada	BBB high	BBB+	135	185	235	0	-35	0	-35	0	-45
Rogers Communications	BBB	BBB+	135	185	245	0	-45	0	-45	0	-50
Loblaw	BBB	BBB	135	185	235	0	-30	0	-25	0	-30
Canadian Tire	BBB high	BBB+	140	190	240	0	-20	5	-15	0	-20
Province Québec	A high	A+	63	87	103	0	-5	-2	-10	-1	-7
Province Ontario	AA low	A+	63	85	98	2	-5	-1	-11	-1	-8
CMHC	AAA	AAA	44	53	---	5	-5	0	-6		

Source: National Bank Financial

CREDIT MARKET

- Canadian corporate bond new issuance reached 7 billion $ in September, down 400 million $ from last month and 6.2 billion $ less than in September 2015. Combined issuance for August and September reached 14.4 billion $, 500 million $ more than in 2015. Since the beginning of the year, corporate bond issuance has reached 64.2 billion $, or 11.5 % less than at the same time last year. Moreover, this year's provincial bond financing needs (2016-17) are expected to reach 74,8 billion $. At mid point, the provinces have already completed 60 % of this amount. British Colombia and Quebec are ahead of their program with 82 % and 81 % funded. In contrast, Alberta appears at the bottom of the list with only 47 % of its plan funded, leaving 8.4 billion $ in bonds to be issued.

- Canadian pipeline operator Enbridge concluded an agreement to acquire its American competitor Spectra Energy for 37 billion $, making the new entity the largest oil infrastructure group in North America. This transaction will be conducted through a share exchange, without increasing debt. When completed, Enbridge shareholders will own 57 % of the new entity. According to Enbridge executives, it is a strategic transaction that will now allow the Canadian company to transport oil to the east coast of the US through Spectra's network. This transaction was well received by bondholders due to lack of debt, resulting in spread tightening of about 20 basis points.

- Deutsche Bank (DB), the largest German bank, could be fined 14 billion $ US in connection with its involvement in the sale of harmful mortgage-backed securities before the financial crisis. According to the U.S. Department of Justice, DB has misled investors by selling them these structured products. It is the largest fine imposed on a foreign bank in the United States. Deutsche shares declined 11.3 % in September, bringing the market capitalization of the bank to 18.2 billion $ US.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	Sept-16	2016
Universe	100 %	0,25 %	5,28 %
Short Term	43,4 %	0,26 %	1,52 %
Mid Term	24,0 %	0,40 %	4,89 %
Long Term	32,6 %	0,14 %	10,83 %
Federal	36,1 %	0,10 %	3,38 %
Provincial	34,5 %	0,30 %	6,95 %
Corporates	27,4 %	0,37 %	5,65 %
RRB		0,18 %	7,80 %

Source: ftse.com

The combined weight of Enbridge and Spectra families in the FTSE-TMX index will rise to 1.7 %, the highest for a non-financial issuer. Spread tightening could be limited, as several bonds are rated BBB and most investment policies restrict their weight by issuer at 2%, leaving little room for overweight positioning.

It is unlikely that DB pays the claimed amount, it's only a starting point for negotiations. The American business bank Goldman Sachs has been fined 15 billion $ for similar facts, yet they resolved this dispute by paying 5.1 billion $ in April this year.

STRATEGIC POSITIONNING

The decisions taken by the Bank of Japan and the Federal Reserve show that central banks continue to believe that there is a transmission belt between monetary policy, financial asset prices and the real economy. The first relationship is well established and its link is strengthened as the sources of growth are running out of steam. It is rather the insidious relationship between financial assets inflation and economic growth, which deserves to be rethought among central bankers. It is wrong to believe that a rate cut encourages companies to invest, since the debt is already at a problematic level and poses a risk to financial stability. The IMF said recently that global debt (private and public) reached 152 000 billion $, the equivalent of 225 % of world GDP. In 2002, this ratio was 200 %. This debt is mainly on the private sector (companies and households) balance sheet and its increase is due to emerging markets. However, public debt of industrialized countries increased since the financial crisis. It is also utopian to think that a rise in stock prices will create a wealth effect. The wealthy benefit more from this value and their marginal propensity to consume is less than the middle class. Failing to have a clear fiscal plan, monetary policy remains the only tool available to promote growth.