MONTHLY BOND LETTER

AlphaFixe Capital

ECONOMIC EVENTS

NOVEMBER 2023

- The Canadian economy contracted by 1.1% over the summer. However, this decline was accompanied by a sharp revision of GDP in the spring. Instead of stagnating, the economy grew at an annualized rate of 1.4% in the second quarter. Businesses cut back on investment, particularly in machinery and equipment, while reducing inventories instead of production. Exports also fell during the quarter, especially petroleum products. The strike at the Port of Vancouver also affected trade this summer. Government spending was more vigorous, but insufficient to act as a counterweight. Household consumer spending stagnated for a second consecutive quarter, but at least residential real estate posted annualized growth of 8.2% in response to the housing shortage.

GDP growth over the past year was just 0.5%. This is lower than population growth (+3.0%) over the same period. A similar analysis applies to the labor market. The economy is not strong enough to create jobs at the same pace as population growth, resulting in an increase in the unemployment rate from 5.0% to 5.8% this year. Immigration is therefore helping to rebalance the job market and relieve pressure on wages, but it is accelerating the rise in shelter prices.

- U.S. existing home sales continued the downward slide that began in February. Resales fell by 4.1% month-on-month in October to an annualized rate of 3.79 million units, the lowest level since August 2010. Over the past 12 months, existing home sales have fallen by 14.6%, but new listing have also fallen by 5.7%. As a result, prices are not softening; on the contrary, they are up 3.4% year-on-year. The limited inventory of homes is driving households to the new construction market. Over the past year, new home sales have jumped by 17.7%, with an average transaction price of $409,300, compared with $391,800 for existing homes.

The dynamics of the real estate market are different in the United States than here. Mortgages are often negotiated over a 30-year term, and rising rates don't encourage homeowners to sell, as they will have to finance their new property at a higher rate. Lacking inventory, households are turning to new construction, and are therefore prepared to pay a little more for a property that meets their needs. If an interest-rate-sensitive sector like real estate doesn't weaken that much, what's going to slowdown the economy?

- China's consumer price index fell by 0.1% in October, bringing the annual variation to -0.2%, a second deflationary reading this year. The annual decline in food prices accelerated from -3.2% in September to -4.0% the following month. Non-food prices rose by 0.7% year-on-year, a timid increase that is unchanged from September. Energy prices were also down (-0.9%), but the decline was less pronounced than in September (-1.3%).

Given the sanitary measures still imposed last year, the annual inflation rate will show a great deal of volatility in the near future. However, the misuse of credit to boost the economy in recent years means that Chinese monetary policy now appears to be caught in a liquidity trap. Cutting rates to avoid deflation no longer stimulates borrowing and growth as much as it used to.

RATE TRENDS

- The message from central banks has softened. According to some leaders, current policy rates are sufficiently restrictive to allow inflation to reach the 2% target in the near future. The European Central Bank has made it clear that it has completed its monetary tightening, while other central banks such as the Bank of Canada and the Federal Reserve are still keeping the door open to further tightening, but the bar is now higher to forced a rise in rates. The end of rate hikes and slowing inflation pushed bond yields down in November. In the U.S., the monthly performance of the benchmark index (+4.53%) was the strongest since May 1985. In Canada, we have to go back to January 2015 to see such a robust performance.

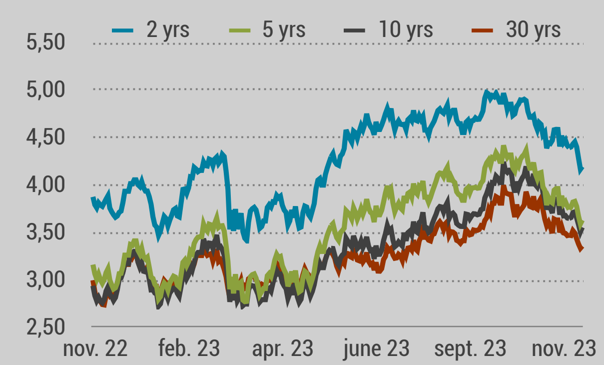
It's impressive to see how the bond market has rallied in the space of a month, when central banks have only hinted at the possibility of a halt to monetary tightening. Neither the Bank of Canada nor the Federal Reserve has hinted at cutting rates anytime soon. In Canada, the economy is slowing under the weight of rate hikes, but activity remains robust in the US. Monthly bond market performances are outperforming those of crisis periods such as the pandemic and the financial crisis. For some investors, the end of rate hikes heralds the beginning of rate cuts. The status quo is rarely a factor in their outlook.

BOND RATES

Nov. 30, 2023	Canada	Monthly Change	Change 2023	United States	Monthly Change	Change 2023
Key Interest Rate	5,00 %	0,00 %	1,25 %	5,50 %	0,00 %	1,50 %
3 months	5,04 %	-0,00 %	0,78 %	5,39 %	-0,07 %	1,04 %
2 years	4,19 %	-0,44 %	0,14 %	4,68 %	-0,41 %	0,25 %
5 years	3,63 %	-0,50 %	0,22 %	4,27 %	-0,59 %	0,26 %
10 years	3,55 %	-0,51 %	0,25 %	4,33 %	-0,60 %	0,45 %
30 years	3,36 %	-0,50 %	0,08 %	4,49 %	-0,60 %	0,53 %
RRB 30 years	1,50 %	-0,51 %	0,30 %			

Source: Bloomberg

CANADIAN RATE TRENDS



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CREDIT BOND RISK PREMIUMS

Issuers	Credit Rating DBRS	Spread 5 yrs	Spread 10 yrs	Spread 30 yrs	Change 5 yrs month	Change 5 yrs 2023	Change 10 yrs month	Change 10 yrs 2023	Change 30 yrs month	Change 30 yrs 2023
Royal Bank, Bail-in-debt	AA	140	170	200	-20	-25	-20	-30	-20	-30
Royal Bank, NVCC	A	200	240	280	-25	-25	-25	-30	-25	-30
Sun Life, subordinated debt	A	175	215	245	-25	-25	-25	-25	-25	-25
Hydro One	A high	90	120	140	-10	-20	-10	-20	-10	-20
Enbridge Inc	BBB high	145	190	230	-20	-30	-20	-25	-20	-30
Altalink LP	A	90	120	140	-10	-15	-10	-15	-10	-15
GTAA	A high	85	115	135	-10	-20	-10	-20	-10	-20
Bell Canada	BBB high	130	180	210	-20	-30	-20	-15	-15	-15
Rogers Communications	BBBL	150	200	240	-25	-30	-25	-25	-15	-30
Loblaw	BBB high	110	150	180	-20	-40	-20	-35	-15	-30
Canadian Tire	BBB	125	170	210	-15	-45	-15	-40	-10	-45
Province Québec	AA low	37	69	88	-8	-9	-6	-3	-7	-6
Province Ontario	AA low	39	71	90	-8	-9	-6	-3	-6	-5
CMHC	AAA	25	42	---	-8	-11	-10	-4		

Source: National Bank Financial

CREDIT MARKET

- Canadian corporate bonds new issuance totalled $10.5 billion in November, up $8 billion from the previous month, but $2.8 billion less than in November 2022. Year-to-date, bond financing totals $87.6 billion, down 18% on the same period last year. This contrasts with the previous month in terms of both the amount financed and the number of different issuers. In fact, there were 17 different companies for 22 issues, and none from the 6 major Canadian banks. These banks were in a blackout period ahead of the release of their annual financial results.
- Canada's Big Six banks reported quarterly profits totalling $12.3 billion, down $6.8 billion on the same period last year. For the full fiscal year 2023, profits total $45.7 billion, a drop of 31% compared to 2022. This decline in profitability comes despite the fact that bank revenues rose by 4.6% during the year. Canadian banks have been hit by significant increases in operating costs, particularly wages. They were also forced to comply with more restrictive capital requirements from OSFI and higher provisions for potentially impaired loans. Rising expenses have forced some institutions to lay off staff in recent months.
- The province of Quebec has carried out an economic update to take into account more difficult future conditions. For the current fiscal year (2023-24), the Minister of Finance expects lower tax revenues, which will be more than offset by higher federal transfers through equalization. Spending will increase by $2.4 billion, including the new wage proposal for unionized public workers. Despite higher spending and a more severe economic slowdown in 2024, the shortfall for fiscal 2023-24 will remain unchanged at $1.8 billion, and a return to balanced budgets is still expected in 2025-26 (excluding the payment to the Generations Fund). To achieve this, the Legault government will draw on its contingency reserves.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	Nov. 2023	2023
Universe	100 %	4,29 %	3,15 %
Short Term	44,3 %	1,77 %	3,46 %
Mid Term	28,3 %	4,05 %	2,38 %
Long Term	27,4 %	8,54 %	3,22 %
Federal	39,4 %	3,37 %	2,11 %
Provincial	33,0 %	5,71 %	2,96 %
Corporates	25,7 %	3,81 %	4,94 %
RRB		6,84 %	-1,62 %

Source: ftse.com

Not surprisingly, the rise in policy rate has disrupted business at Canadian banks. They are still generating high revenues, but lending is becoming riskier and wage inflation is eating into profits. Despite reduced profitability, the Canadian financial system remains financially sound, with high capitalization ratios.

The government is taking advantage of this update to allocate funds to issues of recent concern. Social housing will benefit from an envelope of $1.8 billion over 5 years to build 8,000 new affordable housing units. This is a fine initiative, but to achieve it, we need to find workers in this field, which is already short of manpower.

STRATEGIC POSITIONNING

By the end of the third quarter, investors had adopted a new perspective on the direction of rates, embracing the notion that central banks will need to keep their key rates high for an extended period if they are to definitively stem inflationary pressures. The pessimism raging in the bond market at the end of September quickly dissipated, despite robust economic growth in the USA over the summer (+5.2%). Investors now expect monetary tightening to be a thing of the past as inflation decelerates on both sides of the border and the US labor market shows signs of slowing. There is, however, an important step between the end of rate hikes and the beginning of monetary easing. That step has now been brushed aside. The sharp cut in bond yields in November presupposes an easing of monetary policy in the near future, regardless of the risks that inflation could remain persistent or revive if economic activity does not decelerate sufficiently. Stock markets also surged in November, and are not buying into the scenario of an imminent recession. Before suggesting a rate cut, the Federal Reserve will want to observe a slowdown in wage increases, which are still rising at twice the rate of inflation. The situation is more precarious in Canada, where monetary policy has more teeth and is holding back economic growth.