

MONTHLY BOND LETTER

AlphaFixe
Capital

ECONOMIC EVENTS

JUNE 2019

- Canadian job market stellar performance this year continued in May. After a record gain of 106,500 jobs in April, the Canadian economy added another 27,700 jobs in May, bringing job creation to 249,700 since the beginning of the year, in sharp contrast to the same period last year when 7,600 jobs were lost. These were the most successful first 5 months of the year since 2002, with 77% full-time jobs and 76% from the private sector. The unemployment rate is now at 5.4%, a historic low since the publication of this statistic in 1976.
- Retail sales in the United States rose 0.5% in May after a 0.3% increase in the previous month and 1.8% in March. Gains were reported in 11 of the 13 retail categories, including vehicle sales (0.7%), electronics (1.1%), sporting goods (1.1%) and food services (0.7%). Last February, only 6 categories of goods had recorded sale increases. On an annual basis, sales increased by 3.2% in May.
- According to the World Bank, global economic growth is expected to slow down from 3.0% last year to 2.6% in 2019, the slowest pace since the financial crisis. The Bank attributes this deceleration to growing uncertainty surrounding international trade between some major economies, accompanied by a decline in global investment and confidence.

Certainly, there could be a decline in job creation in the coming months given the recent strong gains. On the other hand, the Canadian economy still has 506,140 vacant positions, 44,295 more than a year ago. In addition, 80% of the positions are related to permanent jobs. The total number of jobs to be filled in Quebec is 114,215, proof that the labour shortage is not about to disappear.

Despite recession warnings from the bond market, households remain confident, driven by job and wage gains. The increase in sales in areas such as sports and electronics is encouraging. These discretionary expenditures are generally the first to be reduced in times of economic uncertainty.

The main concern is that this war is more of an attempt by the United States to contain China's ambition in the technology sector and force it to abandon its unfair trade practices. However, Trump must run for election with a strong economy, so a truce is possible.



RATE TRENDS

- The Federal Reserve has kept its policy rate at 2.5%, but is opening the door for a rate cut this year. The Fed continues to see a sustained expansion in the economic activity with a strong labour market and inflation close to the 2% target. However, growing uncertainties in international trade and the recent moderation in inflationary pressures could tarnish the economy and force the Fed to adjust its policy to support the expansion. Eight out of 17 Fed members now anticipate a rate cut in 2019, while James Bullard voted for a 25 bps cut in June.
- Mario Draghi mentioned that the European Central Bank (ECB) could consider adapting their policy tools in the coming weeks to attenuate the risks to their economic outlook. Options include a cut in the deposit rate, already at -0.4% since 2016, or restarting the asset buyback program. This statement raised President Trump's anger, accusing the ECB of forcing a devaluation of the euro and creating an unfair advantage against the United States.

The Fed showed its colours, promoting expansion and stimulating inflation, even opening the door to a rate cut as early as July. What is worrying is that the Fed relies on financial market inflation expectations to justify a more expansionary policy. Financial markets preach for their portfolios and not for the good of the economy.

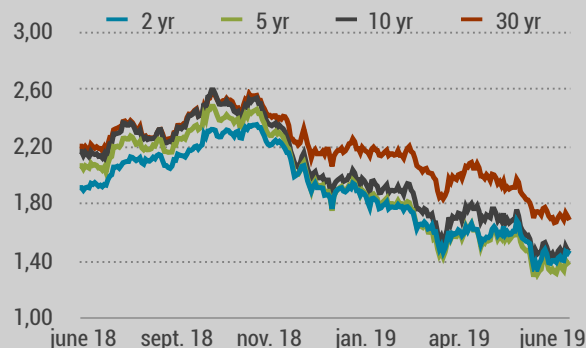
Despite imposing tariffs on its trading partners, the U.S. trade deficit has deteriorated. Trump could also be looking at depreciating the dollar to improve the trade balance. The pressure on the Fed to lower rates is pointing in this direction.

BOND RATES

		Monthly Change	Change 2019		Monthly Change	Change 2019
June 30 2019						
Key Interest Rate	1,75 %	0,00 %	0,00 %	2,50 %	0,00 %	0,00 %
3 months	1,66 %	-0,02 %	0,01 %	2,09 %	-0,25 %	-0,27 %
2 years	1,47 %	0,05 %	-0,39 %	1,74 %	-0,18 %	-0,75 %
5 years	1,39 %	0,03 %	-0,49 %	1,76 %	-0,15 %	-0,75 %
10 years	1,47 %	-0,02 %	-0,50 %	2,00 %	-0,13 %	-0,69 %
30 years	1,69 %	-0,08 %	-0,50 %	2,53 %	-0,04 %	-0,49 %
RRB 30 years	0,32 %	-0,07 %	-0,44 %			

Source: Bloomberg

CANADIAN RATE TRENDS



CREDIT BOND SPREADS

ISSUER	Credit rating DBRS	Spread			CHANGE					
					5 yrs		10 yrs		30 yrs	
		5 yrs	10 yrs	30 yrs	month	2019	month	2019	month	2019
Royal Bank, bail-in debt	AA	100	135	175	-10	-35	-10	-25	-10	-25
Manulife, sub debt NVCC	A	145	190	230	-10	-40	-10	-30	-10	-30
Fortis Inc.	BBB high	100	140	195	-15	-40	-15	-45	-10	-40
Hydro One	A high	75	110	150	-15	-40	-20	-30	-15	-30
Enbridge Inc	BBB high	110	160	230	-15	-50	-15	-50	-20	-45
Encana Corp	BBB	160	225	280	-10	-45	-10	-45	-10	-45
GTAA	---	60	85	115	-15	-25	-15	-20	-10	-25
Bell Canada	BBB high	110	155	220	-5	-45	-10	-45	-10	-40
Rogers Communications	BBB	105	150	215	-5	-45	-10	-45	-10	-45
Loblaw	BBB	115	160	220	-5	-50	-10	-55	-10	-50
Canadian Tire	BBB high	110	155	215	-5	-50	-10	-55	-10	-55
Province of Québec	A high	43	65	76	-4	-16	-7	-19	-5	-20
Province of Ontario	AA low	45	69	80	-4	-18	-7	-20	-5	-21
CMHC	AAA	31	40	---	-5	-12	-5	-16		

Source: National Bank Financial

CREDIT MARKET

- Canadian corporate bond new issues reached \$ 13.1 billion in June, an increase of \$7.1 billion over the month and \$2.1 billion more than in June 2018. Since the beginning of the year, total corporate bond financings amounted to \$48.4 billion, or 3.3% less than at this time last year. Keyera Corp is on the list of new issues with a \$600 million hybrid debt financing maturing in 2079, but redeemable by the issuer in 2029. Rated BB and providing a coupon of 6.875%, this debt combines the characteristics of a bond with its fixed coupon and its maturity, but also that of a share given the possibility of deferring the coupon payment (much like a dividend) without causing a default.
- Royal Bank's (RBC) credit rating was upgraded from AA to AA (high) by DBRS with a stable outlook. This improvement is the result of the Bank's strong credit fundamentals and consistently better-than-peer financial performance. Sector diversification and the geographic diversity also support the rating. In fact, 38% of total revenues comes from outside of Canada. In its assessment, DBRS takes into account the longevity of the credit cycle, the importance of the capital markets business, the high level of Canadian household debt, the possibility of a slowdown in the housing market and the growing uncertainty in the global economy. Despite a volatile financial market environment, RBC's earnings grew by 5% annually in the first half of the year (Nov. 18 to Apr. 19).
- S&P downgraded TransAlta's credit rating from BBB- to BB+ with a stable outlook. Last March, Brookfield Renewable Partners entered into an agreement to invest \$750 million in TransAlta, including \$350 million in subordinated debt and \$400 million in preferred shares. A portion of the proceeds of this investment will be used to advance the company's coal to gas transition strategy (\$350 million), while \$250 million will be dedicated to a three-year share buyback program. According to S&P, all these investments, including preferred shares, are considered debt, which raises debt to EBITDA ratio above the agency's comfort level for an extended period.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	June 2019	2019
Universe	100 %	0,91 %	6,52 %
Short Term	43,3 %	0,14 %	2,67 %
Mid Term	22,7 %	0,53 %	5,91 %
Long Term	34,0 %	2,15 %	12,09 %
Federal	34,8 %	0,34 %	4,04 %
Provincial	35,5 %	1,35 %	8,76 %
Corporates	27,7 %	1,06 %	6,82 %
RRB		1,38 %	8,81 %

Source: ftse.com

Given the current level, a rating upgrade is unlikely. Canadian real estate continues to be a concern for investors. However, 37% of RBC's mortgages are insured (CMHC or other) while the loan-to-value ratio of uninsured mortgages is 57%, leaving RBC plenty of room for manoeuvre.

Despite this downgrade, the TransAlta still remains in investment grade territory in Canada while it is considered high yield in the United States. For the FTSE index, it is the issue rating that matters, not the issuer's rating. However, Moody's (Ba1) does not publish a rating per issue for TransAlta while DBRS and Fitch are still in the BBB category.

STRATEGIC POSITIONNING

The Fed seems to be quietly setting the table to cut its policy rate this year, perhaps as early as July. Are rates too high or is it the U.S. dollar that is too strong? Global supply chains require a significant level of capital to maintain adequate inventory and support account receivables. However, according to the Bank for International Settlements, more than 80% of world trade is in US dollars. Thus, a rising dollar makes credit conditions more difficult for international companies. Rate hikes in the US last year accentuated the dollar's appreciation, reducing international trade and imported goods prices in the US, the two factors behind the Fed's U-turn. However, the dollar is also strong out of spite. Brexit is hurting the pound, European leaders incoherence and lack of a centralized fiscal policy are undermining the euro while Japan is still trying to get out of its slump. The Fed's objective is taking shape: keep short-term rates low to curb the strength of the dollar, stimulate the economy at full employment and boost inflation. International tensions are hurting growth and the Fed believes their toolbox to fight inflation is better stocked than the one against a recession. The Fed has therefore buckled under pressure and is cooking up a recovery at full employment, a bitter recipe for long-term bond holders who are inflation averse.