# MONTHLY BOND LETTER

AlphaFixe Capital

NOVEMBER 2016

## ECONOMIC EVENTS

- Canadian gross domestic product grew at an annualized rate of 3.5 % during the third quarter after a 1.3 % contraction in the previous quarter. Net exports contributed strongly to growth with the resumption of drilling activities and oil extraction which were disrupted as a result of the Alberta forest fires. Household consumption expenditures have also accelerated (+2.6 %), supported by the Federal Child Care program. However, residential real estate fell by 1.4 %, a first decline since the winter of 2014. This decline is attributable to a decreasing resale market in British Columbia due to the introduction of a real estate tax for non-residents.

*Households have only spent a portion of the Child Care allowance received this summer. Therefore, the savings rate climbed to its highest level since 2001 at 5.8 % of disposable income. This provides households an additional cushion. Furthermore, government spending, halted during the summer, should resume in the next few quarters, even in Quebec.*

- US personal income rose by 0.6 % on a monthly basis in October, resulting in an annual increase of 3.9 %. This gain is mainly due to a rise in wages (+ 0.5 %) during the month. On the other hand, consumer spending increased at a lower rate (+ 0.3 %) after a strong gain in September (+ 0.7 %). These favourable conditions have pushed consumer confidence in November to a level unseen since the financial crisis.

*Should we worry about the increase in wages while the economy is near full employment, and that the President-elect wants to restrict immigration? It is at least what investors seems to fear, pricing in inflationary pressures.*

- Chinese authorities are planning new restrictions on overseas investment in order to slow the flood of capital leaving the country, which exerts downward pressure on the yuan. Acquisitions of more than $ 1 billion would be examined if they are outside of their field. State Owned Enterprise will also be prohibited to invest more than $ 1 billion on a single real estate transaction abroad.

*Will the outflow of Chinese capital accelerate in anticipation of expanding control into smaller overseas investments? If so, will we see more Chinese buyers in Canadian real estate despite the new regulations in place?*

## RATE TRENDS

- Donald Trump's election has created shockwaves in the bond market. The "Barclay's Global Aggregate" index fell by 4 % during the month, resulting in a loss of more than $ 1 700 billion worldwide. In Canada, the FTSE-TMX Universe Index declined by 2.07 %, its worst performance since December 1981 (-2.08 %). Since the low point recorded on July 8, Canada 30-year bond rose by 64 bps and 96 bps in the United States. This rise in Canadian long-term interest rates translates into a loss of nearly 12 % for bondholders.

*A significant budget deficit while the economy is at full employment, restrictions on Mexican workers and the possible renegotiation of free trade agreements are all inflationary elements at the heart of the platform of the next president that scare the bond investors.*

- In response to the upcoming fiscal stimulus, investors now expect a rise in interest rates from the Federal Reserve in December. Before the election, odds of a 25 bps rate hike amounted to 65 %. The rise of populism and protectionism in the world are inflationary elements that investors have begun to discount.

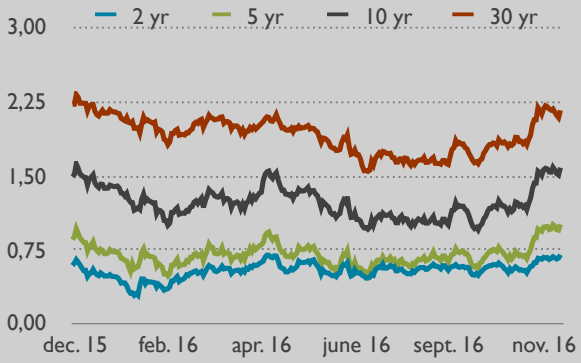
*Finally, central bankers alone won't have to bear the burden of economic growth, as voters claimed for additional fiscal stimulus at the polls. How fast will central bankers adjust to this new reality?*

## BOND RATES

| Nov. 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 | 0,51 % | 0,04 % | 0,00 % | 0,48 % | 0,18 % | 0,31 % |
| 2 years | 0,70 % | 0,16 % | 0,22 % | 1,11 % | 0,27 % | 0,07 % |
| 5 years | 1,01 % | 0,32 % | 0,28 % | 1,84 % | 0,54 % | 0,08 % |
| 10 years | 1,59 % | 0,39 % | 0,19 % | 2,38 % | 0,56 % | 0,11 % |
| 30 years | 2,17 % | 0,32 % | 0,02 % | 3,03 % | 0,45 % | 0,02 % |
| RRB 30 years | 0,36 % | 0,13 % | -0,28 % | | | |

Source: Bloomberg

## CANADIAN RATE TRENDS




1800 Ave. McGill College | Suite 2420 | Montréal (PQ) | H3A 3J6 514-861-3493 www.alphafixe.com info@alphafixe.com

## 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- | 95 | 105 | 150 | 0 | -40 | -5 | -50 | -5 | -40 |
| Manulife, Senior debt | A high | A+ | 115 | 135 | 185 | 0 | -30 | -5 | -35 | -5 | -25 |
| Fortis Inc. | BBB high | BBB+ | 130 | 175 | 235 | -5 | -5 | -10 | 10 | -5 | 20 |
| Hydro One | A high | A | 80 | 110 | 150 | -5 | -30 | -5 | -25 | -10 | -35 |
| Enbridge Inc | BBB high | BBB+ | 135 | 185 | 245 | -15 | -125 | -20 | -130 | -20 | -100 |
| Encana Corp | BBB low | BBB | 265 | 335 | 395 | -20 | -135 | -20 | -140 | -20 | -155 |
| GTAA | --- | A+ | 70 | 100 | 135 | -5 | -20 | -5 | -20 | -5 | -30 |
| Bell Canada | BBB high | BBB+ | 115 | 165 | 225 | -15 | -55 | -15 | -55 | -10 | -55 |
| Rogers Communications | BBB | BBB+ | 115 | 165 | 235 | -15 | -65 | -15 | -65 | -5 | -60 |
| Loblaw | BBB | BBB | 125 | 175 | 225 | -5 | -40 | -5 | -35 | -5 | -40 |
| Canadian Tire | BBB high | BBB+ | 125 | 175 | 230 | -10 | -35 | -10 | -30 | -5 | -30 |
| Province of Québec | A high | A+ | 57 | 83 | 97 | -3 | -11 | -3 | -14 | -4 | -13 |
| Province of Ontario | AA low | A+ | 59 | 84 | 94 | -1 | -9 | -1 | -12 | -3 | -12 |
| CMHC | AAA | AAA | 42 | 54 | --- | 2 | -7 | 3 | -5 | | |

Source: National Bank Financial

## CREDIT MARKET

- Canadian corporate bond new issuance reached $ 9.6 billion in November, an increase of $ 5 billion compared to the previous month and $ 6.5 billion more than November 2015. Since the beginning of the year, corporate issuance reached $ 78.7 billion, or 3.4 % less than at the same time last year. Corporate bonds have behaved well in this bullish environment, losing only 1.28 % of their value, or 0.61 % better than federal bonds. On average, risk premiums fell by 7 bps during the month. The Financial sector recorded the best performance (-0.50 %) due to shorter duration, but also in response to the excellent performance of this sector in the United States which President Trump wants to reduce the regulatory burden.

- Canada Mortgage and Housing Corporation (CMHC) did a stress test to confirm its financial strength. According to CMHC, a sudden spike in mortgage rates (+2.4 % in 6 months) would result in house prices falling by 30 % and the federal insurer losing close to $ 1.1 billion. On the other hand, an extreme case of prolonged economic depression where house prices drop by 25 % and unemployment jumps to13.5 % would result in a loss of $ 3.1 billion. In both cases, the Federal Agency confirmed that its capital is sufficient. In the extreme case, CMHC's level of capital would be more than 200 % of the minimum required by authorities. In the wake of rising rates during the month, Royal Bank announced an increase of 30 bps to its 5-year mortgage rate to 2.94 %.

- After turning down Enbridge's Northern Gateway project, the Federal Government approved two major pipeline projects to facilitate oil export from the Alberta oil sands. KinderMorgan's TransMountain pipeline project will be able to transport up to 890 000 barrels a day from Edmonton to Vancouver in order to export oil to asian markets. Enbridge's line 3 replacement project also obtained approval from the authorities. The modernization of this pipeline, which connects Hardisty, Alberta to the State of Wisconsin, will allow Enbridge to double the transport volume to 760 000 barrels per day. Prime Minister Trudeau justified this decision by indicating that it is in the best interest of the country.

## FTSE TMX INDEX PERFORMANCE

| Sector | Weight | Nov. 2016 | 2016 |
|---|---|---|---|
| Universe | 100 % | -2.07 | 2.17 |
| Short Term | 44,1 % | -0.49 | 1.06 |
| Mid Term | 24,4 % | -2.11 | 1.95 |
| Long Term | 31,5 % | -4.16 | 3.77 |
| Federal | 36,8 % | -1.89 | 0.62 |
| Provincial | 34,2 % | -2.86 | 2.42 |
| Corporates | 27,1 % | -1.28 | 3.89 |
| RRB | | -2.08 | 5.23 |

Source: ftse.com

*This stress test is reassuring considering overheating house prices in some cities. In order to limit the risk of losses to its agency, the Federal Government announced a consultation document proposing shared mortgage risks between insurers and lenders (banks). Currently, this burden relies solely on CMHC.*

*The Government has chosen to put the country's economic interests ahead of climate change concerns. It is a way for the Federal Government to promote growth in Alberta without resorting to fiscal stimulus or create national program which could fuel growth in other provinces.*

## STRATEGIC POSITIONNING

The results of the American election illustrated a great anger in voters who, since the financial crisis, felt abandoned by the political establishment. Indeed, real median income of U.S. households still remains below the pre-crisis levels, while the wealthiest, including American bankers, became richer. M. Trump has channeled that anger towards international trade, immigration, and career politicians. He got elected by promising economic prosperity which relies on tax cuts, significant infrastructure expenditures, deregulation, tighter borders and possible free-trade renegociations in order to prevent jobs from leaving the country. His electoral base, mainly 45 years and older, also recognizes that monetary policy has accentuated income inequality, harmed savings and growth. Today's economy is more indebted, older and less dependent on capital intensive industries, which means that a prolonged period of low interest rate policy has little impact on growth. Instead, older households have less debt and are using their savings to consume. The cure for economic illness could well be higher rates and fiscal stimulus, that's at least what voters seem to be telling their leaders.