MONTHLY BOND LETTER

AlphaFixe Capital

ECONOMIC EVENTS

AUGUST 2019

- The Canadian economy grew at an annualized rate of 3.7% in the second quarter after a 0.5% gain in the first three months of the year. This rebound was largely due to exports, which jumped 13.4% while imports fell 4.0%. Household spending as subdued, rising by only 0.5% compared to a 3 % jump in the previous quarter. Residential real estate rebounded (5.5%) after 3 consecutive quarters of contraction. In contrast, business investments fell 16.2%, erasing the gains recorded in the previous quarter (14.4%).

Although growth was higher than expected, final domestic demand was weaker, particularly consumer spending, despite a robust labour market. However, the next quarter may be brighter for consumers with a housing market recovery that could spur increased spending for housing related items.

- Unit labour costs in the United States, which captures the cost of labour per unit of output, increased by 2.4% in the second quarter, while labour productivity increased by 2.4% in annualized terms. Over the past 12 months, costs have increased by 2.5% and productivity by 1.8%. However, the surprise came from the first quarter revisions. Initially, the Bureau of Labour Statistics reported that unit labour costs fell by 1.6% in the winter, but revised it to a 5.5% increase three months later.

When labour productivity cannot compensate for wage increases, companies have no choice but to pass on these costs to consumers if they want to keep their profit margins. Generally, the increase in unit labour costs is reflected in inflation over the following year.

- The German economy contracted by 0.4% in the second quarter after growing by 1.6% in the winter. The sharp decrease in exports has led to a decline in growth, resulting in a negative contribution from international trade. In contrast, household consumption, government expenditure and business investment increased, but not enough to offset the impact of net exports.

Despite negative interest rates in Germany, the German manufacturing sector is in recession while the service sector is still expanding. Evidence that the Sino-American trade war has a greater negative impact than the level of interest rates.

RATE TRENDS

- With the general decline in interest rates this year, 30% of the global bond market was trading at negative rates at the end of the month, compared to 16% at the beginning of the year. Some governments such as Germany, Switzerland and the Netherlands can now finance themselves at negative rates up to a 30-year term. Moreover, Germany was able to issue €2 billion with a coupon rate of 0% and a price of €103.61, which represents a yield to maturity of -0.11%. If an investor keeps this bond until 2050, he ensures a lose of €3.61.

Due to lack of interest, the private market bought only 40% of the new 30-year issue in Germany. The Bundesbank (German central bank) had to acquire the rest, which it categorically refused to do before. Without the intervention of central banks, bond markets with negative yields cannot survive.

- The U.S. Treasury Department is seriously considering the idea of issuing ultra long-term bonds, 50 or even 100 years. For the Trump administration, this would be a plan to reduce the borrowing costs of the deficit, which is expected to exceed $1 trillion this year. Currently, only Austria, Argentina, Mexico, Belgium and Ireland have issued century-old bonds. Moreover, the price of Argentina's 2117 bond fell by 50% in August following Alberto Fernandez's election.

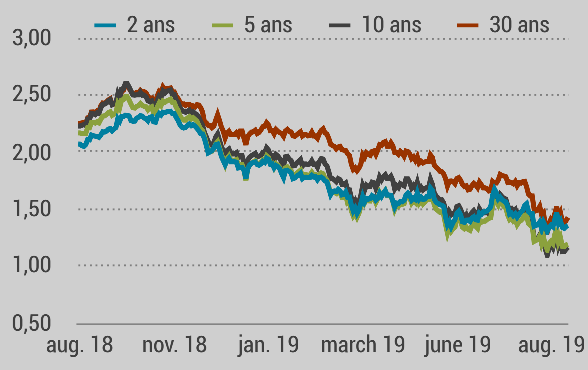
In contrast, the Austrian bond generated a return of 73.6% in 2019 with a price now trading at over 200 € and a yield to maturity of 0.65%. However, with a duration of over 57 years, losses could be significant if rates rise.

BOND RATES

August 31 2019		Monthly Change	Change 2019		Monthly Change	Change 2019
Key Interest Rate	1,75 %	0,00 %	0,00 %	2,25 %	0,00 %	-0,25 %
3 months	1,63 %	-0,03 %	-0,03 %	1,97 %	-0,09 %	-0,38 %
2 years	1,36 %	-0,19 %	-0,51 %	1,53 %	-0,35 %	-0,96 %
5 years	1,19 %	-0,26 %	-0,70 %	1,41 %	-0,41 %	-1,10 %
10 years	1,16 %	-0,31 %	-0,80 %	1,53 %	-0,49 %	-1,16 %
30 years	1,43 %	-0,27 %	-0,76 %	1,99 %	-0,53 %	-1,02 %
RRB 30 years	0,19 %	-0,13 %	-0,57 %			

Source: Bloomberg

CANADIAN RATE TRENDS



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CREDIT BOND SPREADS

ISSUER	Credit rating DBRS	Spread 5 yrs	Spread 10 yrs	Spread 30 yrs	CHANGE 5 yrs month	CHANGE 5 yrs 2019	CHANGE 10 yrs month	CHANGE 10 yrs 2019	CHANGE 30 yrs month	CHANGE 30 yrs 2019
Royal Bank, bail-in debt	AA	105	140	180	15	-30	15	-20	15	-20
Manulife, sub debt NVCC	A	155	200	240	25	-30	25	-20	25	-20
Fortis Inc.	BBB high	105	145	205	15	-35	15	-40	20	-30
Hydro One	A high	85	115	160	15	-30	15	-25	15	-20
Enbridge Inc	BBB high	125	175	245	15	-35	20	-35	20	-30
Encana Corp	BBB	185	245	315	25	-20	20	-25	35	-10
GTAA	---	70	95	125	10	-15	10	-10	10	-15
Bell Canada	BBB high	120	170	230	20	-35	25	-30	20	-30
Rogers Communications	BBB	115	160	225	20	-35	20	-35	20	-35
Loblaw	BBB	125	170	230	20	-40	20	-45	20	-40
Canadian Tire	BBB high	120	165	225	20	-40	20	-45	20	-45
Province of Québec	A high	46	69	82	3	-13	4	-15	6	-14
Province of Ontario	AA low	48	73	86	4	-15	5	-16	7	-15
CMHC	AAA	34	44	---	3	-9	3	-12		

Source: National Bank Financial

CREDIT MARKET

- Canadian corporate bond new issuance reached $5.0 billion in July, a decrease of $1 billion from the previous month and also compared to August 2018. Since the beginning of the year, corporate bond financings reached $59.4 billion, a 2.6% decrease from a year ago. In this environment of uncertainty, the performance of credit bonds in 2019 is impressive and goes against recession fears. Long-term provincial bonds generated a return of 17.4% in the first 8 months of the year, while long term corporate bonds generated 16.0%. However, the best performance goes to long term communication bonds with an 18% return so far in 2019.
- Collectively, the six largest Canadian banks posted earnings of $12.3 billion in the third quarter, up 4.8% from the same period last year. Royal Bank and TD Bank each announced earnings of $3.3 billion for a quarter. Only TD Bank and National Bank showed an improvement in the results of all their activities. For others, such as Scotiabank, CIBC and Royal Bank, earnings from capital markets were lower than in the third quarter last year due to lower transaction revenues. However, most institutions have increased loan loss provisions in this uncertain environment.
- German company Siemens has raised €3.5 billion from the capital markets, including €1.5 billion of two and five-year bonds. These have a 0% coupon and negative yields. The remaining €2 billion is borrowed over longer periods (10 and 15 years) and offered minimal coupon rates. For the 2-year bond, the offered yield was -0.315%, which is the lowest corporate bond yield ever recorded. The 5-year bond was offered at a -0.206% yield. At the end of August, global corporate bonds trading with negative yields totalled $1,151 billion. At the beginning of the year, this amount was almost nil.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	Aug. 2019	2019
Universe	100 %	1,88 %	8,70 %
Short Term	42,5 %	0,66 %	3,34 %
Mid Term	22,7 %	1,88 %	8,05 %
Long Term	34,8 %	3,41 %	16,40 %
Federal	35,1 %	1,80 %	5,81 %
Provincial	35,5 %	2,45 %	11,67 %
Corporates	27,4 %	1,21 %	8,57 %
RRB		1,80 %	11,27 %

Source: ftse.com

Given the high level of Canadian household indebtedness and the low growth prospects in the mortgage market in recent years, the financial results of our Canadian banks are a testimony to their strength and diversity.

There is a huge difference between a sovereign issuer that has taxation power to back its debt and a private company. The idea of buying a negative-yield corporate bond, with an economic cycle and default risks is beyond comprehension. At the same time, why buy this bond if there was a risk of a global recession?

STRATEGIC POSITIONNING

Financial markets do not seem to agree on recession risks. Admittedly, the yield curve inversion has always been a recession leading indicator. While declining 10-year bond rates raises fears of a recession, the good performance of equity markets and high-yield bonds reflects another reality. However, today's yield curve inversion doesn't have the same predicting power as before giving central banks manipulated bond markets using quantitative easing programs. The decline in long-term rates is also the result of foreign buyers having to deal with negative yield curves up to 30-year. In fact, nearly 30% of the global bond market is trading at a negative yield. Even gold, which offers no income, becomes attractive when several investments have negative returns. American bonds are therefore becoming a profitable alternative for foreign investors, especially since the US dollar remains strong. Could we see negative returns in North America? The global financial and banking systems cannot survive if there is no longer a positive alternative for safe assets. We still live with an unpredictable American president who can turn the situation upside down with one tweet if he believes his re-election is in jeopardy. Fundamental analysis is still the best tool for dealing with uncertainty.