



MONTHLY BOND LETTER

AlphaFixe
Capital

ECONOMIC EVENTS

AUGUST 2018

- Canada's gross domestic product grew at an annualized rate of 2.9% in the second quarter, up 1.5% from the first quarter. For the first time this year, foreign trade contributed to growth with exports growing twice as much as imports (12.3% vs. 6.5%). This is the strongest growth in exports since the second quarter of 2014 with notable gains in energy products and consumer goods. Household spending also strengthened in the second quarter (1.5%) under the influence of strong labor markets and a decline in the savings rate. Corporate investments (1.5%) also increased, but at a slower pace when compared to last winter (2.3%).
- The US consumer price index rose 0.2% on a monthly basis in July, bringing the annual price to 2.9%. Excluding volatile components of food and energy, annual price growth was 2.4%, the highest reading since September 2008. Prices for services (excluding energy) increased by 3.1% in 12 months, especially those related to accommodation (3.5%) and transportation (4.0%).
- Japan's economy grew at an annualized rate of 1.9% in the second quarter, after declining 0.9% Q1. Household spending recovered in the spring after being weakened by food inflation during the winter. Corporate investments also contributed strongly to growth, while international trade and residential real estate had the opposite effect. This is a fourth consecutive quarter of decline for residential real estate.

As it was also the case in the United States, foreign trade had been a major contributor to Canadian growth, as our trading partners purchased before tariffs came into effect. Exports could weaken in the third quarter, slowing GDP growth in the fall. In addition, oil production could also dampen growth due to a power outage that paralyzed Syncrude's operations back in July.

If an economy's output gap is totally eliminated, then an increase in demand, resulting from tax reform, can't be fully offset by the use of excess capacity, thus creating inflationary pressures.

Household spending was supported by a 4.3% increase in wages in the last year, a promising indicator in the fight against deflation. However, the decline in real estate investments should give support to the Bank of Japan's zero interest rate policy.



RATE TRENDS

- The minutes from the last Federal Reserve meeting suggest that a rate hike could occur in September due to a favorable economic environment creating inflationary pressures. Even though the Fed is concerned about trade tensions, members have also expressed concerns about the effectiveness of available monetary tools to fight the next recession.
- Since the beginning of the year, the Bank of Canada has issued two 30-year Canada bonds worth \$ 1 billion each. If the trend continues in the fourth quarter, the sum of long-term issues could reach \$ 3 billion in 2018, \$ 500 million less than last year and the lowest level since 2011. By contrast, the US Treasury should issue nearly \$ 180 billion of 30-year securities in 2018, up more than 15% year-over-year.

During the last seven recessions, the Federal Reserve had to lower its policy rate by an average of 7.2% in order to stimulate the economy. With only 2% in ammunition at the moment, the Fed is telling us that it wants to build-up reserves in order to face the next crisis.

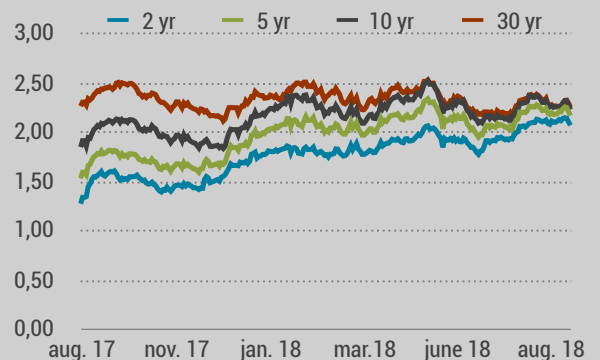
The decline in Canada 30-year bond issuance compared to 10-year bond partly explains the yield curve flattening. In addition, US tax reforms have prompted long-term bond buying in the United States. Until September 15, corporate pension plans can deduct their contributions at a higher tax rate.

BOND RATES

Aug. 31 2018		Monthly Change	Change 2018		Monthly Change	Change 2018
Key Interest Rate	1,50 %	0,00 %	0,50 %	2,00 %	0,00 %	0,50 %
3 months	1,54 %	0,09 %	0,04 %	2,09 %	0,07 %	0,72 %
2 years	2,07 %	0,00 %	0,57 %	2,63 %	-0,04 %	0,74 %
5 years	2,17 %	-0,05 %	0,30 %	2,74 %	-0,11 %	0,53 %
10 years	2,23 %	-0,08 %	0,18 %	2,86 %	-0,10 %	0,46 %
30 years	2,25 %	-0,08 %	-0,01 %	3,02 %	-0,06 %	0,28 %
RRB 30 years	0,54 %	-0,05 %	-0,04 %			

Source: Bloomberg

CANADIAN RATE TRENDS



CREDIT BOND RISK PREMIUMS

ISSUER	Credit rating		Spread			5 yrs		10 yrs		30 yrs		Change	
	DBRS	S&P	5 yrs	10 yrs	30 yrs	month	2018	month	2018	month	2018	month	2018
	Royal Bank, deposit notes	AA	AA-	85	100	140	0	10	-5	10	-5	10	-5
Manulife, Senior debt	A high	A+	95	120	160	0	5	-5	5	-10	-5	-10	-5
Fortis Inc.	BBB high	BBB+	105	150	200	-5	15	-5	15	0	35	0	35
Hydro One	A high	A	75	100	140	-5	10	-5	15	-5	10	-5	10
Enbridge Inc	BBB high	BBB+	115	160	225	0	0	-5	-5	-5	0	-5	0
Encana Corp	BBB low	BBB-	145	200	265	0	15	0	10	0	0	0	0
GTAA	---	A+	60	80	110	-5	10	-5	10	0	25	0	25
Bell Canada	BBB high	BBB+	105	155	215	0	10	5	10	0	15	0	15
Rogers Communications	BBB	BBB+	100	145	215	0	10	5	5	0	15	0	15
Loblaw	BBB	BBB	110	160	210	5	15	5	15	0	10	0	10
Canadian Tire	BBB high	BBB+	105	155	220	0	5	0	5	0	15	0	15
Province of Québec	A high	A+	42	65	80	2	6	2	10	5	15	5	15
Province of Ontario	AA low	A+	45	69	84	2	7	2	10	5	17	5	17
CMHC	AAA	AAA	32	40	---	2	5	0	5				

Source: National Bank Financial

CREDIT MARKET

Canadian corporate bond new issuance reached \$ 6.0 billion in August, up \$ 1.1 billion from the previous month and \$ 700 million more than in August 2017. Since the beginning of the year, corporate bond issuance totaled \$ 61.0 billion, 7.2 % less than at the same date last year. Royal Bank has filed their first prospectus towards issuing a bail-in bond that will be eligible as contingent capital in the event of non-viability. Like subordinated debt, conversion into shares will be at the discretion of the regulator, but to maintain priority, noteholders will receive more shares than subordinated debt. These new notes will also have a lower credit rating than the existing deposit notes, reducing, in the future, the average corporate bond rating in the index.

A consortium led by Air Canada and including TD Bank, CIBC and Visa Canada have entered into an agreement to acquire Aimia's Aeroplan loyalty program for \$ 450 million. This agreement also includes taking over the \$ 1.9 billion member-owned Aeroplan points. This is an increase of 80 % compared to the first offer filed in July by Air Canada, but rejected by Aimia. Last year, Air Canada announced its intention to dissociate itself from Aeroplan and launch its own loyalty plan starting in the third quarter of 2020. In a counter-offer, Aimia announced its intention to offer "the ability to book any seat with any airline in the world, anywhere, anytime" as of July 2020.

Moody's downgraded the rating of Ford Credit from Baa2 to Baa3 while keeping a negative outlook. This is the lowest rating for an investment grade bond. Moody's cited erosion in the company's global business position and the challenges it face in executing its cost reduction plan. Ford's new CEO plans to cut \$ 14 billion in materials and engineering spending over the next five years. In early 2018, Ford announced that the rising costs of steel and aluminum would cut profitability. The auto company also wants to eliminate some car production to focus more on trucks and SUVs.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	Aug. 2018	2018
Universe	100 %	0,75 %	0,62 %
Short Term	44,6 %	0,34 %	0,75 %
Mid Term	22,4 %	0,77 %	0,43 %
Long Term	32,9 %	1,30 %	0,53 %
Federal	35,7 %	0,64 %	0,68 %
Provincial	34,2 %	0,81 %	0,24 %
Corporates	28,2 %	0,82 %	1,03 %
RRB		1,13 %	2,59 %

Source: ftse.com

Members now have greater certainty about the future of their points, but is it more beneficial for them? If there had been two loyalty programs, the members could have benefited from greater flexibility and more advantageous offers as shown by the counter-offer that Aimia wanted to implement.

Ford was already struggling with rising steel and aluminum prices even before tariffs came into effect. Moreover, if Canada can't come to an agreement on NAFTA, Trump has threatened to tax cars produced in Canada. But Ford will not be spared because it produces 5 vehicles at its Oakville plant in Canada.

STRATEGIC POSITIONNING

Momentum in the Canadian and US economies continued with strong growth rates recorded in the second quarter. Because of higher job gains and wages, US households have increased spending and their confidence has reached its highest level since October 2000. US small business leaders are also optimistic about the future with a confidence index that is within one-tenth of its record high recorded back in July 1983. Labor shortage remains a serious problem for these leaders, with 52 % of them reported having little or no qualified candidates for vacant positions. These production constraints could encourage companies to raise wages to attract workers or invest more to automate part of their production. Currently, NAFTA uncertainties restricts some executives as investments in Canada show modest growth in the second quarter. If an agreement is reached with the United States and this uncertainty dissipates, the Bank of Canada will find itself in a booming economy, where production constraints and labor shortages won't be able to keep up with a growing demand at a time when inflation is already at 3 %. We can expect the Canadian policy rate to rise again in October in order to gradually remove the monetary stimulus still in place.