MONTHLY BOND LETTER

AlphaFixe Capital

FEBRUARY 2019

ECONOMIC EVENTS

- In the last quarter, the Canadian economy recorded its slowest growth rate since 2016, 0.4% on an annualized basis compared to 2.0% in the third quarter. This brings annual growth to 1.8%, a significant decrease from 2017 (3.0%). This deceleration in the fourth quarter was due to weaker consumer spending, as well as declining business investments, government spending and the real estate sector. On the other hand, companies replenished their inventories, which improved growth. For the year 2018, consumer spending grew by only 2.0%, the slowest pace in 6 years.

- The US economy grew at an annualized rate of 2.6% in the last quarter, bringing growth to 2.9% in 2018, the best since 2015. Consumer spending (2.8%) and business investment (6.2%) have supported growth over the past 3 months. Residential real estate (-3.5%) contracted for the fourth consecutive quarter, while net exports also slowed growth. Companies have replenished their inventories for a second consecutive quarter, which suggests that inventories will decline at the beginning of the year.

- In order to stimulate its economy, China has adopted a series of measures, including credit expansion. Since the beginning of 2018, the government has reduced the banks' reserve requirement ratio five times, resulting in a substantial increase in credit last January. New loans from banking institutions reached 3,230 billion yuan (US$477 billion), the highest monthly amount since 1992. In addition, the government has announced a reduction in the corporate tax rate.

RATE TRENDS

- During his speech in Montreal, Bank of Canada Governor Poloz reiterated the Bank's intention to raise the policy rate, which is still below the inflation target and could lead to imbalances through undue risk taking. On the other hand, the economic impact of a rate hike on households indebted balance sheet remains uncertain, as do the consequences of a trade war between China and the United States. Given these risks, the Bank prefers to be patient.

- Jerome Powell addressed Congress where he indicated that he wanted to take a cautious approach to conducting monetary policy. He justifies this decision by lower inflationary pressures, slower global economic growth and uncertainty surrounding the United States' trade policy, particularly towards China.

Canada's sluggish economy has prompted some to use the word recession. While business investment spending has declined, it's mostly oil-related uncertainty from last year than a widespread fear. For example, companies added 66,800 employees to payrolls in January. In addition, in the aftermath of the SNC scandal, it is possible that the Trudeau government will offer an election budget to promote its candidacy in October.

The sugar rush of Trump's tax cut is gradually fading so that the U.S. economy is now expected to grow close to its potential (2.0 to 2.5%). Demand is expected to be supported by strong employment, healthy household balance sheet and business investment to address labour shortages.

Many believe that China's slow economic growth last year was linked to the trade dispute with the United States. However, exports to the United States represent only 3.8% of GDP compared to 42% for business investments. Thus, the measures announced are likely to have a significant economic impact.

Admittedly, the economic impact of a rate increase in Canada is different from that in the United States given the level of household debt. On the other hand, our policy rate (1.75%) is still below the inflation target (2.0%), so monetary policy is still accomodative.

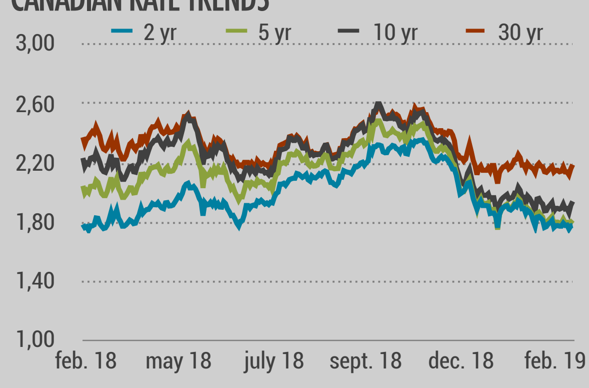
Oil price increases since the beginning of the year (+26%) coupled with higher wages and China's economic stimulus measures could force the Fed to raise rates in the second half of the year to counter renewed inflationary pressures.

BOND RATES

February 28 2019	Canada	Monthly Change	Change 2019	United States	Monthly Change	Change 2019
Key Interest Rate	1,75 %	0,00 %	0,00 %	2,50 %	0,00 %	0,00 %
3 months	1,67 %	0,02 %	0,02 %	2,43 %	0,05 %	0,08 %
2 years	1,78 %	0,01 %	-0,08 %	2,51 %	0,06 %	0,03 %
5 years	1,82 %	0,03 %	-0,07 %	2,51 %	0,08 %	0,00 %
10 years	1,94 %	0,06 %	-0,03 %	2,72 %	0,09 %	0,03 %
30 years	2,19 %	0,05 %	0,01 %	3,08 %	0,08 %	0,07 %
RRB 30 years	0,71 %	0,03 %	-0,06 %			

Source: Bloomberg

CANADIAN RATE TRENDS



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CREDIT BOND RISK PREMIUMS

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	AA low	105	140	180	-10	-30	-5	-20	-5	-20
Royal Bank NVCC sub debt	A low	150	195	235	-10	-35	-5	-25	-5	-25
Fortis Inc.	BBB high	115	165	215	-5	-25	0	-20	0	-20
Hydro One	A high	90	120	160	-5	-25	0	-20	5	-20
Enbridge Inc	BBB high	135	175	230	-5	-25	-10	-35	-5	-45
Encana Corp	BBB low	175	240	295	0	-30	0	-30	0	-30
GTAA	---	70	90	125	-5	-15	-5	-15	0	-15
Bell Canada	BBB high	125	170	225	-5	-30	-5	-30	-5	-35
Rogers Communications	BBB	120	165	220	-5	-30	-5	-30	-10	-40
Loblaw	BBB	130	180	230	-10	-35	-10	-35	-10	-40
Canadian Tire	BBB high	125	175	235	-10	-35	-10	-35	-10	-35
Province of Quebec	A high	46	70	81	-1	-13	-2	-14	-4	-15
Province of Ontario	AA low	50	75	86	-1	-13	-1	-14	-3	-15
CMHC	AAA	35	46	---	0	-8	-1	-10		

Source: National Bank Financial

CREDIT MARKET

- Canadian corporate bond issuance reached $4.3 billion in February, an increase of $1.2 billion from the previous month and $1.7 billion less than in February 2018. Among the issuers, let us note the first bank bail-in issue for National Bank. With a 5-year term and a credit rating of A, this bond offered a yield of 2.983%, or 34 bps more than the old deposit notes with the same term. When this new bank debt structure was created on September 1st, 2018, the spread to deposit notes was only 15 bps. Unlike deposit notes, the bail-in debt allows the bank to be recapitalized in the event that the regulator considers that is is no longer viable.
- Montreal-based company Saputo announced the acquisition of the British firm Dairy Crest Group for $1.7 billion. This is a first step into the British market for Saputo, which plans to finance this transaction through a bank loan. Following this transaction, DBRS announced that it was reviewing Saputo's A(low) credit rating for a possible downgrade in light of Saputo's additional debt. The degree of the downgrade will depend on Saputo's ability to generate cash flows with this acquisition and the use of these cash flows. DBRS expects the company to refrain from repurchasing its shares and use free cash flow to repay debt.
- Quebec's engineering firm SNC-Lavalin's credit ratig was downgraded by one notch to BBB- by S&P while DBRS placed its rating (BBB) under review for a possible downgrade. S&P estimates that the firm's financial profile deteriorated following the disclosure of a $1.6 billion loss in the fourth quarter attributed to difficulties in the mining and metallurgy division. The potential criminal conviction in Canada for fraud combined with the risks of a global economic slowdown was also a factor in S&P's decision. DBRS, for its part, based its rating review on risk management within the firm and projects control that have résulte in substantial loss. However, DBRS prefers not to comment on the judicial process for fraud due to uncertainty and delays.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	Feb. 2019	2019
Universe	100 %	0,18 %	1,52 %
Short Term	44,6 %	0,21 %	0,88 %
Mid Term	22,2 %	0,16 %	1,61 %
Long Term	33,3 %	0,15 %	2,34 %
Federal	36,0 %	-0,05 %	0,64 %
Provincial	34,7 %	0,31 %	2,05 %
Corporates	27,4 %	0,31 %	2,00 %
RRB		-0,28 %	1,06 %

Source: ftse.com

With Brexit negotiations still on the back burner, the timing of this transaction may be questionable. However, Dairy Crest realizes that 98% of its sales in the United Kingdom and is sourced only from British farms. Saputo therefore obtains British market share and access to the European market if an agreement occurs.

SNC-Lavalin's case is a perfect example of our approach in using ESG factors to evaluate a company. If the company adequately manages its extra financial risks, such as governance, it signals to creditors that it's able to manage its financial risks as well. Clearly, governance has failed for several years at SNC.

STRATEGIC POSITIONNING

Financial markets rallied in January when the Fed changed course by announcing a pause in monetary policy. Progress in US - China talks to resolve their trade dispute have also strengthened stock markets in February, so that in 2019, the S&P 500 index posted an 11.1% gain, the best performance for the first two months of the year since 1991. The combination of last year's drop in oil prices and global trade tensions dampened growth in Canada in late 2018. The Bank of Canada recognized the challenges facing the Canadian economy in its press release on 3 March 2019, in which it justified keeping its policy rate at 1.75%. However, these factors have eased in the last 2 months. Oil prices have recovered and Mr. Trump seems to be pushing for an agreement with China to increase his chances of re-election in 2020. Central bankers have adopted a wait and see approach, but some elements could prompt rate hikes in the second half of the year. China has just adopted stimulus package that will help raise commodity prices. In addition, companies absorbed a portion of last year's wage increases as they benefited from even larger tax cuts. This should not be repeated in 2019 unless lower profit margins are accepted. Central banks patience will therefore reached a limit in the second half of the year.