# MONTHLY BOND LETTER

AlphaFixe Capital

## ECONOMIC EVENTS

APRIL 2018

- During the month of March, Canada's trade deficit to the rest of the world reached a record of $ 4.1 billion. Imports rose by 6.0 % reaching a record level of $ 51.7 billion, while exports rose by 3.7% to $ 47.6 billion. This new record is due to a sharp rise of imports in motor vehicles and parts (8.3 %) and consumer goods, including clothing, footwear and accessories (20.8 %). The trade surplus with the United States narrowed by $ 600 million to $ 1.7 billion while the deficit with other countries widened to $ 5.8 billion.

*Labor strength and consumption is responsible for import growth and illustrates the strength in domestic demand. Higher imports of machinery and equipment may indicate an increase in corporate investments. Nevertheless, it is expected that international trade will dampen GDP in the first quarter.*

- The US economy grew at an annualized rate of 2.3 % in the first quarter of the year, a decrease from the previous quarter (2.9 %). This solder pace is mainly due to consumer spending, which grew at a rate of 1.1 % compared to 4 % in the fourth quarter of 2017. Who says that less consumption also means less imports. They actually increased by 2.6 % compared to 14.1 % in the previous quarter. Given that exports increased faster (4.6 %), international trade contributed to growth. Corporate investments remain strong (6.1 %), primarily capital expenditures (12.3 %).

*The deceleration in consumer spending between the previous quarter and this quarter was predictable given strong sales growth during the holiday season and post-hurricane reconstruction efforts. The tax reform and labor market strenght point to a recovery in consumer spending and sustained GDP growth.*

- China's GDP grew by 6.8 % year-over-year in the first quarter under the influence of strong consumer demand and real estate investments. The latter is surprisingly robust given the measures taken to control rising house prices. The rise in consumer spending accounts for nearly 78 % of GDP growth in the first three months.

*The strong contribution of consumer spending is reassuring given the apparent trade conflict between China and the United States. China is seeking to rebalance its economy and diversify its sources of growth, which will be desirable to the global economy.*

## RATE TRENDS

- The Bank of Canada kept its monetary policy unchanged again in April. Governor Poloz estimates that the Canadian economy is growing at full steam and that inflation is approaching the target, but remains concerned about the uncertainties surrounding NAFTA and economic sensitivity to interest rates due to household indebtedness. Higher gas prices and minimum wages in Ontario and Alberta could push inflation above its target in 2018 (2.3 %), but this will be transitory, according to the Bank. On the other hand, they have lowered growth forecast for 2018 due to weakness in consumption, residential real estate and exports. Asked whether a positive NAFTA outcome would imply a rate hike, M. Poloz said the link is not direct.

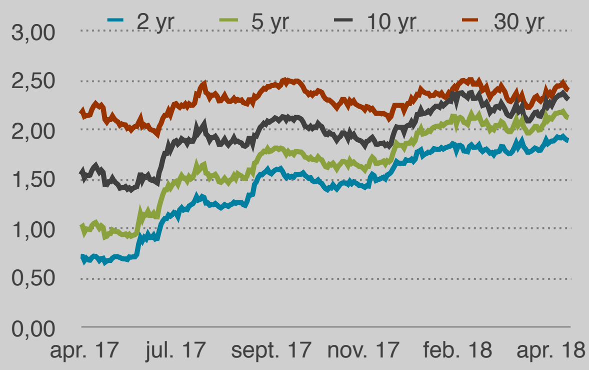
*The Bank of Canada has kept a mystery surrounding its monetary policy. On the one hand, they paint a glowing picture of an economy close to full employment, which is expected to grow above its potential in the next three years and whose policy rate (1.25 %) is 175 bps below the neutral rate. On the other hand, they kept the rate low since high level of household debt makes rate increases more significant during this cycle. However, shouldn't low interest rates explain much of this high level of indebtedness? It is a vicious circle that should be broken.*

## BOND RATES

| April 2018 |  | Monthly Change | Change 2018 |  | Monthly Change | Change 2018 |
|---|---|---|---|---|---|---|
| Key Interest Rate | 1,25 % | 0,00 % | 0,25 % | 1,75 % | 0,00 % | 0,25 % |
| 3 months | 1,20 % | 0,09 % | 0,14 % | 1,80 % | 0,10 % | 0,42 % |
| 2 years | 1,89 % | 0,12 % | 0,20 % | 2,49 % | 0,22 % | 0,60 % |
| 5 years | 2,13 % | 0,16 % | 0,26 % | 2,80 % | 0,24 % | 0,59 % |
| 10 years | 2,31 % | 0,22 % | 0,26 % | 2,95 % | 0,21 % | 0,55 % |
| 30 years | 2,40 % | 0,17 % | 0,14 % | 3,12 % | 0,15 % | 0,38 % |
| RRB 30 years | 0,62 % | 0,09 % | 0,05 % | | | |

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 2018 | Change 10 yrs month | Change 10 yrs 2018 | Change 30 yrs month | Change 30 yrs 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Royal Bank, deposit notes | AA | AA- | 75 | 95 | 135 | -5 | 0 | -5 | 5 | -5 | 5 |
| Manulife, Senior debt | A high | A+ | 90 | 120 | 165 | -5 | 0 | 0 | 5 | -5 | 0 |
| Fortis Inc. | BBB high | BBB+ | 100 | 140 | 170 | -5 | 10 | 0 | 5 | -5 | 5 |
| Hydro One | A high | A | 70 | 90 | 130 | -5 | 5 | -5 | 5 | -5 | 0 |
| Enbridge Inc | BBB high | BBB+ | 130 | 180 | 240 | 5 | 15 | 5 | 15 | 0 | 15 |
| Encana Corp | BBB low | BBB | 130 | 185 | 255 | -5 | 0 | -5 | -5 | -5 | -10 |
| GTAA | --- | A+ | 60 | 80 | 105 | 0 | 10 | -5 | 10 | 5 | 20 |
| Bell Canada | BBB high | BBB+ | 100 | 145 | 200 | -5 | 5 | -5 | 0 | -10 | 0 |
| Rogers Communications | BBB | BBB+ | 95 | 135 | 200 | 0 | 5 | -5 | -5 | -5 | 0 |
| Loblaw | BBB | BBB | 100 | 150 | 205 | -5 | 5 | -5 | 5 | -5 | 5 |
| Canadian Tire | BBB high | BBB+ | 105 | 155 | 215 | -5 | 5 | -5 | 5 | -5 | 10 |
| Province of Québec | A high | A+ | 42 | 63 | 75 | -1 | 6 | 1 | 8 | 0 | 10 |
| Province of Ontario | AA low | A+ | 44 | 67 | 78 | -1 | 6 | -2 | 8 | -2 | 11 |
| CMHC | AAA | AAA | 30 | 39 | --- | -1 | 3 | -1 | 4 | | |

Source: National Bank Financial

## CREDIT MARKET

- Canadian corporate bond new issuance reached $ 7.5 billion in April, down $ 1.3 billion from the previous month, but $ 1.1 billion more than in April 2017. Since the beginning of the year, corporate bond issuance reached $ 28.6 billion, down 4.1 % from the same period last year. Although there were 15 issues during the month, the financial industry got most of the attention with 4 issues totaling 73 % of the total monthly amount. Scotiabank and Royal Bank each issued 5-year term notes with outstanding amounts of $ 2.25 and $ 2 billion respectively. A new bail-in deposit bank note is expected to be introduced in the fourth quarter this year.

- Transcontinental announced the acquisition of US packer Coveris Americas for US $ 1.32 billion, allowing the Quebec company to become the seventh largest player in the North American packaging industry. With this transaction, Transcontinental is seeking to distance itself from printing because of dark future prospects in this sector. Once the transaction is completed, 48 % of the company's revenues and 37 % of operating profits will come from the packaging division, compared to 45 % of revenues and 59 % of profits from printing activities. The media division fills the rest. Prior to this announcement, packaging accounted for only 15 % of revenues. Transcontinental will pay cash, but will also issue shares for $ 250 million. As a result, the debt/EBITDA ratio is expected to rise to 3.2x once the agreement is approved, but will drop to 2.0x by 2020.

- DBRS has confirmed the Province of Ontario credit rating at AA (low) while keeping a stable outlook. According to the agency, the pre-election budget published last March should push the debt to GDP ratio to 43 %, but the outlook is not inconsistent with the current rating. The Liberal government have proposed new initiatives totaling $ 20.3 billion over a period of 3 years. For the current fiscal year (2018/19), the projected deficit is $ 6.7 billion compared to a surplus of 643 million last year. A rating downgrade could occur if the province's budgetary outlook deteriorates beyond what is already proposed. DBRS also recognizes that this budget implementation depends Liberal re-election.

## FTSE TMX INDEX PERFORMANCE

| Sector | Weight | Apr. 2018 | 2018 |
|---|---|---|---|
| Universe | 100 % | -0,86 % | -0,76 % |
| Short Term | 45,6 % | -0,07 % | 0,15 % |
| Mid Term | 22,5 % | -0,82 % | -0,81 % |
| Long Term | 31,9 % | -2,00 % | -2,00 % |
| Federal | 36,6 % | -0,70 % | -0,38 % |
| Provincial | 33,6 % | -1,26 % | -1,54 % |
| Corporates | 27,9 % | -0,55 % | -0,27 % |
| RRB | | -0,83 % | 0,54 % |

Source: ftse.com

*By relying solely on credit metrics and debt ratio, this transaction could trigger a credit rating downgrade which is already at the lowest investment grade quality (BBB low). However, activity and revenue diversification away from the precarious printing industry will reduce business risk.*

*Trailling in the polls, the Liberal government is trying everything to get re-elected. However, using deficits and expecting economic growth to return to a balance budget is a dangerous strategy, especially at the end of the economic cycle. The good years of growth are more behind us than ahead.*

## STRATEGIC POSITIONNING

Although consumer spending in the United States was less vigorous in the first quarter than the previous one, consumers did not lose their way to the stores. Labor market strength will contribute to consumer spending, the main source of economic growth in the United States. In this regard, the latest reports from the Bureau of Labor Statistics indicated that there were 6.55 million vacant jobs and 6.35 million registered unemployed. This is the first time in 17 years that the number of jobs available have surpassed the unemployed. Household disposable income is also expected to grow, courtesy of Mr. Trump's tax reform. In fact, this reform is expected to add 0.8 % to GDP this year and 1.3 % next year. Government revenue shortfall may need to be replenished through the Treasury market. The US Treasury will issue $ 200 billion more this year to finance this reform. However, Americans are not the only ones to issue more bonds. For the current year, total government issuance net from central bank purchases is expected to reach nearly $ 1.3 trillion and more than $ 1.5 trillion next year, the highest since 2010. What is unusual this time is that the excess supply in bonds is combined with rising interest rates. This situation should therefore have an upward effect on interest rates.