MONTHLY BOND LETTER

AlphaFixe Capital

December 2017

ECONOMIC EVENTS

- The consumer price index in Canada rose by 0.5 % in November, bringing the annual increase to 2.1 %. The annual inflation rate was 1.4 % in the previous month. In addition to clothing and footwear, prices for seven of the eight components of the index increased in the past year. Transportation-related prices rose 5.9 % over a 12-month period primarily due to gasoline prices rising 19.6 % in one year. Notwithstanding energy and food, the price index rose 0.2 % in November and 1.8 % over the last twelve months.

While gasoline has been a major contributor to the price index, inflation has been noticed in a broader range of activity. The strength of the labor market has pushed up the average wage by over 5 % and Ontario's minimum wage increase to $ 14 an hour starting January 1st, will keep inflationary pressures in place.

- The holiday shopping season got off to a good start in the United States as retail sales jumped 0.8 % in November, bringing the annual change to 5.8 %. If we subtract the volatile components of auto sales and gasoline, sales also increased by 0.8 %. Strong gains were recorded in electronics (2.1 %), furniture (1.2 %), building materials (1.2 %) and non-store retail sales (2.5 %). This latter component includes online shopping.

Sales were supported by a vigorous job market, crazy Friday frenzy, and post-Hurricane Harvey and Irma reconstruction efforts. Unless there is a sales collapse in December, GDP growth in the last quarter should be robust.

- The Japanese economy grew at an annualized rate of 2.5 % in the third quarter, marking the seventh consecutive quarter of gains and the most prolonged expansion since the mid-1990's. International trade and corporate investments strongly fuelled growth, while household spending fell back.

While the Fed is slowly raising its key rate, the Bank of Japan does not seem to be derogating from its ultra-expansionary monetary policy. Widening interest rate differential to the US market will depreciate the yen, further favoring exports.

RATE TRENDS

- As expected, the Federal Reserve raised its key interest rate by 0.25 % to 1.5 % on the back of stronger job market and sustained economic activity. Inflation still remains below the 2 % target, but the Fed expects it to reach its objective within the year. Given the tax reform adopted by Congress, the Fed has raised its growth forecast for next year from 2.2 % to 2.6 %, but still expect to raise rates three times in 2018.

By forecasting higher growth next year without adding additional rate hikes, the Fed is warning us that it anticipates no inflationary pressure from tax measures. Given the faster impact of tax measures relative to monetary policy, the Fed could be perceived as being behind the curve on its policy.

- The Bank of Canada kept its policy rate at 1 % in December, stating, among other things, that there is still labor slack despite recent significant gains in employment. Although a rate hike will be necessary in the future, the Bank will be cautious and will guide its monetary policy according to incoming economic data.

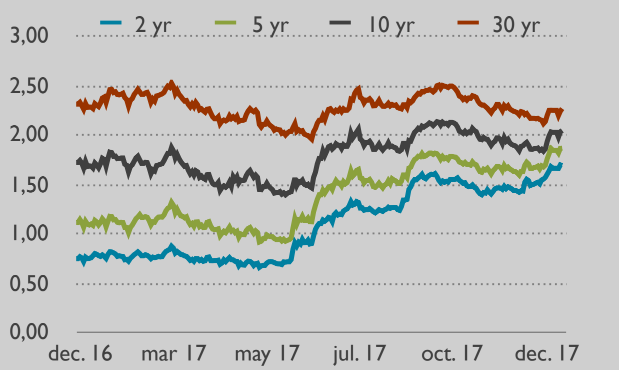
The under employment commentary refers to the low youth participation rate (15 to 24-yr), which is at a 20-year low at 64 %. However, an analysis by the National Bank indicates that most of this decline comes from the fact that there are more young people aged 15 to 19 in school than before, which is good for the economy in the long run.

BOND RATES

Dec. 31 2017		Monthly Change	Change 2017		Monthly Change	Change 2017
Key Interest Rate	1,00 %	0,00 %	0,50 %	1,50 %	0,25 %	0,75 %
3 months	1,06 %	0,18 %	0,60 %	1,38 %	0,12 %	0,88 %
2 years	1,69 %	0,26 %	0,94 %	1,88 %	0,10 %	0,69 %
5 years	1,87 %	0,24 %	0,75 %	2,21 %	0,07 %	0,28 %
10 years	2,05 %	0,16 %	0,32 %	2,41 %	-0,00 %	-0,04 %
30 years	2,27 %	0,04 %	-0,05 %	2,74 %	-0,09 %	-0,33 %
RRB 30 years	0,58 %	-0,04 %	0,08 %			

Source: Bloomberg

CANADIAN RATE TRENDS



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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 2017	Change 10 yrs month	Change 10 yrs 2017	Change 30 yrs month	Change 30 yrs 2017
Royal Bank, deposit notes	AA	AA-	75	90	130	0	-20	0	-20	0	-25
Manulife, Senior debt	A high	A+	90	115	165	0	-25	0	-20	0	-20
Fortis Inc.	BBB high	BBB+	90	135	165	0	-30	0	-30	-5	-60
Hydro One	A high	A	65	85	130	0	-15	0	-20	-5	-20
Enbridge Inc	BBB high	BBB+	115	165	225	0	-15	0	-15	-5	-15
Encana Corp	BBB low	BBB	130	190	265	-5	-85	-5	-95	-10	-80
GTAA	---	A+	50	70	85	0	-20	0	-25	-5	-50
Bell Canada	BBB high	BBB+	95	145	200	0	-20	0	-20	0	-25
Rogers Communications	BBB	BBB+	90	140	200	0	-25	0	-25	5	-35
Loblaw	BBB	BBB	95	145	200	-5	-25	-5	-25	-5	-25
Canadian Tire	BBB high	BBB+	100	150	205	-5	-25	-5	-25	-5	-25
Province of Québec	A high	A+	36	55	65	-6	-19	-5	-23	-5	-27
Province of Ontario	AA low	A+	38	59	67	-5	-18	-3	-20	-4	-22
CMHC	AAA	AAA	27	35	---	-4	-11	-5	-13		

Source: National Bank Financial

CREDIT MARKET

- Canadian corporate bond new issuance reached $ 3.5 billion in December, down $ 9.6 billion from the previous month and down $ 1.1 billion from December 2016. For 2017, corporate bond issuance reached $ 103.7 billion, up 24.5 % from 2016 and a new record for the Canadian market. Part of this increase in 2017 is due to the presence of new US issuers in the Maple bond market. In fact, they issued a total of $ 12.6 billion against $ 5.5 billion in 2016. The telecommunication industry was also more active this year, doubling their new issue size to $ 5 billion. Public services as well as public-private partnership projects also recorded strong gains in volume.

- Provincial bonds in the FTSE-TMX long-term index (6 %) outperformed corporate bonds (4.95 %) in the last quarter. However, for 2017, the provinces (8.0 %) could not outperform the excellent performance of corporate bonds (8.8 %). Foreign investor's interest for new provincial issues partly explains this performance. Provinces issued a total of $ 25.4 billion in foreign markets, the second largest annual volume ever recorded. In contrast, Canadian investors shared a total of $ 52 billion in new issues in the domestic market. As a result, the 10 provinces completed 96 % of their funding requirements for the current fiscal year with a quarter to complete. Ontario and Quebec, on the other hand, took the lead with 102 % and 153 % of the funding completed.

- The rating agency DBRS has cautioned Laurentian Bank (A low) after it announced irregularities of one of its subsidiaries in residential mortgages underwriting granted on the basis of erroneous documentation by individuals. DBRS, which downgraded the rating outlook to negative, noted concerns over the underwriting quality control measures and risks as a result of this anomaly. The Bank has indicated that it may have to buy back up to $ 304 million of mortgages deemed irregular, which is less than 1 % of its total loans.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	Dec. 2017	2017
Universe	100 %	-0,41 %	2,52 %
Short Term	45,1 %	-0,46 %	0,08 %
Mid Term	22,3 %	-0,89 %	0,96 %
Long Term	32,6 %	0,00 %	7,03 %
Federal	36,7 %	-0,63 %	0,13 %
Provincial	34,0 %	-0,21 %	4,33 %
Corporates	27,4 %	-0,37 %	3,38 %
RRB		0,12 %	0,72 %

Source: ftse.com

High foreign demand therefore subtracted $ 10 billion in new issues from the Canadian market compared to last year. The province of Quebec is still overfinding, but the volume this year seems to be stronger. Risks related to the NAFTA renegotiation in 2018 and the provincial election may have warranted an acceleration of new issues.

Although the amount of loans to buy back seems insignificant for the bank and it has sufficient cash to do so, this episode highlights a risk control problem. However, the bank is financed more from personal deposits than from institutional investors, which reduces refinancing risk.

STRATEGIC POSITIONNING

The global economy is doing very well, with all OECD countries reporting positive economic growth, a first in 10 years. This upturn does not seem to be running out of steam. In the United States, most of the leading economic indicators, such as jobless claims, new manufacturing orders and cyclical spending, are showing sustained growth. Financial markets have responded well to this economic positivism with the flagship S&P 500 recording its best annual performance since 2013 at 22 % and 14 months of uninterrupted monthly gains, the longest run in its history. The adoption of the US tax reform is expected to further boost the economy in the beginning of the year and give a tax break to small businesses struggling with skilled labor shortages. According to the most recent survey of small business owners (NFIB.com), 54 % of respondents said they found no or few skilled workers to fill the vacancies, a new record. At the same time, 23 % are considering increasing wages to attract workers. Inflation could therefore surprise the Fed who is still shy in raising its policy rate given the balance sheet reduction in place. Rising inflation, the Fed's balance sheet reduction and larger government deficits is a dangerous mix for rates in the first half of 2018.