MONTHLY BOND LETTER

AlphaFixe Capital

AUGUST 2020

ECONOMIC EVENTS

- The Canadian economy recorded the worst contraction since the quarterly data collection began in 1961, with a 38.7% drop in GDP in the second quarter of 2020 on an annualized basis. Household spending, business investment, residential real estate and international trade all posted significant declines as a result of the pandemic. However, the government's support measures allowed household disposable income to jump 10.8% from the first to the second quarter. These transfers more than offset the loss of labour income. As a result, families were able to significantly increase their savings, which now stand at 28% of disposable income.
- Inflation rose 0.6% in July in the United States, bringing consumer price growth to 1.0% for the past year. The core inflation index, which subtracts volatile changes in energy and food, rose 1.6% in the past year and 0.6% in July alone. This is the largest monthly jump since January 1991. This increase is mainly due to service industries where social distancing reduces output and results in higher costs passed on to consumers.
- The euro area economy fell 12.1% in the second quarter or 40.3% on an annualized basis. However, the contraction was uneven across countries. Those severely hit by Covid, such as Spain (-18.5%) and France (-13.8%), recorded sharper declines, while countries that were frugal in negotiating the stimulus plan fell less. Finland's GDP fell by 3.2%, the Netherlands' by 8.5% and Denmark's by 7.4%. By contrast, the UK economy contracted by 21.7%.

The federal government put in place measures that were intended to allow Canadian households to replace work income lost during the lockdown. However, according to published data, primary household income fell by $113.7 billion while government transfers jumped by $222.8 billion. Admittedly, there was a need to act quickly at the onset of the pandemic. However, the new Employment Insurance program is also very generous and does not provide incentives to return to work.

This recession is different. It is not only a drop in demand, but also a supply shock due to distancing and protection measures. These measures reduce output at the same time as household incomes have risen, which is atypical of a recession. Inflation is always the result of scarcity.

The increase of Covid cases in Europe is worrisome for economic growth as well as for unity. Although the European Central Bank will buy more bonds this year than will be issued, frugal countries will be more reluctant to support joint programs without a more unified health policy.

RATE TRENDS

- The Federal Reserve Chairman delivered a speech at the annual Jackson Hole Symposium. The main point of his speech was the move to an average inflation target. "After periods when inflation has been below 2%, an appropriate monetary policy will likely aim to achieve inflation slightly above 2% for some time," Powell said. To achieve this, the Fed has moved away from negative interest rate policy and yield curve control, preferring to continue quantitative easing.
- Canada's long-term Real Return Bond yield closed the month at -0.17%, up 5 bps compared to a 24 bps jump in the 30-year nominal bond yield. As a result, the expected inflation rate imbedded in these securities stands at 1.33%, up 0.63% from March low. In the U.S., inflation expectations for 30-year RRBs stand at 1.85%, up 0.85% from March.

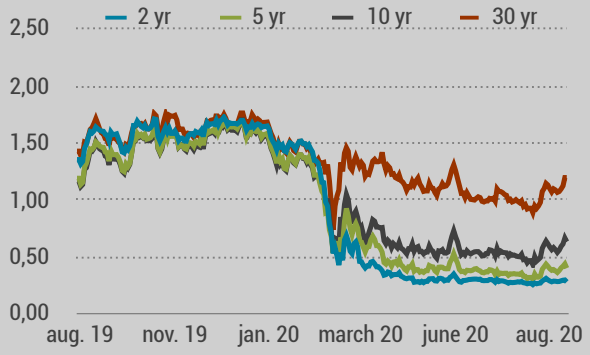
This is a major change in monetary policy that now seeks to stimulate inflation and inflation expectations. The Fed's message is clear: we will keep the policy rate at the floor and pursue quantitative easing for a long period of time in order to push inflation well above target and build our reputation with this new approach. Long-term rates will now have to discount this loss of purchasing power. In times of government and corporate over-indebtedness, inflation becomes essential to help borrowers pay off their debts. Deflation risks causing a wave of defaults could lead to depression.

BOND RATES

August 31, 2020		Monthly Change	Change 2020		Monthly Change	Change 2020
Key Interest Rate	0,25 %	0,00 %	-1,50 %	0,25 %	0,00 %	-1,50 %
3 months	0,15 %	-0,02 %	-1,51 %	0,09 %	0,01 %	-1,45 %
2 years	0,28 %	0,01 %	-1,42 %	0,13 %	0,03 %	-1,44 %
5 years	0,39 %	0,07 %	-1,29 %	0,27 %	0,06 %	-1,42 %
10 years	0,62 %	0,16 %	-1,08 %	0,70 %	0,18 %	-1,21 %
30 years	1,16 %	0,24 %	-0,60 %	1,47 %	0,28 %	-0,91 %
RRB 30 years	-0,17 %	0,05 %	-0,55 %			

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 2020	Change 10 yrs month	Change 10 yrs 2020	Change 30 yrs month	Change 30 yrs 2020
Royal Bank, Bail-in-debt	AA	90	120	160	0	5	0	0	0	0
Royal Bank, NVCC	A	140	175	225	0	20	0	5	0	15
Sun Life, subordinated debt	A	105	140	190	-5	5	-5	-5	-5	5
Hydro One	A high	70	100	145	0	10	-5	15	0	15
Enbridge Inc	BBB high	120	160	245	-15	20	-15	10	-10	25
Altalink LP	A	65	95	140	0	10	-5	15	0	20
GTAA	A high	95	130	165	5	40	5	50	5	55
Bell Canada	BBB high	100	145	210	-15	0	-5	-5	-5	5
Rogers Communications	BBB	95	140	205	-15	0	-5	-5	-5	0
Loblaw	BBB	95	140	205	-10	-10	0	-15	0	-5
Canadian Tire	BBB	130	190	270	-25	30	-15	40	-10	65
Province Québec	AA low	40	69	83	-3	4	-3	10	-1	14
Province Ontario	AA low	43	73	85	-3	5	-2	11	-2	12
CMHC	AAA	25	39	---	-7	-4	-1	1		

Source: National Bank Financial

CREDIT MARKET

- Canadian corporate bonds new issuance reached $4.4 billion in August, a decrease of $600 million from the previous month and also from August 2019. Year-to-date bond financings totalled $79.6 billion, up 34% from the same time last year. Brookfield has been active with 3 issues from 3 different fields of activity: renewable energy ($425 million), real estate ($500 million) and infrastructure ($500 million). In the United States, the sum of new corporate bond issues this year reached $1,919 billion, surpassing the former annual mark established in 2017 ($1,916 billion) with only 8 months of activity.
- Canada's 6 major banks released their financial results for the third quarter of 2020. Profits totaled $9.8 billion, up 69% from the second quarter, but $2.3 billion lower than in the third quarter last year. In contrast, loan loss provisions declined 38% between the second and third quarters of 2020 to $6.8 billion. Compared to the same period last year, however, banks increased their provisions by $4.3 billion. Net interest income declined during the quarter, affected by the low interest rate environment and lockdowns that reduced credit card transactions. In contrast, non-interest income increased, influenced in part by capital markets activity and asset management.
- The Government of Alberta released an economic update forecasting a $24 billion deficit, up $17 billion from the February budget. Spending is expected to grow by 9.3% to $62.6 billion, primarily due to public health expenditures and Covid-related support measures. On the other hand, revenues will fall 23.1% to $38.5 billion. The government's projections now assume an oil price of $35.60 per barrel compared to $58 in February. The debt is projected to reach $66.9 billion or 22% of GDP, below the ratio of over 40% in Ontario and Quebec. Financing requirements for the current fiscal year will be $29.9 billion, up $12.8 billion from the February budget.

FTSE TMX INDEX PERFORMANCE

Sector	Weight	Aug. 2020	2020
Universe	100 %	-1,13 %	7,66 %
Short Term	40,4 %	0,09 %	4,63 %
Mid Term	25,3 %	-0,42 %	8,92 %
Long Term	34,3 %	-3,01 %	10,54 %
Federal	33,5 %	-0,90 %	7,11 %
Provincial	37,5 %	-1,75 %	8,73 %
Corporates	26,9 %	-0,51 %	6,81 %
RRB		0,92 %	10,95 %

Source: ftse.com

The recovery in retail sales combined with a steeper yield curve should improve net interest income in the coming quarters. The majority of households that had taken a mortgage vacation during the crisis have resumed their payments. Provisions for credit losses therefore appear to be sufficient, as long as the economy is not hit by a strong second wave.

While Alberta's debt ratio is half of that of Quebec and Ontario, the rate at which the debt is accelerating is worrisome. In fact, the dependence of government revenues on the oil sector brings a great deal of volatility and uncertainty to achieving a balanced budget. The province has an economic diversification plan that should be

STRATEGIC POSITIONNING

If someone had mentioned to you last December that the global economy would fall by 5-10% in 2020, that the unemployment rate would jump to more than 10% with corporate profits depreciating, would you have thought that stock markets would be up for the year, that credit spreads would remain largely unchanged, and that real estate prices would skyrocket around the world? This environment is the result of a combination of very accommodative fiscal and monetary policies. This is no ordinary recession. Output fell, but household incomes jumped under the influence of government programs, allowing real estate and the stock market to soar. Central banks also contributed, printing money to finance the monster government deficits and allowing businesses to borrow at low cost. The role of central banks does not end there. Stimulating inflation is now an objective for the Fed using quantitative easing programs. This was supposed to happen after the first wave of asset purchases following the financial crisis with no concrete results. Why should it be different this time? With the Covid crisis, the new money created is not just going into the financial system, it is in the pockets of households who are ready to spend on goods and services that become more difficult to produce because of health measures. Inflation is always the result of scarcity.