November 29, 2017 - (Vol. 1, No. 65)

Quick Hit — Ruminations on provincial valuations

Provincial bonds have been quite a hit recently. A noted spread contraction has sparked a healthy valuation debate, with many questioning whether the recent rally can be extended into the New Year. To inform the discussion, let's start by taking stock of current spreads, relative to the levels observed prior to and coming out of the global financial crisis of 2008-09.

First off, we'd highlight that the significant spread contraction witnessed since early September (with provi spreads snapping in across the term structure) can be seen as part of a broader, more generalized movement towards tighter credit spreads that's been taking shape for almost two years now (since February 2016). We'll come back to this point in a minute, but corporate credit on both sides of the border (e.g., bank deposit notes in Canada, broader IG indices stateside) have also experienced a significant tightening since February 2016, consistent with sturdy equity markets, low volatility and a fairly healthy global risk appetite.

Back to our focus, consider the movement in Ontario's constant maturity 10-year vs the GoC curve. Spreads have tightened in astonishing fashion since early 2016, and currently stand toward the tighter-end of the post-crisis spectrum. Today's 10-year spread is tighter than at any time since early 2011, and stands some 20 bps tighter (a ~23% appreciation) compared to the post-crisis average (Chart 1). It's a similar story in Ontario 30-years: roughly 20 bps tighter, equivalent to ~22% appreciation vs the post-crisis average. Five-year provi spreads are also nearing their post-crisis tights, but have appreciated to a relatively lesser extent vis-à-vis 10s or longs: 5-year spreads are in 8 bps relative to the post-crisis average, ~16% appreciation.

As for a comparison to pre-crisis levels, one needs to be a little careful. Obviously, the underlying yield environments—today vs pre-2008—are entirely different animals. Relative fiscal fundamentals have also shifted, be it the sovereign vs sub-sovereign government relationship, across individual provinces, as well as between provincial and corporate credits. Supply mechanics have also been altered, while today's regulatory environment is wholly different than that prevailing pre-crisis. So there are more than a few caveats. We'd nonetheless highlight that 10-year Ontario spreads are approaching some of the widest pre-crisis levels. For instance, Ontario's constant maturity 10-year spread (off the curve), at ~63 bps, is only about 8 bps shy from the pre-crisis peak reached back in 1998. It's taken a while, but provincial credit spreads are increasingly looking and feeling like they did back in the good ol' days.

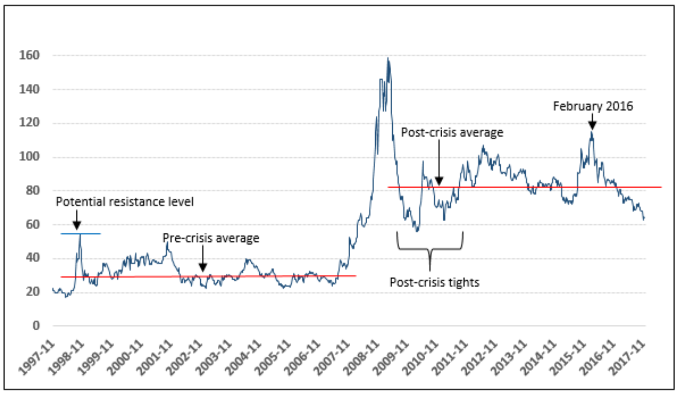
Moving on, let's briefly reflect on the historical provincial-corporate spread relationship; the basis between Ontario and senior deposit notes being an oft-cited metric (for the latter we're using Royal Bank). In the 10-year term, this relationship (dep notes over Ontario) has been hovering around the tighter-end of the range for some time now. That's true whether you're looking at outright spread differentials or the ratio of 10-year deposit notes over Ontario. The largely steady spread ratio implies an approximate similar tightening of both 10-year deposit notes and Ontario spreads since, say, 2016. Specifically, RY dep notes have tightened in ~44%, with the upcoming bail-in having for the most part contributed to the movement, and Ontario by ~39%.

If you put any stock in this type of relative value analysis, you might conclude that deposit notes don't necessarily have much wiggle room for further relative outperformance vs provincials. That could, in turn, be supportive of i) wider deposit notes spreads from here; ii) tighter Ontario spreads; or iii) both wider deposit notes' and a tighter Ontario spreads.

When it comes to near-term direction, we'll look to upcoming December coupon payments and the subsequent anticipated lull in new issue supply as 2017 draws to a close. Provincial spreads may look tight on a post-crisis chart, but in light of positive fundamental and technical forces, we wouldn't rule out a further modest contraction in 10-year Ontario spreads, bringing them ever closer to the pre-crisis peak referenced above. Mid-50s in Ontario 10s could be thought of as a potential resistance point, a legitimate test of which could be in the offing… given a still favourable global economic backdrop, the successful diversion of provincial supply to international markets, and the seasonal tendency for credit spreads to tighten in during calendar Q1 (Note: There are a number of risk factors that have the potential to short-circuit/derail further credit spread compression in our provincial market, with geopolitical uncertainty, NAFTA worries and housing market anxiety being obvious examples).

Chart 1: Ontario 10Y historical spreads

Ontario constant maturity 10-year spread



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