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Quick Hit — Headwinds South of the Border

If, like us, you track the ebb and flow of provincial bond supply closely, you might have observed an interesting trend of late: a noted drop-off in international supply. Outside of a couple small AUD prints by Alberta, provi supply was a domestic story in January. That stands in stark contrast to where things stood a year or two ago, with January typically one of the busiest months of the year for international issuance (Chart 1). January's lull extended a streak of relative inactivity; since Sep-2017, the provinces have lifted the equivalent of just C$1.3 billion internationally, less than 10% of their total funding over that timeframe (Chart 2). The drop-off in USD activity—traditionally the most heavily utilized foreign currency market by our provinces—is particularly noteworthy. The sole US dollar provi deal in the past four months was New Brunswick's US$500 million 2.50% 12/12/2022 trade in December.

International funding is at least partly a function of economics: does it pay, or rather not cost too much, to issue outside of the home, CAD market? It's hardly shocking that the recent lull in international supply goes hand-in-hand with a deterioration in international funding arbs (Chart 3). The so-called "arb" has a few component parts, so let's take a look at what's been happening of late. First, wider USD Libor re-offer spreads going into year-end 2017 negatively affected the USD funding arb, which was only amplified by the concurrent rally seen in C$ provincial spreads. There's a relative demand story here to be sure. Against a fairly steady drumbeat of demand for C$ paper, our New York colleagues confirm a lack of investor traction in USD provis (away from the very short-end of the curve). For levels, consider that the indicative Libor re-offer spread on 5-year Ontario bonds drifted wider by 7 bps in the final months of 2017. Meanwhile, comparable 5-year Ontario constant maturity spreads in the domestic market tightened by 12 bps. [Ontario 5-year USD Libor spreads contracted by a massive 50 bps between late February 2016 and early May 2017—roughly double the move tighter in CAD OTC spreads—keying a drastic improvement in the USD funding arb and opening the floodgates for international supply.]

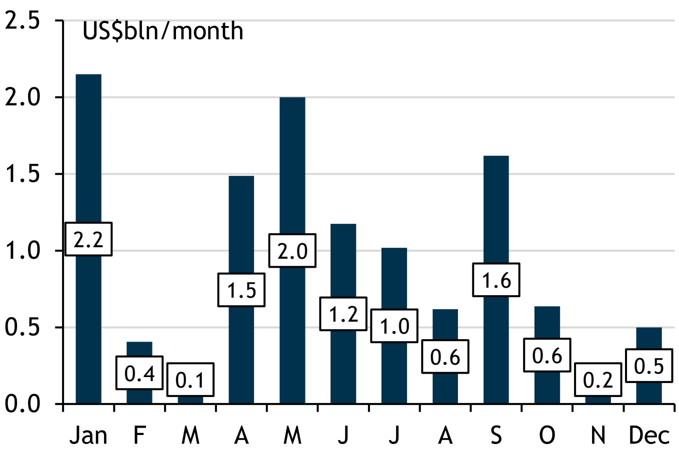
It's fair to say that a lot of that USD Libor re-offer spread weakening into year-end was driven by tighter US swap spreads, the latter being somewhat of a seasonal nature. Notable US swap spread contractions tend to be observed around year-end, typically followed by a widening to kick-start the year. A possible explanation for this, away from new issuance US flow, could be a balance sheet premium toward the end of year. Institutions might be more inclined to sell assets this time of year—to conceivably exhibit the best possible leverage ratios—resulting in a bear scenario for swap spreads.

Taking a closer look at year-end 2017, the tightening in US swap spreads was seemingly associated with receiving flows from investors wanting to take profit ahead of January's seasonal new corporate issuance, which generally bring about lower US swap spreads. However, this very scenario failed to materialize into 2018—leaving U.S. swap spreads back to their wider levels of mid-October 2017—likely over expectations of Liquidity Coverage Ratio (LCR) easing requirements that could in turn reduce the future associated balance sheet cost. Furthermore, let's highlight that various currencies' basis swap pricing, relative to the USD, dipped notably in late December (Charts 4, 5, and 6), possibly reflecting the reluctance of US institutions to execute synthetic foreign exchange positions and weighing on the balance sheet premium component.

Meanwhile, Canadian swap spreads, having mostly see-sawed in recent months, could be in the process of establishing a downtrend. The same may also be true for BA/LIBOR. If continued, these trends could signal a return of the USD funding arbitrage's appeal, but there's some way to go. Finally, it must be said that funding arbs have not always dictated the direction of supply… there are a plethora of other factors at play. But barring a noted improvement in the USD funding arb, provinces could well remain more focused toward C$ issuance ahead, which in light of large-scale future funding requirements, could lean against further significant domestic spread outperformance from here.

Chart 1: Jan normally busy… not this time

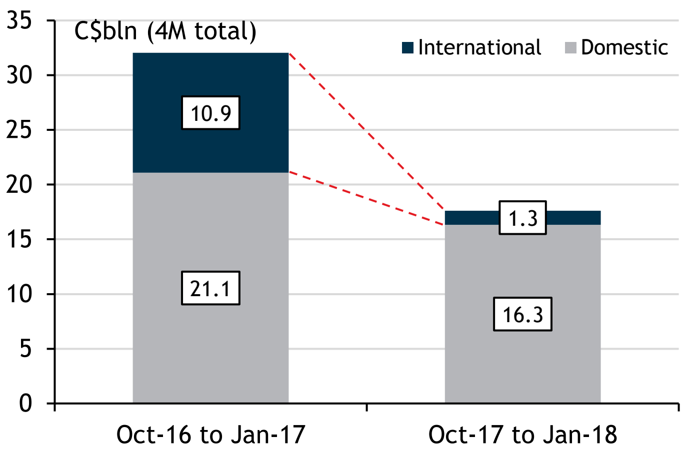
Average USD provincial bond supply by calendar month: 2010-2017



Source: NBF, Bloomberg

Chart 2: International markets go quiet

Provincial bond supply: Domestic vs international markets



Source: NBF, Bloomberg

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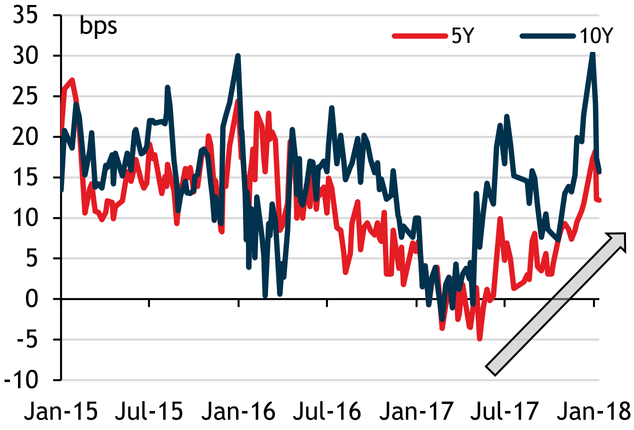
Chart 3: USD funding arb moved away

*Ontario indicative USD vs CAD funding arbitrage**



Source: NBF | Note: +ve values indicate USD relatively more expensive

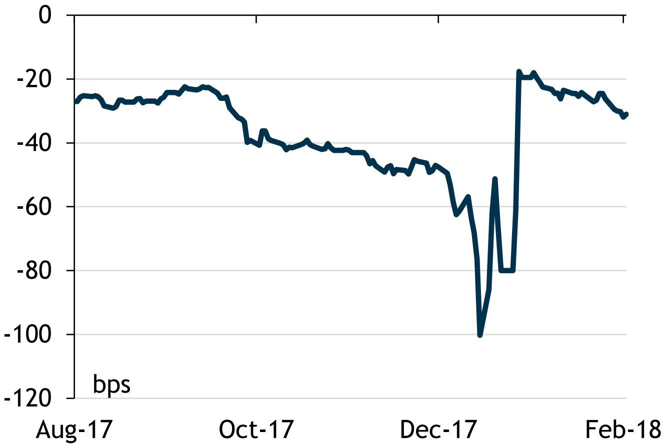
Chart 4: Late 2017 dip in Japanese basis swap

JPY basis swap (LIBOR) 3-month

Source: NBF, Bloomberg

Chart 5: …observable in EUR-USD Cross-currency

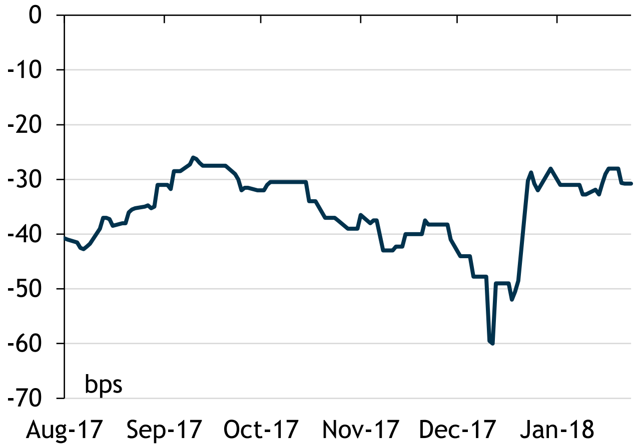
EUR-USD XCCY basis (3-month)



Source: NBF, Bloomberg

Chart 6: …and Canadian basis swap as well!

CAD basis swap (3-month)



Source: NBF, Bloomberg

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