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Market View – For Ottawa, it's extraordinary times indeed

By Warren Lovely / Taylor Schleich

Even before the spread of COVID-19, fiscal 2020-21 was shaping up to be an extraordinary year of funding for the Government of Canada. Then the world ended… or rather, ordinary life ceased, and an astonishing amount of economic activity was suspended. We're now knee deep in the corresponding (and truly striking) policy response. In Canada's case, the action plan entails conventional monetary policy easing by the Bank of Canada (100bps so far, with more on the way), a host of very substantial (read expensive) fiscal relief/response measures (primarily aimed at supporting disaffected workers/businesses and a health care system fighting the virus head on), on top of a growing array of extraordinary credit/liquidity facilities (witness the accumulating alphabet soup of program acronyms).

The end result is overwhelmingly the largest funding requirement Canada's federal government sector has ever seen. In dollar terms, it's not even close, requiring enough new treasury bills and bonds to make a trader's head spin. Moreover, the feds need the money **NOW!**

Some perspective/context, starting with the federal deficit but moving on to other elements of Ottawa's extraordinary funding requirement:

- Back in December, when most still thought the economy would be growing in 2020, Ottawa's 2020-21 deficit was pegged at $25 billion or just over 1% of GDP (prior to the "adjustment for risk"). But the 3.7% nominal growth that figure was based on is now a fairy tale.
- There's massive uncertainty attached to the economic outlook, but we see real GDP contracting sharply in 2020. Second quarter GDP will be the stuff of nightmares and **on a full year basis, something like a 5% drop in national output might come to pass**. Meantime, decisively lower oil prices (WCS trades <US$10/bbl currently) equate to a terms of trade shock and mean a weaker GDP deflator, widening the hole in the budget. Lower interest rates make for a smaller interest bill, all else equal, but the savings here are pennies on the dollar compared to the monumental revenue decline.
- At this moment (and things are clearly fluid), we see a range of outcomes where **an economic contraction adds $20-50 billion to the underlying federal deficit for 2020-21**. Split the difference and call it ~$30 billion. Critically, that's **BEFORE** adding the cost of new actions. *[Warning: Many economists are still wrapping their heads around the economic impact of COVID-19. This report is based current NBF economic assumptions, which could (and likely will) change as the persistence and depth of virus-related shutdowns/job losses become clearer. No one should claim 20-20 eyesight here. We certainly won't.]*
- As for those new measures, the Trudeau government has offered tangible support. Federal commitments might have been modest at first, with the establishment of a $1 billion "response fund" on 11-Mar but last week, a further $27 billion of assorted relief measures for workers/businesses was trotted out, much of the help designed to come immediately. However, in light of a monumental surge in EI claims, that too was deemed insufficient. Cue the Canada Emergency Response Benefit, which will see eligible Canadians receive up to $2,000 per month for the next four months. **That's pushed the fiscal price tag beyond $50 billion, with a further $55 billion in tax payment deferrals also being provided.**
- **And Ottawa isn't done.** There is, after all, the not-so-subtle question of shoring up Western Canada's ailing energy patch. FinMin Morneau tells us help is coming, and quick. You might be seeing headlines related to pledged aid for oil producers at the same time you're opening this document. There's also the outstanding question of direct fiscal stabilization payments to hard-hit provincial governments, which could (and probably should) be made retroactive to 2015. Stay current, because things are changing fast.
- Given the starting point for the deficit, accounting for the new and considerably weaker GDP profile, and adding in announced fiscal measures, **the federal deficit already looks to have pushed beyond $100 billion or roughly 5% of GDP**. Again, it could well be biased higher.
- Ottawa's triple-digit deficit for 2020-21 is going to blow away the prior record for a single fiscal year—which was $56 billion back in 2009-10, another crisis year. Historians will point out that the deficit, as a percent of GDP, ran around 5% of GDP for a number of years in early 1990s and had further back had a relative fiscal shortfall of more than 8% of GDP way back in 1984-85.
- **The deficit will be sufficiently large to let slip the last vestige of a fiscal anchor in Ottawa: a declining debt-to-GDP ratio.** Finger in the air, that key metric could jump 7%-pts or thereabouts in the coming 12 months (subject, like everything, to change).

But budgetary red ink is but a single component of the federal government's borrowing requirement. In fact, **the extraordinary credit facilities required during times of crisis/stress events can have as much or greater influence on funding needs**. And here, Ottawa has been very busy:

- There's the revised **Insured Mortgage Purchase Program** (call it IMPP v2.0), which will buy up to $150 billion of NHA-insured mortgage pools from participating financial institutions (note that this program has already been quickly and substantially expanded as it was initially announced to be up to $50 billion only ten days ago). The first operation, worth $5 billion, was fully subscribed Tuesday. Although administered by CMHC, you could think of this program as **quasi quantitative easing**, since the government is buying its own risk. To ensure banks can access this program, the government is upping legislated limits on CMHC's mortgage insurance/guarantees by $150 billion.
- In no particular order, there's also: the **Business Credit Availability Program** (BCAP) worth $10 billion+, being run through BDC and EDC; a **Bankers' Acceptance Purchase Facility** (BAPF), which kicked off this week with an initial installment of $15 billion and runs through the end of April; a freshly announced **Provincial Money Market Purchase** (PMMP) program, starting Wednesday and allowing the BoC to buy up to 40% of provincial bills and prom notes (12 months and in); an additional $5 billion in **lending capacity at Farm Credit Canada** for the agriculture sector; temporarily **expanded term repo facilities**, which now extend to 6 and 12 months and comprise a more liberal list of eligible collateral and; notably **expanded buybacks of outstanding GoC bonds and CMBs** to support liquidity. Note that these GoC bond buybacks are in addition to existing bond maturities, which at the time of writing amounts to a cumulative $92 billion for 2020-21.

- And don't forget the $55 billion of tax payment deferrals for individuals and businesses, that might not necessarily have a permanent fiscal price tag but will nonetheless add to the government's near-term borrowing needs (at least up to September).

If you've lost count of how much borrowing all this adds up to, you're forgiven. Without being too critical, **Ottawa doesn't even know exactly how much funding will be needed in the coming weeks and months or over the course of the 2020-21 fiscal year. Qualitatively, however, the answer is simply: MORE… LOTS MORE… AND FAST!** In other words, get ready for a massive, wholly unprecedented funding lift by the Government of Canada, starting now and extending at least through the first half of fiscal 2020-21 (and likely well beyond that in our opinion). Typically, we'd look to the *Debt Management Strategy* for guidance as to how precisely the government intends to approach the market. But given the absence of a full-blown budget, we don't yet have a DMS for 2020-21. We do, however, have a few pieces of info, all of which point to a sense of urgency in Ottawa when it comes to getting money in the door.

Firstly, starting in April, **Ottawa is moving from biweekly to weekly treasury bill auctions. This is a not-so-innocuous change**—even during the 2008-09 crisis, the feds stuck to biweekly pattern—and could provide, quickly and significantly, some of the extra cash the government wants to rush out the door in fiscal measures and/or liquidity facilities. Much depends on the size of the weekly tenders, as our scenarios in Table 1 make clear. As but one example: if sustained, an average weekly tender of $10 billion (i.e., $20 billion every two weeks) would add nearly $75 billion to the current T-bill stock by the end of September. Of course, given the immediate nature of Ottawa's fiscal policies, the need for cash is greatest now and in the coming weeks/months so it's likely we see a front-loaded issuance calendar with tender sizes tapering off towards year-end. (Note: At its peak, GFC-related bill supply hit $18 billion on a biweekly basis.) This is consistent with the notion that bills are a financial shock absorber, prone to move up and down much more quickly than bonds as we saw during the 2008-09 financial crisis (Chart 1).

But even in the bond market, desperate (or at least extraordinary) times call for drastic action. Witness Monday's *Quarterly Bond Schedule*, which was extraordinary not merely in terms of the day of its release, but more vitally in the sheer number of auctions planned for the coming three months. An unprecedented fourteen nominal bond auctions (and one RRB) will be conducted from April to June—an average of more than one per week. (The prior record for nominal quarterly auctions was 11.) And again, owing to the immediacy of the announced fiscal measures, quarterly auctions are heavily concentrated in April. Seven of the quarter's fourteen auctions are set to take place next month and could mean roughly $25-30 billion of gross supply. More than the sheer number of operations, we fully expect average auction sizes to step up. That's seemingly already happening, as today's 2-year auction (following the first IMPP v2.0 operation) will be a record $5 billion. Again, you could run any number of scenarios, but we've opted for a summary table below (Table 2) which, assuming larger average auction sizes, would point to perhaps $50-60+ billion of gross nominal bond issuance in the coming quarter—dwarfing the prior quarterly record of $33.6 billion.

It's not yet clear how well Canada's fixed income market will absorb this looming wall of supply. There's a chance that the extraordinary economic damage being done by COVID-19, the resulting extraordinary fiscal response and the related extraordinary government borrowing (both T-bills and bonds) will require one more extraordinary element: **true blue Quantitative Easing in Canada, whereby the BoC establishes a program to help absorb (at least on a temporary basis) outsized and entirely unprecedented net GoC debt issuance**. Time will tell.

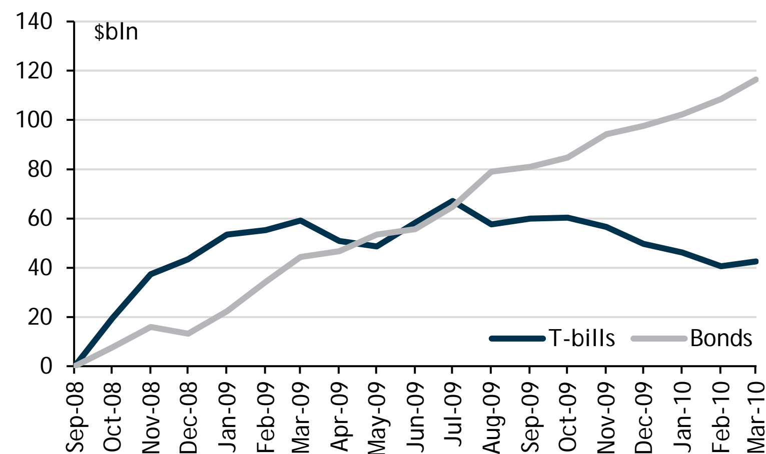
A few **additional implications**: First, more ample T-bill supply, in conjunction with bond buybacks, should work to lessen/compress the current spread that has opened up between bills and short-dated bonds (Chart 2). Mind you, there will be no shortage of relatively shorter-dated Canada bonds. If the fresh QBS is any indication, there remains a decided focus on the 2- to 5-year sectors when it comes to bond funding. We estimate roughly 75-80% of the coming quarter's gross GoC bond issuance will be 5 years and in. In terms of fixed points, the belly of the curve should see the greatest marginal boost as the number of 5-year auctions (which already are the largest in size at $4.2 billion) is set to double from 2 to 4, which could impact rates here more than elsewhere, *ceteris paribus*. Further out the curve (i.e., in 10s and longs), we are going to see more bonds in absolute terms but supply here will remain overshadowed by the volume of bonds pushed into the shorter tenors. And if curves are as much function of relative supply (vs shorter tenors or competing markets), it seems like Canada's sovereign bond curve is destined to remain relatively flat, after controlling for the re-steepening tied to the lower policy rate of course.

Is Ottawa missing a chance to term out? There's no question that long-term interest rates are historically attractive. But **a crisis isn't necessarily the most natural time to stuff dealers and investors with excessive/incremental risk**. Again, it could be that a *bona fide* QE program is needed to help sop up a near-term deluge of GoC paper. History shows that when big lifts are required, the path of least resistance is to shorten, not lengthen, the weighted average term of supply. To the extent many of the fiscal, tax payment deferral and special liquidity programs are meant to be temporary in nature—bridging the worst of the health crisis and resulting shut-in of activity—then a shorter-term funding strategy makes sense. If Ottawa intends on running permanent deficits, then fine, some of the financing could/should be longer term in nature. But the real drivers of the increase in today's gross borrowing needs hopefully won't last. (Although, we'll concede a growing worry about potential permanent capacity destruction as shut-downs extend.)

That brings us to a **final and concluding thought**, one rather fundamental in nature. Should the massive global policy response to the COVID-19 pandemic prove successful, the wholesale destruction of economic activity we're seeing today will give way to recovery… the buds of which we hope to see in second half. Again, treat this as entirely preliminary in nature, but **if Canada's economy ends up contracting by 5% or so in 2020, then we could see at least that much of rebound (likely more) coming in 2021. If that's the case, we won't be seeing or needing emergency style interest rates and excessively stimulative fiscal policy for long.** Until then, markets will certainly have their fill of government debt all round the world, including here in Canada. Extraordinary times indeed.

Chart 1: The historical GoC bill-bond playbook

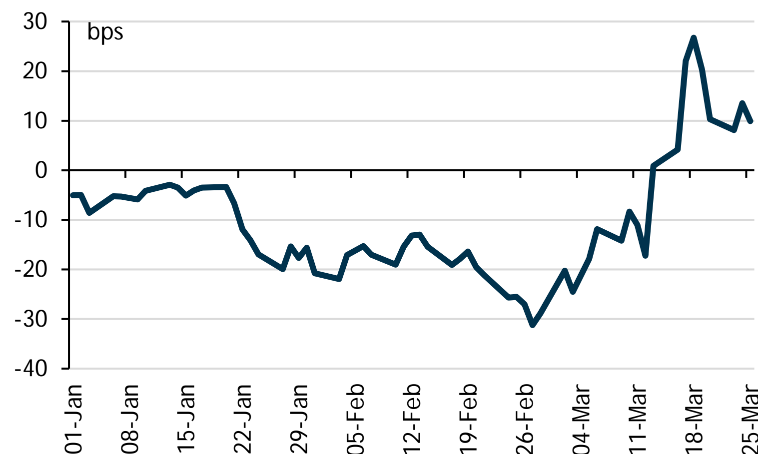
Change in bills and bonds outstanding from September 2008



Source: NBF, StatCan

Chart 2: Significant short-end steepening

2-year bond – 6-month bill spread in 2020



Source: NBF, StatCan

Table 1: Potential Scenarios for GoC treasury bill auctions

Potential bill issuance strategies (i.e. auction size per week) for BoC in coming months and resulting bill stock outstanding/change versus today

Oustanding as at March 26, 2020: *146.9*

	Bills outstanding (end of month, $ bln)					Change in bill stock vs. March 26, 2020				
Month	$8 bln	$9 bln	$10 bln	$11 bln	$12 bln	$8 bln	$9 bln	$10 bln	$11 bln	$12 bln
Apr-20	149.5	153.5	157.5	161.5	165.5	2.6	6.6	10.6	14.6	18.6
May-20	157.9	165.9	173.9	181.9	189.9	11.0	19.0	27.0	35.0	43.0
Jun-20	175.5	188.5	201.5	214.5	227.5	28.6	41.6	54.6	67.6	80.6
Jul-20	172.6	187.2	201.8	216.4	231	25.7	40.3	54.9	69.5	84.1
Aug-20	176.3	192.5	208.7	224.9	241.1	29.4	45.6	61.8	78.0	94.2
Sep-20	184.7	202.9	221.1	239.3	257.5	37.8	56.0	74.2	92.4	110.6
Oct-20	184.3	203.3	222.3	241.3	260.3	37.4	56.4	75.4	94.4	113.4
Nov-20	187.3	207.1	226.9	246.7	266.5	40.4	60.2	80.0	99.8	119.6
Dec-20	192.5	213.3	234.1	254.9	275.7	45.6	66.4	87.2	108.0	128.8

Source: NBF, Bloomberg, Bank of Canada | Note: Columns relate to assumed weekly auction sizes and assumes weekly auctions continue through Dec-20

Table 2: Potential scenarios for the GoC bond program in coming quarter

Potential bond issuance strategies for Bank of Canada in calendar Q2 based on size shocks to 2019-20 auction sizes and the quarterly bond schedule

2020-21		Min/Max/Avg. Auction Sizes						Amount Issued		
Q1 (Apr-Jun)		Peak GFC (Jan-Dec 2009)			2019-20			Scenario (vs. 2019-20 average size)		
Tenor	# auctions	Min	Avg	Max	Min	Avg	Max	+10%	+30%	+50%
2Y	4	2.5	3.3	4.5	3.0	3.1	5.0	13.7	16.2	18.7
3Y	2	3.2	3.4	3.5	2.4	2.4	2.4	5.3	6.2	7.2
5Y	4	2.5	3.4	5.5	4.0	4.1	4.2	18.2	21.5	24.8
10Y	2	3.0	3.3	3.5	3.0	3.3	3.4	7.2	8.5	9.8
30Y	2	1.3	1.4	1.5	1.4	1.4	1.4	3.1	3.6	4.2
Sum	*14*	-	-	-	-	-	-	*47.4*	*56.0*	*64.6*

Source: NBF, BoC | Note: Scenario amounts calculated by scaling up average auction size from 2019-20 by 10%, 30% and 50% and multiplying by number of planned auctions in coming quarter.

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