August 4, 2020 - (Vol. IV, No. 45)

Market View – Enter the dog days of summer

By Warren Lovely / Taylor Schleich

If you're in the northern hemisphere, chances are you're getting a dose of hot, humid weather. Whether you suffer or celebrate the dog days of summer, August has tended to produce relative quiet on trading desks. Not anymore. Desks may be only partially staffed, with transactions more likely originating from a home office somewhere, but virus-related fallout means this August will deviate from prior iterations in a few important respects. The virus itself appears reenergized, a particularly problematic development in parts of the U.S. Where and when possible, there are economic restarts to undertake, absent any historic precedent and lacking a genuinely uniform approach from one jurisdiction to the next. Washington is once more home to classic, partisan brinkmanship as it relates to a much-needed second round stimulus package. Even Ottawa's Parliament Hill has its own dose of political intrigue, as the WE charity controversy has politicos all atwitter and popular support for the minority Liberal government flagging (if recent polls are to be believed). Traditionally mundane first quarter fiscal updates will be anything but this year, as key provinces are poised to re-state their budgetary outlooks like never before. Consistent with a gusher of budgetary red ink, there's a mountain of debt to issue, summer holidays or not. Related debt issuance strategies and central bank liquidity/QE/CE programs are, in some cases, being adjusted… non-trivial tweaks that will keep market participants on their toes.

All that to say, August 2020 is apt to look nothing like the summer slumber that has often characterized this month. That raises the question: given the wholesale change in socio-economic, fiscal, financial fortunes, are August's relatively well-entrenched seasonal tendencies unlikely to hold this time around? Here, we offer up considerations (and related trading bias) across a range of key metrics/sectors:

	Central Tendency	2020 Considerations
Economic data	Looking back over the past decade, there's an apparent tendency on the part of economists to overstate economic health in the summer months. Eventual disappointments in actual readings have left U.S. economic surprise indices in negative territory for 7 of the past 10 Augusts. That's tended to give way to upside surprises later in the year, mind you. Call it residual seasonality if you want, but economic disappointment has been common enough.	To listen to economists, the outlook is a veritable alphabet soup of possibilities: Vs, Us and most troubling, Ws. Look, after a savage Q2, growth has improved this summer. Anything would have looked better than the disaster that was April-May. Those same economic surprise indices noted at left are currently a mile high in the U.S. The question isn't whether we get more growth over the balance of the summer, but how much and critically whether it can be sustained. We're cautiously optimistic on Canadian prospects, given what appears to be better containment of the virus. But south of the border, 2nd wave fears could lead to consumer and business retrenchment, and thus data disappointments. Recent reading on jobless claims have been worrisome and one near-term downside surprise could be July non-farm payrolls (landing Friday). As for the fall/winter months, who knows!? Economic uncertainty has never been this elevated so take any economic prognostication with a block of salt. Were we to handicap the balance of risks to the North American economy, they appear tilted one way: to the downside. | **NBF bias: No 2nd wave in baseline forecast but risks are mounting; data disappointments are a growing likelihood, with the all-important U.S. labour market a chief focus.**
US treasuries	For treasuries, no other month has seen as great of a Treasury rally as August (based on the past decade of trading). 5, 10s and 30s have moved lower by an average of 10, 16 and 17 bps. In each of the last three years, yields across the curve have moved decisively lower in August.	On paper, there should be little to no volatility in short-end rates, with negative fed funds off the table (so Powell tells us) and rate hikes nowhere in the realm of possibility over the next couple of years. Out the curve, with yields already at record lows, it's fair to ask: how much lower can yields really go? Yes, signs of a slowing recovery would argue for rates to continue to rally, but with Congress (hopefully soon) introducing another round of stimulus (US$1+ trillion), there could be some pressure on longer yields to sell off (or at least dull a rally) on the related bond supply shock. | **NBF bias: Limited additional rally, based on current location, bucking traditional August pattern; risk of stimulus-led sell-off if Dems get their way on US$3+ trillion package.**
UST yield curve	Flattening curves have characterized Augusts over the past decade, with the 2s-10s curve a prime example. This curve has moved flatter 8 of the past 10 years (including all of the last 6) by an average of 12 bps, far and away the biggest move of any month.	The curve has already been moving decisively flatter over the last two months. Yes, we could get a modest continued move flatter on the back of weak economic data/virus pessimism. But the scope for any kind of significant move has been largely wiped out in recent months, as longer yields are at or near all-time lows. A large stimulus plan, and thus another large bond lift, could see the earlier flattening reverse course, particularly if the Treasury takes a page out of the GoC's book and places marginal issuance out the curve in order to lock in ultra-low long-term borrowing rates. A sensible enough strategy to us. | **NBF bias: Recent bull flattening could stall out in August, assuming Washington lawmakers ultimately come to their senses.**
Canada-US yield differentials	History tell us Canada underperforms in August, particularly out the curve. On average, over the past decade, Canada 10s have underperformed by an average of 5 bps, lagging treasuries in 7 of 10 years. There's a similar record for 5s and long bonds, as we've seen underperformance in the majority of years by an average of 3 bps and 9 bps respectively.	While Canada typically underperforms in August, the current context this year may allow for a break from historical tendencies. With Canada 10s and 30s underperforming Treasuries by 13 bps and 21 bps respectively from mid-June, Canada bonds look *relatively* attractive. There aren't many catalysts for a major Canada sell-off given we've already seen the sticker shock of the GoC's full-year bond program. Importantly, the BoC is committed to continuing its pace of bond buying, and the overnight target is all but guaranteed to be on hold for at least two years. Meanwhile, a US$1, $2 or even $3+ trillion stimulus package south of the border would likely put pressure on Treasury yields, particularly out the curve. | **NBF bias: Traditional underperformance already captured, with potential for modest reversal; keep eye on 1-Sep coupon effect & related duration shift, which some may seek to front-run.**

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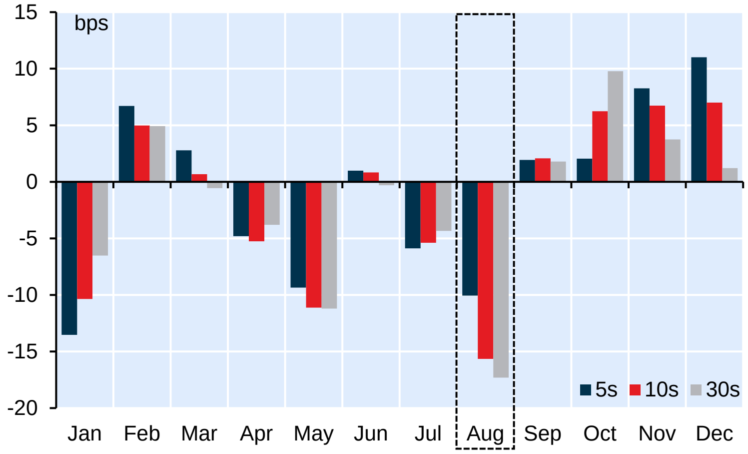
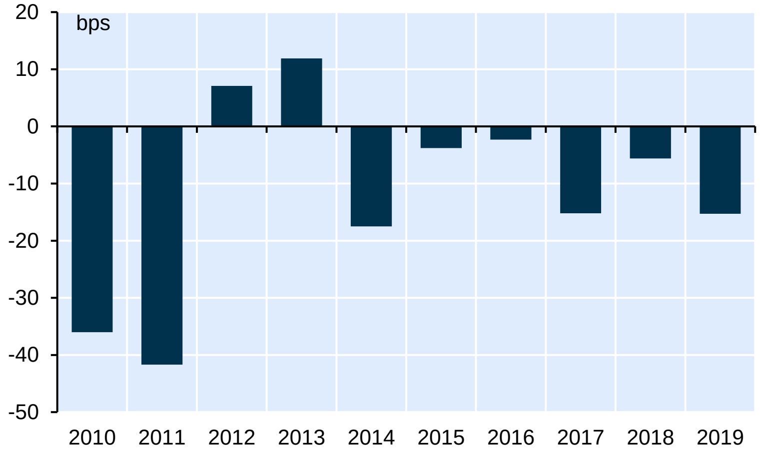
Swap spreads	In Canada, traditional seasonality leads to swap spread widening in the spring on the back of mortgage hedging and a tightening in the summer as housing activity slows. Canada's 5-year swap spread, for example, has tightened in 8 Augusts over the past decade by an average of 4 bps.	This year, COVID-19 related shutdowns have postponed some major purchases by Canadian households, which could lead to above-trend mortgage origination in August. Call this a classic case of pent-up demand, notwithstanding evident damage to labour markets and still-shaky consumer confidence. Meanwhile, BoC QE purchases and forward guidance should keep a lid on GoC yields. Currently, our swap traders see spreads as fundamentally on the wide side. Saying that, we don't necessarily see any major catalysts that would move spreads decisively tighter near-term. | **NBF bias: Neutral; less scope for traditional August narrowing.**
Credit spreads	Coming on the heels of typically tighter July levels, August hasn't traditionally been the best month for credit spreads. Whether you're looking at U.S. or Canadian names, high grade or low grade, public sector or corporates, short or long tenors, August has tended (on average) to deliver a roughly one standard error back-up in spreads… softness that, more often than not, carries over into September.	We're hesitant to label credit as truly "rich", given the wall of cash that's been available to chase product and the "whatever it takes" attitude on the part of central banks (in terms of backstopping markets). An expected agreement on U.S. stimulus might provide a short-term injection of confidence, but ultimately much depends on whether the U.S. can successfully contain the virus. There's still tremendous uncertainty on that score. Governments are starting to own up to the massive fiscal damage wrought by the virus, including the hefty price tag attached to stimulus programs that may prove difficult to wind down. In Canada's provincial sector, that's translating into record deficits, rapid debt accumulation, unprecedented issuance and credit rating pressure. Fiscal disclosure remains a work-in-progress, with some eye-popping deficit figures still to come and medium-term guidance largely MIA. Some of the virus damage, so the thinking goes, could prove temporary, but don't mistake that for a rapid return to fiscal health in the public sector… in Canada or elsewhere. July's fed-prov restart agreement has paved the way for a needed financial lifeline for municipal sector, easing anxiety even if pressures are likely to remain through 2021. A few corporate sectors, meanwhile, are walking a precarious road indeed, with quasi-permanent damage and virus-spawned bankruptcies accumulating (e.g., retail, accommodation/food services, recreation, real estate, transportation). Not the prettiest of pictures all in all. The best news, however, may be the increasingly non-existent yield available via sovereign curves, which makes credit (however risky) a place many investors seek out for needed yield enhancement. | **NBF bias: Neutral to somewhat defensive, as material disclosures to come, rating risks skewed to downside and relative strength likely to be issued into; ample liquidity & central banks cap downside.**
GoC bond supply	August has typically been the month with the most GoC bond issuance, with an average of $10.7 billion over the past 10 years. No other month has, on average, seen as many Canada government bonds being issued.	So August is normally a relatively active month for Canada's sovereign. And the coming month doesn't look to disappoint. This August, a projected $41 billion in GoC bonds look to be auctioned, as Ottawa terms out some of its earlier outsized T-bill supply and generally finances its extraordinary fiscal response to the virus. GoC issuance is absolutely shattering pre-COVID records, and our assumption for August would even exceed the current $34 billion monthly record set back in April. Distributionally, we're looking at $18 billion in 2s, $10 billion in 5s, $10 billion in 10s and $3 billion in 30s over the course of the month. Keep in mind that the BoC's newfangled bond buying program will see about half of this supply immediately neutralized, on top of the usual 13% of each auction that the Bank gets allocated. | **NBF bias: Record supply in August; September to be slightly lower but outsized issuance to continue throughout fiscal year before tapering to lower but still historically elevated levels in 2021-22; Ottawa embracing term extension given low long-term yields and evident demand.**
Cdn sub-sovereign bond supply	If you're looking for evidence of a summer slowdown, this has traditionally been the place to turn. Whether its provinces, municipalities or corporates, August typically (but not always) ushers in relative calm in primary markets. Secondary trading volumes are likewise relatively subdued, based on the past couple years of MTRS 2.0 bond vol stats at our disposal.	Nothing's normal these days, least of all when it comes to bond supply levels and patterns. So forget the prior tendency. Yes, we have provincial fiscal updates to work around, including sizeable expected restatements from Ontario (on/before 15-Aug) and Alberta (27-Aug). Related blackouts will temporary sideline two of our largest provincial issuers. And it's also true that provinces took a lot of liquidity on board during the first four months of fiscal 2020-21. Still, the sheer magnitude of today's gross borrowing requirement suggests August will be anything but quiet in the domestic provincial market. It's usually a slumber in muni land during August, but here again we might see a couple issuers approach the market. And don't forget a larger CMB offering coming mid-month, consistent with an increased issuance program and CMHC's enlarged limit on mortgage insurance-in-force. Absolute and relative CMB spread performance in/around deal time is a topic we, as always, are happy to take up with interested parties. If there's a sector where relative quiet may reign, it might just be in Canadian corporates. One caution: in the corporate universe (as everywhere), treasurers would do well to remain nimble given such a highly uncertain economic backdrop. If anything, ultra-low coupons and evident available cash might just pull a few issuers into the market… perhaps not a bad strategy to employ if you thought a 2nd wave was a clear and present danger. | **NBF bias: Blackouts to impact some provinces, but 2020 will continue to see above-average supply in light of record funding needs; pipeline will start to build for some munis; corps could be quiet; CMB a near-term focus.**

Chart 1: Treasuries historically well-bid in August
Average monthly changes in U.S. Treasury yields by month: 2010-2019



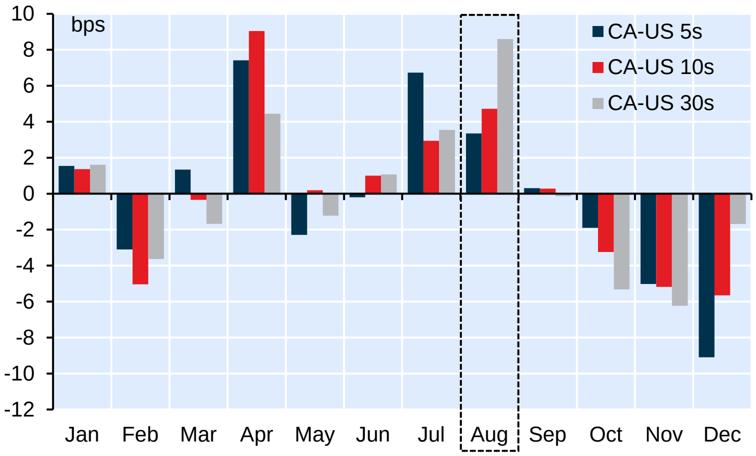
Source: NBF, Bloomberg

Chart 2: Flatter curves have been an August staple
Change in 2s-10s U.S. Treasury curve in August: Last 10 years



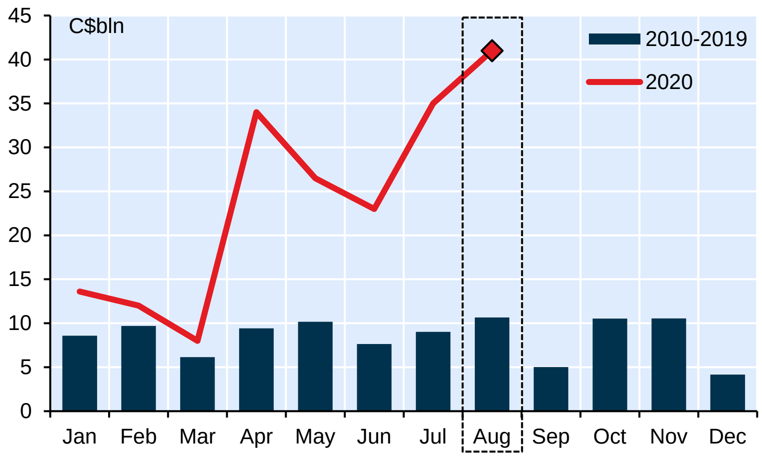
Source: NBF, Bloomberg

Chart 3: Canadas tend to underperform in August
Average monthly changes in Canada-US yield differentials: 2010-2019



Source: NBF, Bloomberg

Chart 4: Record GoC supply in 2020
GoC supply by month: 2020 vs. monthly average from 2010-2019



Source: NBF, Bloomberg | August 2020 is NBF projection

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