NATIONAL BANK OF CANADA FINANCIAL MARKETS

August 17, 2020 - (Vol. IV, No. 47)

Market View – The long and short of Ontario's new long bond

By Warren Lovely

With last week's Q1 Update out of the way, Ontario can get back to funding itself. There's certainly enough to do. Ontario's long-term borrowing requirement has moved up to $52 billion for the 2020-21 fiscal year—a record bond crop consistent with an unprecedented budgetary shortfall. Long-term funding needs would be larger if not for an increase in short-term outstandings, made possible by the Bank of Canada's Provincial Money Market Purchase (PMMP) program. As for bonds, the marginal increase in long-term funding versus a March projection (+$8.5 billion) will be more than offset by Ontario's share of the central bank's Provincial Bond Purchase Program (PBPP), which is slated to buy up to $50 billion of provincial bonds through May 2021. Yes, the PBPP extends only to 10-years and Ontario's average term on completed funding, at 11.0 years, is today shorter than the post-GFC trend. But Ontario hasn't given up on the long bond. Far from it. Given exceptionally low long yields and a preference for reducing refi risk, Ontario will be back in the 30-year saddle soon enough. Rather than tap an existing bond, it's time to set down a new marker. Some points to ponder in advance:

- Ontario's next 30-year benchmark should bear a 2051 maturity. When the new bond comes, it will close the book on the ONT 2.65% Dec-2050s, a bond launched in May 2019 and issued almost 20 times, leaving outstandings north of $14 billion—a float on par with sovereign long bonds. This should be obvious, but Ontario's new long bond will sport a record low coupon, roughly 2% based on prevailing yields;
- We may be in the grips of a pandemic, but the new long bond won't have a crisis-level spread attached to it. Assuming pricing in the context of the existing 30-year, currently ~85 bps vs. CAN 2051s, the new issue spread could be tighter than average, compared to where other longs were launched. A word on NI pricing and more specifically the tendency towards 30Y inversions: Last time, with the 2050s, the new bond was priced -1 bp to the existing benchmark. Ditto for the 2049s, which came -1 bp vs. the old bond. Further back, the green banner for the 2048s went up at equivalent of -0.5 bps vs. the prior benchmark. As for the 2046s, that bond was priced flat to the 2045s;
- Perhaps more exceptional is the relative difference in 30-year yields/spreads against 10s. Ontario's long bond currently offers ~45% yield enhancement over the current 10-year benchmark. That captures a demonstrably lower but not necessarily flatter 10s-30s Canada curve, relative to where things stood at the establishment of Ontario's earlier 30-year bonds. One must be careful with ratios when yields get close(r) to zero, but fair to say the 30-year sector adds some non-trivial juice vs. ultra-skinny yields down the curve. Meanwhile, the 10s-30s credit box, at 12.5 basis points, is steeper than prior go-rounds. Here, it's worth reiterating the technicality tied to BoC provi bond purchases (i.e., 10Y and in), which resulted in an identifiable steepening of provincial credit curves, all else being equal;
- Ontario's benchmarks have long afforded investors ample liquidity. And it doesn't take too long to build up size in the new 30-year benchmarks, re-opened in just 13 days (median) and hitting the $5 billion o/s threshold as quickly as 138 days after launch (or 4½ months). Given record funding needs, the new 30Y might just build at a faster-than-normal clip, assuming market conditions remain favourable;
- Ontario's new 30-year bonds have a solid (if unspectacular) performance record vs. Canadas. We typically don't see a meaningful move tighter in the first handful of trading days. After 10, 20 or 50 sessions though, the new bond has (on average) ground in by 1½-3 basis points. The historical track record isn't bullet proof, mind you. Nor does the new bond necessarily best the old benchmark right away. Given enough time, however, a non-trivial benchmark premium tends to get built in. Based on prevailing levels vs. the GoC curve, we'd cuff Ontario's 30-year liquidity premium at 1.3-2.5 bps for each year you move away from the on-the-run security. Note: There's currently a 3 bp/year premium between the current benchmark (the 2050s) and the next closest off-the-run (the 2049s);
- Unlike prior years, when the provinces largely had the run of things in the long end, the feds are getting more active out the curve. After all, Ottawa is running a proportionately larger deficit than all the provinces combined, on top of a fresh desire to term out. Watching recent US Treasury funding, it's clear that pushing a lot of marginal supply into the long end can impact curves and competing product. But before you stress about the provinces being crowded out, consider that the most significant BoC purchase program (i.e., the one that buys GoC bonds) continues to suck up the net supply of Canadas being placed in the long end—even more so now that the Bank targets the on-the-run benchmark (CAN 2051s), rather than the shorter-dated, less liquid off-the-runs that were the focus through July;
- In terms of seasonals, August-September isn't typically the greatest time of the year for provincial credit spread performance. But as we always caution, any number of caveats must be attached to seasonal analysis, particularly in today's exceptional environment. One seasonal to be bear in mind is the September 1st coupon effect/index extension. This might not be as meaningful as the outsized June 1st or December 1st moves, but could nonetheless generate marginal demand for duration at the turn of the month, *ceteris paribus*;
- Fundamentally, Ontario will set down its new 30-year marker amidst an extraordinary environment. The province's unemployment rate, while receding from a record high, remains in double digits. Real GDP looks to contract 6-7% this year, admittedly with scope for economic recovery next year. Fiscally, last week's update put the deficit at $38.5 billion or 4.6% of GDP. Again, that's a wholly unprecedented shortfall. Notably, Ontario had four long-term credit ratings affirmed between May and July, each with a "stable" outlook. So while intrinsic credit quality in the broader provincial sector has eroded due to COVID-19, there may not be immediate rating risk for investors. Saying that, rating agencies will be keenly interested in Ontario's eventual budget (complete with a medium-term plan), which is due in the fall;
- Never lose sight of the fact that Ontario has proven access to international markets, having already tapped the US dollar, euro and pound sterling markets this fiscal year. Domestic investors, be they active in longs or down the curve, won't be asked to swallow Ontario's full bond program. Don't be surprised if we get near-term reminders of just how effective/deep international markets are for the provinces;
- A final caveat and one that always bears repeating: As much as we focus on Ontario's performance and issuer-specific aspects, its the global appetite for risk, more than anything, that will determine where Ontario's new long bond comes and how it ultimately performs. Of this, there should be little debate.

Table 1: A look back at Ontario's 30-year domestic benchmarks

Introduction, development & performance of Ontario C$ 30-year benchmark bonds

Ontario: Introduction of New 30-year Benchmark Bond																		
		First	Latest/last	Total	Times	First issue	Average	Time to	Days to reach O/S amount:			Spread level & change vs GoC compared to close of NI day:						
Maturity	Coupon	issued	re-opening	issued	issued	size	R-O size	first R-O	$2bln	$5bln	$7bln	NI close	Bench	+1D	+5D	+10D	+20D	+50D
date	%	date	date	$mln	#	$mln	$mln	days	days	days	days	bps	CAN	bps	bps	bps	bps	bps
12/02/2050	2.65	05/24/2019	07/16/2020	14,100	19	600	750	11	20	138	172	82	12/51	0	2	1	-3	-4
06/02/2049	2.9	11/28/2017	05/14/2019	13,250	18	750	735	20	134	178	267	70	12/48	0	0	-1	-4	0
06/02/2048	2.8	06/16/2016	09/25/2017	12,700	18	600	712	13	40	176	336	107	12/48	-1	-6	-5	-9	-9
12/02/2046	2.9	01/28/2015	05/31/2016	14,700	20	750	734	1	22	141	180	92	12/45	0	-6	-5	-7	-8
06/02/2045	3.45	05/07/2013	12/03/2014	16,050	24	750	665	22	63	202	268	100	12/45	0	0	-2	-1	-2
06/02/2043	3.5	01/26/2012	04/04/2013	11,200	17	600	663	13	41	195	295	86	12/45	0	2	0	2	12
06/02/2041	4.65	06/10/2010	12/02/2011	11,650	18	600	650	34	109	239	335	92	6/41	0	3	0	1	-1
06/02/2039	4.6	01/10/2008	08/31/2010	9,700	22	600	433	109	168	692	840	56	6/37	0	-1	2	2	12
06/02/2037	4.7	02/17/2006	12/04/2007	9,100	17	500	538	77	154	353	558	58	6/37	0	2	4	0	-5
Average	3.26	Post GFC, NEW 30Y typically established every 15-20 months, but timing/maturity less rigid than 10s		13,379	19	664	701	16	61	181	265	90.0		-0.2	-0.8	-1.8	-3.0	-1.6
Median	2.90			13,250	18	600	712	13	41	178	268	91.7		0.0	0.0	-1.0	-3.4	-2.4
Min	2.65			11,200	17	600	650	1	20	138	172	70		-1	-6	-5	-9	-9
Max	4.65			16,050	24	750	750	34	134	239	336	107		0	3	1	2	12

Notes: These tables show the evolution of NEW Ontario 30-year benchmark bonds; the dotted line separates post-GFC crisis from prior period (on basis on new issue date);
average, median, min and max values relate to bonds first issued in post-GFC period (i.e., 2041-2050 maturities); all dollar amounts are par value; "R-O" refers to re-opening; "O/S" refers to outstanding; "NI" refers to new issue;
in some cases, benchmark GoC used for spread calculations may not have been original pricing bond
Source: NBF, Bloomberg

Table 2: Market context prior to launch of Ontario's earlier 30-year bonds vs. now

Underlying GoC/Ontario yields and curves prior to Ontario launching new C$ 30-year benchmark bond, including other economic/financial market indicators for reference

Ontario: Prevailing Levels One Day Prior to Introduction of New 30Y Benchmark Bond																			
New	Day	GoC benchmark bond yield				Ontario yield (existing benchmark)				Ontario spread vs. GoC				US IG	Equity	Cdn	Jobless	Credit ratings	
30Y BM	before NI	10Y	30Y	10Y-30Y		10Y	30Y	10Y-30Y		10Y	30Y	10Y-30Y		CDX 5Y	vol (VIX)	dollar	rate	S&P	Moody's
maturity	date	%	%	bps	ratio	%	%	bps	ratio	bps	bps	bps	ratio	bps	index	vs. USD	%	LT|outlook	LT|outlook
2051 WI	Current*	0.61	1.13	51.6	1.84	1.34	1.98	64.0	1.48	72	85	13	1.17	68	22	1.33	11.3	A+|Stb	Aa3|Stb
2050	05/23/2019	1.64	1.88	24.4	1.15	2.37	2.71	33.4	1.14	73	82	9	1.12	65	17	1.35	5.2	A+|Stb	Aa3|Stb
2049	11/27/2017	1.86	2.22	35.8	1.19	2.48	2.93	45.4	1.18	61	71	10	1.16	54	10	1.28	5.5	A+|Stb	Aa2|Stb
2048	06/15/2016	1.08	1.76	67.7	1.63	2.05	2.84	79.2	1.39	97	108	11	1.11	85	20	1.29	6.2	A+|Stb	Aa2|Stb
2046	01/27/2015	1.43	1.99	56.4	1.39	2.25	2.92	67.4	1.30	82	93	11	1.13	67	17	1.24	6.8	AA-|Neg	Aa2|Neg
2045	05/06/2013	1.80	2.47	66.9	1.37	2.72	3.49	76.7	1.28	92	102	10	1.11	71	13	1.01	7.5	AA-|Neg	Aa2|Stb
2043	01/25/2012	2.04	2.65	60.7	1.30	2.99	3.55	55.8	1.19	84	90	6	1.07	102	18	1.00	8.1	AA-|Stb	Aa1|Neg
2041	06/09/2010	3.35	3.76	40.7	1.12	4.24	4.67	42.6	1.10	89	91	2	1.02	-	34	1.04	8.3	AA-|Stb	Aa1|Stb
Summary stats for 2041-2050 benchmarks	Average	1.89	2.39	50.4	1.31	2.73	3.30	57.2	1.23	83	91	8	1.11	74	18	1.17	6.8		
	Median	1.80	2.22	56.4	1.30	2.48	2.93	55.8	1.19	84	91	10	1.11	69	17	1.24	6.8		
	Min	1.08	1.76	24.4	1.12	2.05	2.71	33.4	1.10	61	71	2	1.02	54	10	1.00	5.2		
	Max	3.35	3.76	67.7	1.63	4.24	4.67	79.2	1.39	97	108	11	1.16	102	34	1.35	8.3		

Notes: Levels for 2041 to 2050 benchmarks refer to prevailing market conditions on the day prior to launch of new Ontario 30-year benchmark; levles for 2051 WI refer to 14-August-2020;
Ontario spreads refer to prior benchmark vs. corresponding GoC bond; jobless rate refers to SA average for month of bond issue (or latest); credit ratings & outlook refer to Ontario
Source: NBF, Bloomberg, StatCan, S&P, Moody's

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Paul-André Pinsonnault
Senior Economist
paulandre.pinsonnault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rate Strategist, Economics and Strategy
warren.lovely@nbc.ca

Taylor Schleich
VP, Rates Strategist, Economics and Strategy
taylor.schleich@nbc.ca