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Market View – Arb-chair quarterback

By Warren Lovely

The NFL season is meant to kick off in less than two weeks' time. Assuming games go as scheduled, we will soon have no shortage of arm-chair quarterbacks critiquing every sweep, post route and field goal attempt. But you don't need to be dashing around a professional playing surface to have your actions scrutinized these days. Policymakers are under the microscope, and for good reason, given historic accommodation to counteract COVID-19.

In Canada, the fallout from and response to the virus has meant unprecedented funding needs for provincial governments (among others). As it stands, the domestic bond market has proven quite receptive to our provinces; just look at the parade of bonds successfully launched since April 1st. But with such outsized funding requirements (which could well extend into 2021-22), *international* bond markets can and will be an important outlet for many of the larger issuers. So allow us to play *arb*-chair quarterback for a minute, with an international issuance playbook that goes something like this:

- By way of context, Canada's provinces collectively project a deficit of almost C$100 billion for 2020-21, almost 4X the prior record shortfall in dollar terms. Every province is in the red, yet few have presented fiscal recovery plans. Many are waiting until the fall, when uncertainty will hopefully recede and the path forward may become clearer. Shout out to Saskatchewan, who offered up high-level multi-year guidance in a fresh Q1 Update last week (which sees that province's deficit erased in 2024-25).

- As befits a monumental/record fiscal gap, provincial borrowing needs have skyrocketed. Officially, nearly C$155 billion needs to be taken out of bond markets in 2020-21, either at home or away. Yes, that's undeniably a record too. For good reason then, the provinces have been getting busy. Five months into the fiscal year, fully C$90 billion has been raised in term markets. That would have been a full year's worth of effort in pre-COVID days. Three quarters of the completed borrowing has been sourced here at home (i.e., CAD), the remaining quarter (or C$23 billion) taken out of foreign currency markets (mostly USD or EUR).

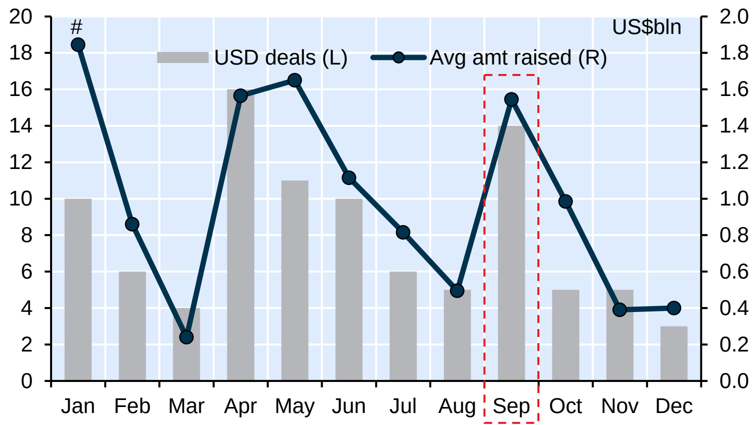
- Simple subtraction implies almost C$65 remains to be funded in fiscal 2020-21, subject to revised official guidance. Expect the majority to be printed in CAD, given evident demand from institutional investors and the BoC's proverbial backstop in the form of its PBPP. (That program has sucked up C$7½ billion and counting of provincial bonds since getting off the ground in May.) Nonetheless, international markets—particularly stateside—could be a useful tool to rapidly advance borrowing programs and ensure access to the widest possible investor base. Call it supply diversion (not to be confused with a diversionary tactic). No one's really trying to obfuscate here.

- Thinking about the Yankee market, seasonal patterns are informative, although not necessarily predictive. Over the past decade, September trails only April in being the busiest month of the year for provincial issues (based on number of trades). Technically, more money tends to get raised in January, that month's average deal size being larger (as investors have more dough to put to work as we flip the calendar perhaps?) (Chart 1).

- Ontario, as the largest province and thus most prolific issuer of the group, has tapped the USD market seven of the last ten Septembers, including last year (ONT USD1.25bln 2% 10/2029). We're not seeking to put the province in play, nor is Ontario technically behind schedule on its 2020-21 borrowing program. But there's still about 50% of a big number to go, or ~C$26 billion remaining in Ontario. As for other large provincial issuers, Alberta has ~C$11 billion to fund, while Québec is closer to C$10 billion. British Columbia and Manitoba, despite both being ahead of schedule, still have a non-trivial amount of borrowing to do too. Note that remaining requirements *do not* account for any prefinancing that some may wish to undertake.

Chart 1: September a common month to access USD market

Distribution of provincial USD deals & average amount raised by month: 2010-19



Source: NBF, Bloomberg | Note: Avg amt raised in a given month not be confused with avg USD deal size

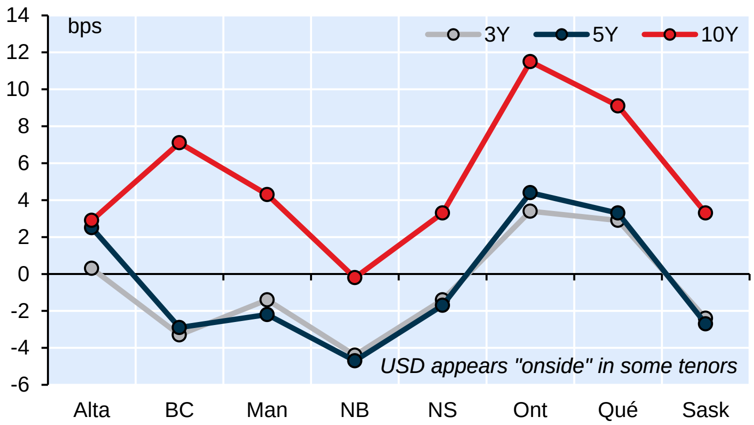
- How receptive and efficient do international markets look? Not to be flippant, but we would tend to consider the USD market wide open for many provinces. The reception shown other high-grade names, notably SSAs, is generally encouraging. True, dollar spreads hit a bit of a speed bump last week, leaving some recent high-grade deals trading flat to small back of their new issue level. But that's more likely consolidation after an impressive run, rather than a legitimate buyers strike. Not to take anything away from various SSA issuers—who sport top notch ratings and tight spreads for good reason—but for yield starved investors, provinces offer some non-trivial juice.

- What of relative pricing (to the issuer)? Without overcomplicating matters, let's just say that international funding arbs have a few moving parts. Let's look at a representative example, based on the largest international market (USD), the biggest provincial issuer (Ontario) and the most commonly accessed term in dollars (5-year). The way we see things today, Ontario's *all-in* cost to access the USD market in 5-years might be less than 5 bps vis-à-vis the corresponding domestic funding rate (excluding XVA). History suggests that might be close enough for Ontario to justify heading south, particularly when you consider how large a lift the giant USD market can allow for on a single deal. This year's average Yankee trade is USD2.3 billion, translating into more than 3.1 billion loonies (based on prevailing exchange rates at the time of launch). The dollar market is efficient, if nothing else.

- A similar case could be made for Alberta. For although USD indicative pricing might be a touch above domestic comps (1-6 bps depending on tenor), a large successful outing might well elicit a sigh of relief in the home market (where the majority of bonds reside). Not to get carried away, but a quick glance at the arbs suggests BC and Manitoba might be able to *save* taxpayers a bit of money by steering a trade into the U.S. (Chart 2).

Chart 2: USD funding arb snapshot in provi land

Indicative USD vs. CAD funding arbitrage levels by term/province

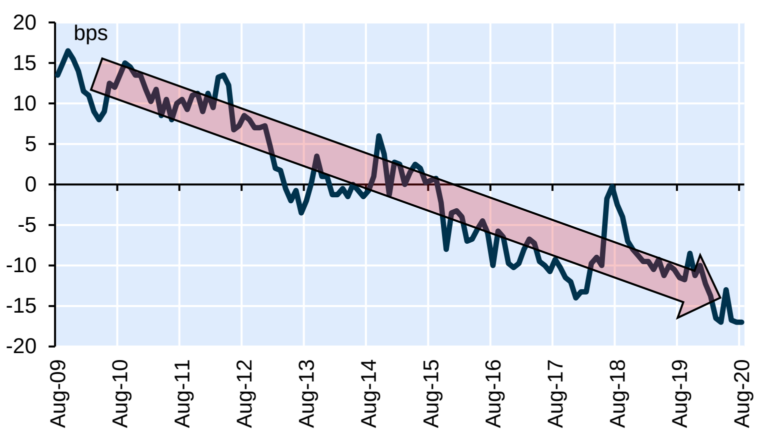


Source: NBF | Note: Indicative levels (as at 31-Aug) presented for illustration; excludes XVA; negative values denote USD market more cost effective vs. CAD

- We caution that the cross-currency funding arbs we've cited here are both indicative and subject to change. Clearly, the CAD-USD basis swap—a central ingredient in any arb calc—could be influenced by significant flows. Right now, BA-Libor basis, at -17 bps in 5-years, is notionally helpful for provinces that want to bring proceeds from a USD dollar deal back home to Canada. More than a lot of basis markets, BA-Libor has been locked in one big declining channel for over a decade (Chart 3), reflective of the generalized preference to hold dollars over loonies (among other factors). Interesting side note: There could be something of a symbiotic relationship between Yankee provincials and Maple SSAs, who prefer to go in opposite directions on cross currency swaps. A noted pick-up in one flow could facilitate an offsetting trade, adding a potentially interesting dimension to IADB's two recent Maple transactions (CAD500mln 0.875% 08/2027 and CAD600mln 0.75% 10/2025).

Chart 3: Long-standing trend in BA-Libor basis

CAD-USD 5-year basis swap spread (monthly average)

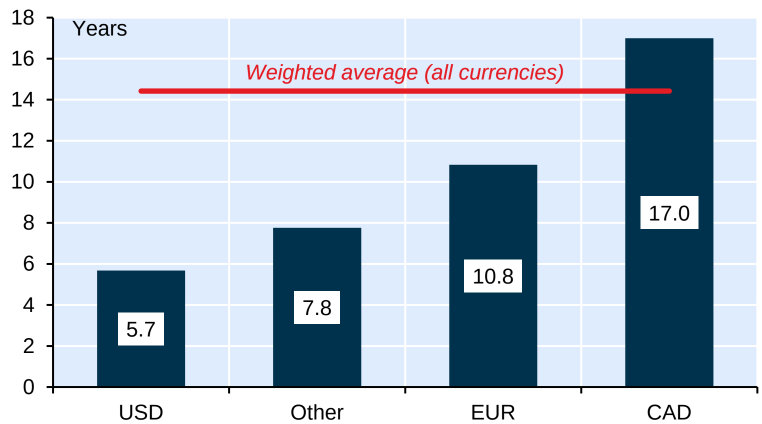


Source: NBF, Bloomberg

- The knock on the USD market, if there is one, has always been the duration available to issuers. The numbers speak for themselves. Over the past decade, the vast majority of USD provincial supply has been steered to 5-years and under, with the corresponding weighted average term less than what the provinces typically achieve in other currency markets (Chart 4). These relatively shorter dollar maturities might seem at odds with the preference for long-term funding at the provincial level. (That in turn reflects the nature of provincial requirements, which often include sizeable capital plans for assets with a long lifespan, to say nothing of historically attractive long-term funding costs available these past many years in Canada.) Historically, ready access to a deep pool of investor demand for 10- and 30-year paper in Canada meant the odd shorter-term international trade kept their average duration bogeys (for new issues) intact for our provinces.

Chart 4: Provinces get long-term funding in CAD

Weighted average term of provincial bond supply: 2010-20



Source: NBF, Bloomberg | Note: Based on marketable bond issuance Jan-2010 to Jul-2020

- Some have worried about access to Canada's long end in today's COVID era. The BoC's PBPP only extends to 10-years, while the sovereign is terming out more of its supply. To us, however, crowding out fears are misplaced. Deconstruct the BoC's QE program and you will see much of the marginal GoC issuance in 10s and longs is being absorbed. In our opinion, there appears sufficient demand to enable provinces to get coveted duration domestically. By extension, the prospective USD trades we're contemplating needn't upset the borrowing apple cart. Moreover, we'd highlight a couple of successful 10-year USD trades from earlier this year (Alberta in July; Québec in May), and likewise note that recent re-pricing (i.e., higher/steeper curves) has made 10s more attractive for investors.

- Finally, we don't want to suggest that international opportunities are limited to USD. Fact is, Canada's provinces have proactively cultivated investor demand in most major currencies, be it EUR, GBP, AUD, CHF or others. Based on prevailing exchange rates, the par value of these non-CAD/non-USD deals totals about C$63 billion, comprising 7% of marketable provincial bonds outstanding. That's hardly a decisive share but isn't necessarily scraps either. In light of unprecedented funding requirements, even these less frequented markets could serve a useful purpose.

As busy as it has been over the past five months (i.e., since the 2020-21 fiscal year kicked off), there's little reason to let up if you're a provincial issuer. Coming back to our football analogy, Canada's provinces can still go deep/long in the domestic market… no question. It's a proven strategy and one, importantly, that appears to have survived the virus. But today's funding playbook includes some interesting routes that could be run in USD or other foreign currency markets. These look to be effective options for putting some needed borrowing points on the board. So, all else being equal, you'll likely see provincial issuers take the international field soon enough. Ontario could well lead them out the tunnel.

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