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Market View – Bank of Canada: Tapering without the tantrum?

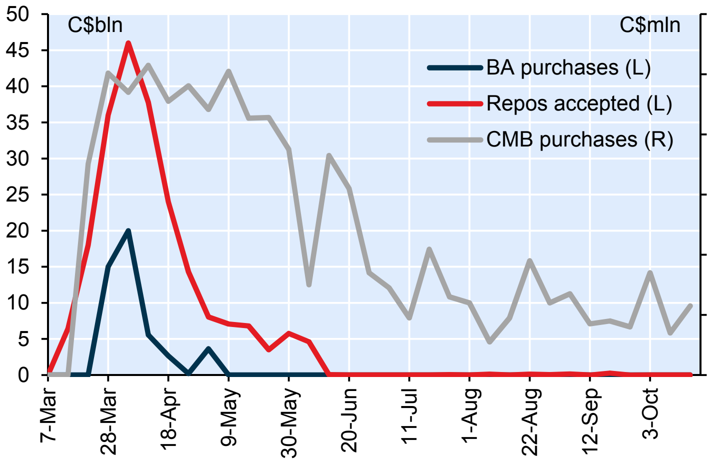
By Warren Lovely / Taylor Schleich

The Bank of Canada caused a stir last week, announcing that two asset purchase facilities—one for Bankers' Acceptances, the other for federally-guaranteed Canada Mortgage Bonds—would be discontinued. The frequency of Term Repo operations will also shift from weekly to bi-weekly. Not surprisingly, this left many wondering if a more material tapering of extraordinary BoC policy accommodation was in the offing? It probably should be. To our eyes, **it looks like the Bank has been overdoing it on Quantitative Easing (QE) and could conceivably walk things back (or change their approach) without seriously upending the market.** A few points before we go further out on the limb:

1) The specific changes announced last week should *not* come as a surprise. The Bank hadn't bought anything via its BA Purchase Facility (BAPF) since late April (and thus has none on its balance sheet). As for the CMB Purchase (CMBP) program, take-up had been quite low of late (a mere fraction of what it was back in March and April). On Term Repos, there'd also been very limited take-up recently (less than C$800 million since early June vs. an enormous $218 billion in the three months before that).

Chart 1: BoC program terminations appear justified

BoC purchase activity by program, by week



Source: NBF, Bank of Canada | Note: X-axis refers to the last day of the week

2) In one sense, last week's announcement is another example of the Bank making sensible adjustments in the face of evolving market conditions. Earlier market notices announced tweaks to various programs, many of which were set up on the fly during the spring-time panic. The Bank had previously altered its BAPF and Term Repo programs (prior to the announced wind down) and has lowered its participation in T-Bills and the Provincial Money-Market Purchase (PMMP) program. Eligibility for its Standing Liquidity Facility (SLF) was amended as markets healed.

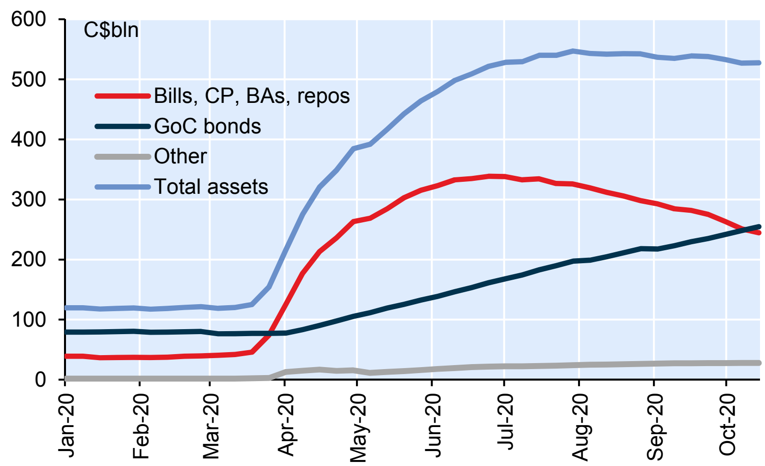
3) This should go without saying, but the BoC reserves the right to bring these programs back (or to introduce other measures) should the situation deteriorate. In Canada and elsewhere, monetary policy is "live"; it's being regularly re-calibrated to provide the level of support a still-vulnerable economy needs.

4) Although the BoC is nuking its BA and CMB purchase programs, it may be premature to roll up the full suite of liquidity and credit easing programs out there. The Provincial Bond Purchase Program (PBPP) still has utility in our opinion. Yes, the pace of buying has slowed here too (~C$350 million/week currently vs. closer to C$700 million/week when first set up). At the current rate, this program will fall well shy of the 12-month purchase ceiling initially established (C$50 billion max by May-2021). Nonetheless, Canada's provinces face exceptional borrowing needs and a highly uncertain outlook. Without being too alarmist, a worrisome second wave risks complicating provincial recoveries and may require marginal, debt-financed stimulus in some corners. Whereas the CMBP program was initially designed as a non-crisis balance sheet management tool and morphed into a vehicle to support market functioning, the PBPP has somewhat broader goals in mind, including the "efficiency" of funding. If efficiency (or cost) is still a consideration, the BoC has reason to keep this program in place. As for the PMMP program, it was always more clearly focused on providing liquidity. BoC participation has already stepped down from a peak of 40% to 10% currently. There may not be evident strains in the short-term provincial borrowing market, but it's maybe not a bad idea to keep this safety valve in place until we get a sense that all provincial governments are on a firmer footing. After all, we're not so far removed from earlier anxiety over the sustainability of the provincial sector in general and a province or two in particular.

5) That brings us to the mother of all purchase programs: QE or in BoC parlance, the Government of Canada Bond Purchase Program (GBPP). Add up all the bonds on the Bank's balance sheet (excluding repos), and holdings of GoC bonds (overwhelmingly nominals, with a couple billion dollars of RRBs thrown in for good measure) are 12-13 times as significant as CMBs, provincials and corporates combined. If, as, when the time comes to taper, this is the program that really moves the dial.

Chart 2: QE is propping up the BoC's balance sheet

BoC balance sheet holdings by asset aggregate as of 14-Oct



Source: NBF, Bank of Canada | Note: GoC bonds includes RRBs

Let our premise be clear: Canada's QE program (at least in its current form) has gotten too big for our bond market britches. It's time to step this program down, perhaps to half its current size. To be clear, we're talking *moderation* or *modification*, not *elimination*. Allow us to explain our thinking.

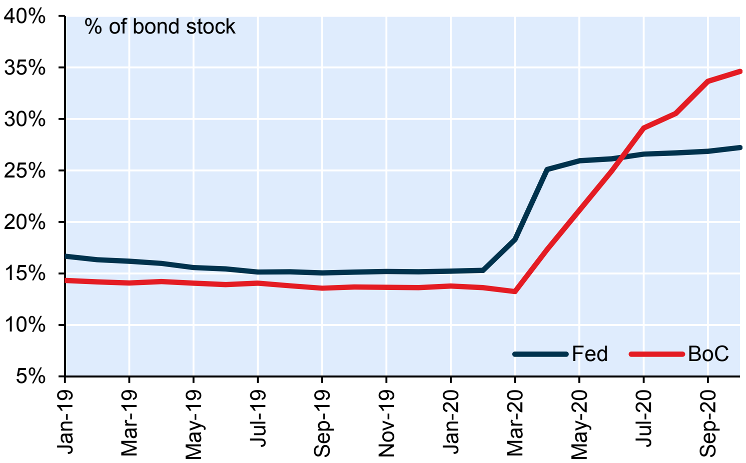
First off, the current C$5 billion weekly purchase pace, in addition to feeling somewhat arbitrary, is *much more* aggressive than what the U.S. Federal Reserve Board is doing when it comes to QE. **Proportionately, the BoC QE program is over twice the size relative to GDP or more like six times as large based on bonds outstanding.**

We may be just seven months into Canada's QE experiment, but the cumulative impacts are already impossible to ignore. In that relatively short period, BoC holdings of GoC bonds have shot up from C$80 billion to C$260 billion—a more than three-fold increase and a rate of accumulation that, unlike the BoC's overall balance sheet, has not moderated.

Looking at the Bank's ownership share of Canada bonds puts this accumulation into context. At the start of the year, the BoC accounted for less than 15% of outstanding Canada bonds. Its holdings were largely steady, the result of unobtrusive participation at auction. **Today, the Bank owns more than a third of all outstanding C$-denominated GoC bonds, making the central bank the single most dominant holder of sovereign debt in this country,** having displaced other investor types (be they domestic or non-resident). Again, comparisons to south of the border show the BoC has elbowed its way into the market much more aggressively than the Fed, where the corresponding ownership share of outstanding Treasuries is lower and increasing at a considerably slower rate.

Chart 3: BoC buying a greater share of gov't bond market

Percentage of outstanding GoC/Treasury bond stock owned by BoC/Fed

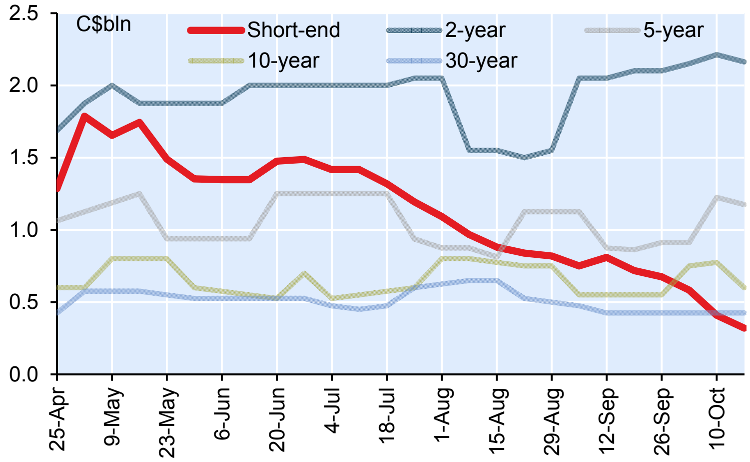


Source: NBF, Bank of Canada, SIFMA, Federal Reserve | Notes: Includes TIPS/RRBs, FRNs. Does not include Treasury bills. Outstandings are as of month end. Ownership amount is the last data point of each month in the central banks' weekly balance sheet releases.

As in other asset classes, it follows that **less diversified ownership can impair liquidity.** Here, security- or tenor-specific details are informative. The BoC's outsized buying has aggressively drawn down the available float on a growing number of Canada bonds, particularly in the front end. Control for all the bonds bought up by the BoC and there are currently just 14 of 46 nominal Canada bonds with outstandings in the marketplace north of C$10 billion. In pre-COVID days, 29 of 44 nominal bonds had available (i.e., non-BoC-held) outstandings topping C$10 billion. And that was in the context of a much smaller bond stock (about 25% smaller in fact). For dealers and end investors, there simply aren't that many large Canada bonds to get your hands on these days. Rather, there are a handful of very large bonds (i.e. benchmarks and building benchmarks) and a large, hollowed out selection of off-the-runs. Indeed, another potential (required?) tweak to the QE program that we'd advocate for would be purchasing building benchmarks sooner, so as to limit the outstanding 'humps' that now characterize the Canada curve.

Chart 4: BoC can't find front-end bonds to buy

4-week moving average of purchases by maturity bucket



Source: NBF, Bank of Canada | Notes: Maturity bucket as per BoC classification. X-axis refers to the last day of the week

Barring a notable change in the Bank's QE program, the situation will only be exacerbated. **Simulation analysis suggests that continuing to purchase C$5 billion/week would see the BoC's ownership share of domestic Canadas reach ~40% in three months, approaching 45% in six months from now.** Theoretically, Bank ownership could reach 50% in 12 months time, if QE lasted that long. And that's assuming today's break-neck issuance pace is fully maintained. Were gross supply to moderate—as extraordinary supports step down, for example—the share locked up by the BoC would rise even faster. Note that the ownership figures cited here are based on outstanding nominal and RRB Canada bonds. As the BoC has concentrated its purchases on nominal securities, the corresponding ownership share of non-RRBs is a couple percentage points higher.

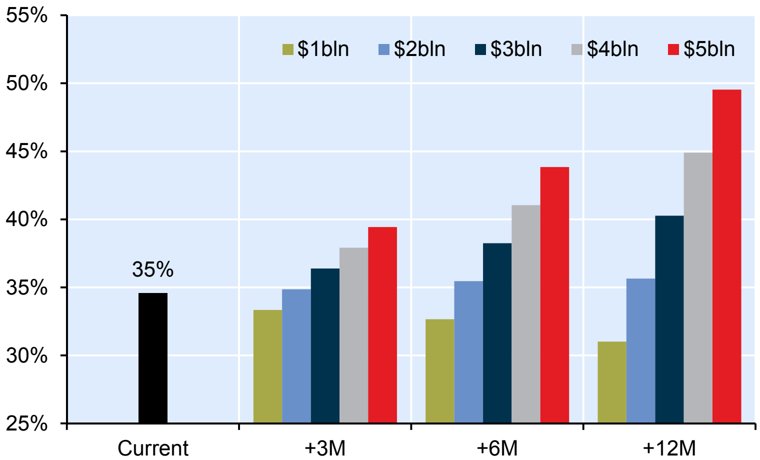
While we understand the merits and benefits of QE, it's not necessarily apparent that an already elevated BoC ownership share needs to continue to march higher… particularly if it means distorting/impairing secondary liquidity. **If, like us, you were felt the BoC's market footprint was heavy enough, then the solution seems obvious enough: slow the pace of purchases.**

Reverting to our simulations, we estimate the BoC could cut its QE program in half, to C$2-3 billion per week vs. the current C$5 billion pace, and still see its outsized ownership share creep a bit higher near-term. True, reducing the size of QE would mean asking the Street to take down a larger share of net bond supply, but things are clearly unbalanced as it stands. Asking the Street to participate more meaningfully would simply reverse the outright reduction in GoC holdings we've seen in recent months (Chart 8). Not that we need to be too guided by the Fed, but at C$2-3 billion/week, the BoC program would more closely approximate what Jay Powell & Co. are doing.

To us, it would be most obvious to regulate/slow purchases in the very front end, where there is increasingly a dearth of product to buy up. If anything, an observed moderation here likely reflects the growing scarcity of available product. If the BoC more-or-less maintained its purchases of 5-year and longer bonds, the weighted average term of QE purchases would better align with the term of new supply (which post a July *Debt Management Strategy* pivot, has extended out to close to 7 years). This would continue to absorb much of the net supply being placed out the curve, dulling risks of a material curve steepening.

Chart 5: Under status quo, ownership share headed to 50%

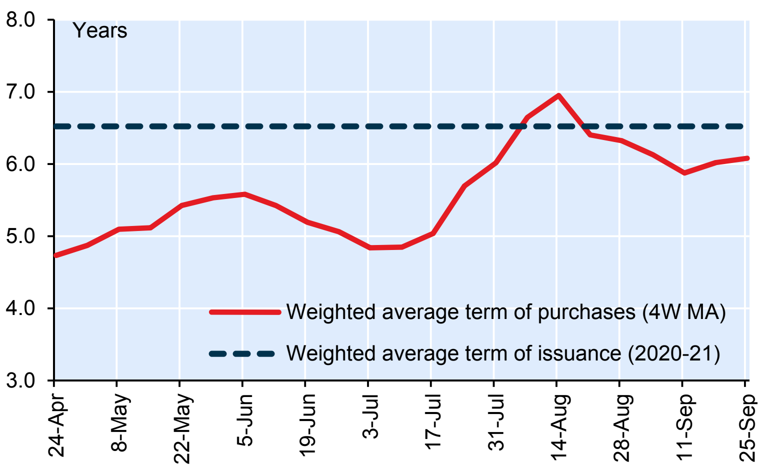
BoC share of o/s GoC bonds, including projections based on weekly QE pace



Source: NBF, BoC | Note: Assumes issuance of C$409bln (AR); controls for existing maturities/holdings; assumes 13% auction allocation

Chart 6: There's room to lengthen term of purchases

Weighted average term of purchases vs. weighted average term of issuance



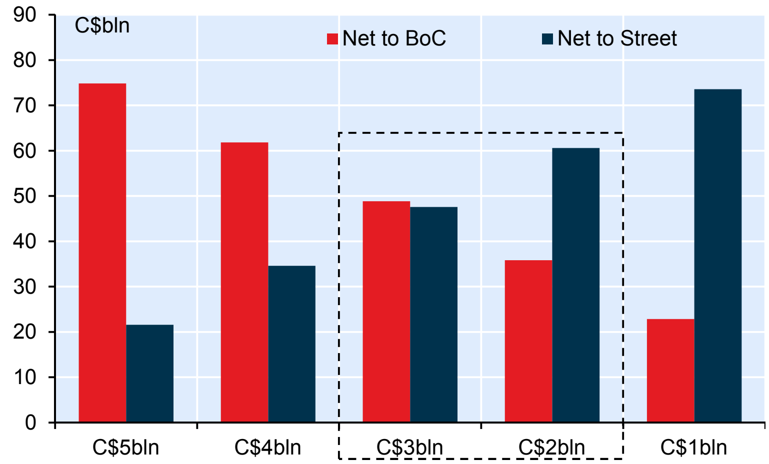
Source: NBF, BoC, GoC | Notes: WAT of purchases is 4-week moving average.

The obvious question that follows is: *when* should the BoC taper? **To us, an announcement at next week's monetary policy meeting wouldn't come as a huge surprise.** One could argue that the shutdown of the BAPF and CMBP program may have been partially designed to brace markets for an upcoming QE taper. Meanwhile, GoC bond market distortions are getting worse not better. Quite simply, the BoC appears to be running out of front-end bonds to buy, implying the current pace likely isn't sustainable.

If there's an argument for waiting (perhaps till later in the year), it's to benefit from greater clarity on one of the biggest wildcards in this entire analysis: GoC bond supply. Finance Minister Chrystia Freeland will be presenting a fiscal update this fall, which promises to set out not just a near-term deficit target but medium-term thinking on Ottawa's fiscal path. If super-sized deficits are with us for longer, then the case for maintaining QE closer to the current pace would presumably hold more weight. Even in such a scenario, we'd advocate for changes. On the other hand, if the governing Liberals telegraph a serious moderation from today's truly extraordinary levels of spending and outline a legitimate commitment to meaningful deficit reduction that may give the BoC that extra nudge (beyond current market signals) to take its foot off the QE gas. When it comes to debt strategies in Canada (on both the issuing and buying sides of the ledger), this update will be an important one.

Chart 7: Slower QE means putting more bonds to the Street

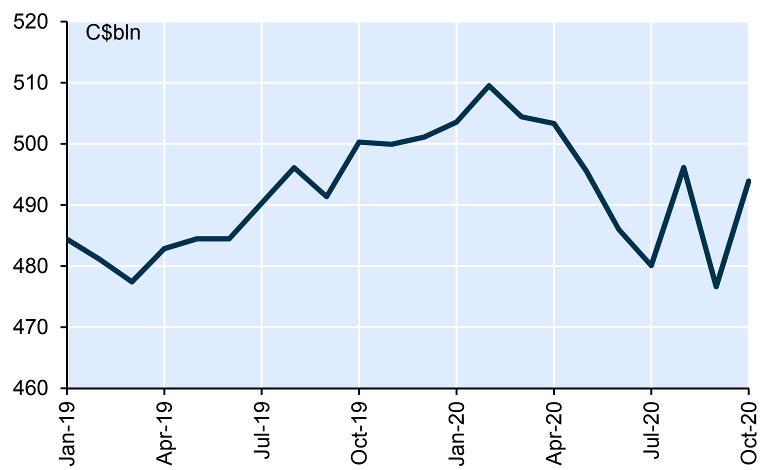
Distribution of net GoC supply over 3M by weekly QE pace



Source: NBF, BoC | Note: Based on C$105bln gross supply less C$9bln maturity over 3 months; assumes 13% auction allocation

Chart 8: Bonds "on the street" now below pre-COVID levels

Total outstanding GoC bonds less Bank of Canada holdings



Source: NBF, Bank of Canada | Notes: Includes RRBs. Does not include Treasury bills. Outstandings are as of month end. Ownership amount is the last data point of the month from the BoC's weekly balance sheet releases. October is an estimate.

Notwithstanding this debate on likely timing, the BoC needs to reduce or divert the suction on its QE bond vacuum lest a raft of Canada's risk-free benchmark securities become special. Modulating the power of this all-important purchase program is not to be confused with pulling the plug on QE altogether. Turns out the BoC didn't know its own strength, partly because we've never experimented with such large-scale asset purchases before. In our view, they could do considerably less QE while still leaning against a supply- or an inflation-induced back-up in longer-term interest rates—which most agree would be counterproductive at this stage of the recovery.

Here's a final idea to consider: If the Bank is legitimately nervous about how many bonds the Street may be able to comfortably digest, it might be more appropriate to shift some of their focus from secondary purchases (i.e., QE) to greater participation at auction (i.e., passive primary accumulation). The Bank could increase their auction allotment from the current 13% to say 20-25%, supporting new, building-to-benchmark bonds while limiting secondary market distortions. Something to think about and easy enough to implement. We've presented a couple of tables below that highlight the potential trade-off between QE and auction allocation for a given level of gross GoC bond supply.

So a tapering or at least a tinkering is needed. Material and near-term changes could be orchestrated. But a market tantrum? Perhaps not so fast.

Tables 1-2: Illustrating potential BoC ownership & net supply to Street under various QE/auction allocation/supply scenarios

6M Illustration 1: Maintain the current GoC issuance pace (C$409bln annual rate as per DMS)

	BoC Quantitative Easing (QE): Weekly purchase pace (current=C$5bln)											
	BoC ownership share of GoC bonds in 6M (current=35%)						Net supply to the Street over 6M (i.e., excluding BoC): C$bln					
Auction allocation (current=13%)	C$5bln	C$4bln	C$3bln	C$2bln	C$1bln	Nil	C$5bln	C$4bln	C$3bln	C$2bln	C$1bln	Nil
13%	44%	41%	38%	35%	33%	30%	19	45	71	96	122	148
15%	44%	41%	39%	36%	33%	30%	15	41	67	92	118	143
20%	45%	43%	40%	37%	34%	31%	5	31	56	82	108	133
25%	47%	44%	41%	38%	35%	33%	-5	21	46	72	97	123
30%	48%	45%	42%	39%	36%	34%	-15	10	36	62	87	113
35%	49%	46%	43%	40%	38%	35%	-26	0	26	51	77	103
40%	50%	47%	44%	41%	39%	36%	-36	-10	15	41	67	92

Source: NBF, BoC | Note: Table for illustration purposes only; based on ***continuation of current gross GoC bond issuance pace*** *over six months (i.e., C$205bln over 6M); controls for existing BoC holdings & maturity profile; net supply to Street is after maturities & BoC QE/auction allocation; blue shading denotes current QE pace/auction allocation*

6M Illustration 2: Moderation in GoC issuance pace (-25% to ~C$300bln annual rate)

	BoC Quantitative Easing (QE): Weekly purchase pace (current=C$5bln)											
	BoC ownership share of GoC bonds in 6M (current=35%)						Net supply to the Street over 6M (i.e., excluding BoC): C$bln					
Auction allocation (current=13%)	C$5bln	C$4bln	C$3bln	C$2bln	C$1bln	Nil	C$5bln	C$4bln	C$3bln	C$2bln	C$1bln	Nil
13%	46%	43%	40%	37%	34%	31%	-28	-2	23	49	74	100
15%	46%	43%	40%	37%	34%	31%	-31	-5	20	46	71	97
20%	47%	44%	41%	38%	35%	32%	-38	-13	13	38	64	90
25%	48%	45%	42%	39%	36%	33%	-46	-20	5	31	56	82
30%	49%	46%	43%	40%	37%	34%	-53	-28	-2	23	49	75
35%	50%	47%	44%	41%	38%	35%	-61	-35	-10	16	41	67
40%	50%	48%	45%	42%	39%	36%	-68	-43	-17	8	34	60

Source: NBF, BoC | Note: Table for illustration purposes only; based on a ***slower gross GoC bond issuance pace*** *over six months (i.e., C$150bln over 6M); controls for existing BoC holdings & maturity profile; net supply to Street is after maturities & BoC QE/auction allocation; blue shading denotes current QE pace/auction allocation*

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