

Provincial credit spreads too tight? [Or not tight enough!?!]

By Warren Lovely

Credit spreads have extended a broad-based rally into early 2021. At one point last week, Ontario's 10-year bond spread was back to pre-COVID tightness. We've since backed up a bp or two, with ONT 12/2030s quoted +59 bps as we penned this note. Here's some quick perspective on this most fundamental of provincial spreads, including a word on our base case forecast. Note: We're keying on Ontario 10s and intentionally keeping it brief, setting the stage for follow-on notes that explore additional RV aspects of Canada's public sector credit markets.

Notwithstanding a slight widening this week, the 50-day Z score on Ontario's 10-year secondary spread is -1.8 (i.e., 1.8 standard deviations tighter than the 50-day average). So we're not too far removed from the bottom end of a traditional Bollinger band. We model provincial credit spreads a variety of ways. But keying on observed secondary market levels and controlling for underlying yields and some key competing credit spreads, so-called 'fair value' in Ontario 10s might today be closer to +57 bps. As tight as provis may look relative to last year's trading range, they're not necessarily rich—at least based on a few model specifications and various periods/samples we've tested.

Mind you, the high-frequency models we're referencing here aren't perfect. Sure, you'll find R-squared values in excess of 0.9 looking at favoured specifications over the past few years. But statistical relationships can and do break down; just look at the fit (or lack thereof) on some models during the past 50 days. Moreover, there are any number of alternative approaches to modeling credit, including longer-term lower frequency analysis that incorporates fundamental elements related to the economy, finances, supply, ratings, etc. With the standard econometrician's caveats in mind, where might provincial credit spreads be headed from here? Again, the starting point, in terms of 'fair value', is supportive. So too is our base line macro forecast, which acknowledges fresh virus-related restrictions but nonetheless assumes a reasonably forceful North American expansion starting in Q2. Consistent with our fresh asset allocation (which remains overweight equities), we'd see scope for provincial credit to grind tighter from here. Despite steady supply, Ontario 10s could get down to +55 bps in the coming quarter, matching the cyclical tightness established in early 2018. Pretty remarkable given virus scarring, but a reasonable near-term target all the same.

Chart 1: One approach to modeling 'fair value' in Ontario's 10-year credit spread

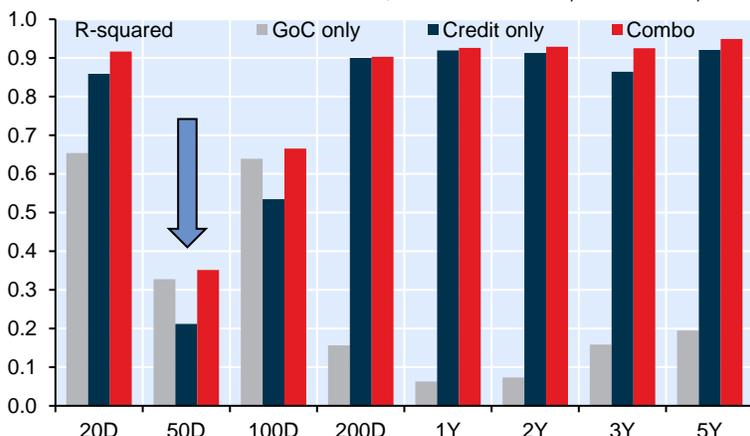
Province of Ontario generic 10-year benchmark bond spread vs. GoC: Actual vs. NBF fitted value (based on one of many tested specifications)



Source: NBF, Bloomberg | Note: NBF fitted values based on specification inclusive of GoC yields & select competing credit spreads; contact NBF for greater detail on approach

Chart 2: Fair value models not always perfect

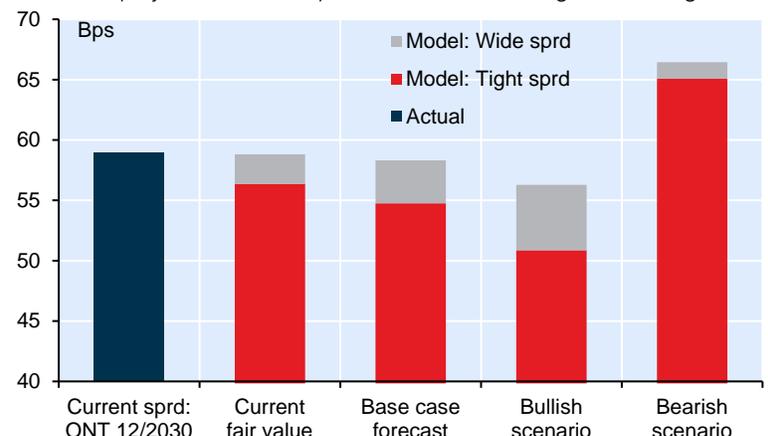
R² of select fair value models of ONT10s, based on various periods/samples



Source: NBF, Bloomberg | Note: Combo models include both GoC & credit elements

Chart 3: Where are spreads headed near term?

Current vs. projected (3M fwd) spread for ONT10s (incl. tight/wide range)



Source: NBF, Bloomberg | Note: Forecasts/scenarios refer to 3M fwd (i.e., early Apr-2021)



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