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Domestics liking the taste of Maple SSAs

By Warren Lovely, with a contribution from Michael Ferro, Fixed Income Analyst, New York Office

We're only a couple of weeks into 2021, but a few themes have already emerged in Canada's fixed income market. One such tendency relates to the decidedly warm welcome SSA issuers have received in the maple bond market. Increasingly and understandably, the domestic investor base likes what it sees in these securities.

Consider that we've already had three benchmark SSA maple bond trades in the first few days of the year. The International Bank for Reconstruction & Development (IBRD) kicked things off on January 4th, launching what would become a C$1.5 billion 5-year Sustainable Development Bond—the first deal of the year for the Canadian dollar bond market. As an aside, IBRD has become something of staple in terms of early year CAD trades, 2021 marking the fourth year in a row that this issuer has come to Canada shortly after flipping the calendar over. The Inter-American Development Bank (IADB) followed the World Bank a few days later, adding C$600 million to a 7-year Sustainable Development Bond first issued last summer (bringing total outstandings to C$1.1 billion). Then came the European Investment Bank (EIB), which last week tapped the maple market via a C$1 billion 7-year Climate Awareness Bond (CAB). That was EIB's second CAB offering of the new year (the first steered to the Kangaroo market).

By design, maples aren't traditionally the most active segment of Canada's fixed income universe. So three deals totaling in excess of C$3 billion in just a handful of days constitutes a flurry of activity. What's behind the pick-up in issuance and what do we take away from these early year trades? A few things stand out to us:

- Sterling credit fundamentals – SSA issues tend to have unimpeachable credit fundamentals (if you'll forgive the use of the word). That's particularly true of the names that have tapped the CAD market of late. Really, IBRD, IADB and EIB constitute the very tippy top of the Tier 1 SSA issuer list. Triple-A ratings and stable outlooks are hallmarks here, reflecting robust risk management, abundant liquidity and preferred creditor status, among other strengths. This translates into greater ratings stability than virtually any other major sector of global bond markets (vs. sovereigns or LRGs for example). Simply put, bondholder safeguards are legit and numerous… always have been.
- Clear & long-standing alignment with ESG objectives – Sustainability is perhaps one of the more compelling elements/selling features of the SSA bonds in question. We look favourably upon the ESG credentials of these Tier 1 SSAs. IBRD's new 5-year was focused on UN SDG #3 (Good Health and Well-being) and #5 (Gender Equality)—issues top-of-mind for many Canadians and a growing number of bond investors. As our colleague Scott Graham, Managing Director & Head of SSA Finance, nicely put it: "The overwhelming global support for the World Bank continues to be magnified by its underlying sustainability principles that reinforce its overall purpose of eliminating global poverty." IADB is another stalwart in the broader ESG movement. The 7-year maple bond it recently tapped was aligned with UN SDG #3 (Good Health and Well-being), consistent with the institution's broader ESG remit—it's focused on tackling poverty and inequality in a sustainable/climate-sensitive manner. As for EIB, its green/sustainable credentials can't be overemphasized. EIB was a true pioneer in green bonds, bringing the world's inaugural offering way back in 2007. To this day, EIB effectively serves as the EU Climate Bank. EIB's demonstrated focus on sustainability (and a dedicated sustainable funding team, established in 2018) is wholly consistent with EU's broader sustainable development goals/objectives. In Europe, as elsewhere, the pandemic has raised awareness of social issues beyond climate change mitigation, which EIB is positioned to address through its Sustainability Awareness Bonds (the first of which was issued in 2018). In general, comprehensive ESG frameworks, alignment with global/regional standards and legislation, detailed reporting, third party verification/assurance and overall transparency nullify concerns over greenwashing, an issue that has plagued certain issuers in the sovereign and corporate space. Quite positively, ESG awareness is one of the seemingly irreversible trends in financial markets. To that end, IBRD, IADB and EIB, among others, remain well positioned to supply investors what they increasingly demand: regular, deep and more diversified access to genuinely ESG-aligned assets.
- Active/sophisticated treasury operations – We're talking about well-established and large-scale issuers, with clear/understandable mandates. Whether you're looking at bonds outstanding or borrowing program size, IBRB, IADB and EIB are among the largest SSAs. Don't forget the likes of KfW, Asian Development Bank or International Finance Corporation, which have themselves accessed the CAD market in the past couple of years. We'd refer you to our *SSA Fact Sheet* for a more comprehensive comparison. Not surprisingly, SSAs run sophisticated treasury operations, which includes consistent and comprehensive surveillance of international funding opportunities. When and where favourable market conditions exist, one can expect these issuers to respond. Put another way, if a given Tier 1 SSA finds support for a maple trade, there's likely a similar platform for its immediate peer set. That helps explain the bunching of trades that have tended to characterize the maple market. In general, CAD remains a small but nonetheless strategically important part of global funding operations for a number of the large SSAs (Chart 2, page 3).
- Consistent focus on investor relations – Credit these issuers for consistent and effective marketing of their absolute and relative strengths, including active investor outreach and best-in-class IR websites/presentations/marketing materials. As any number of issuers can attest, IR is particularly important in today's rapidly evolving economy. The large multi-lateral development banks and other SSAs are being asked to lend marginal support to anti-virus stabilization and recovery efforts across the globe. And as emphasized above, these issuers remain at the forefront of global ESG initiatives. There should be no misunderstanding their true motive or focus.
- Non-trivial yield enhancement – There's an RV argument here as well. These top-rated SSAs offer non-trivial yield pick-up vs. the risk-free curve. IBRD's 5-year came at MS -13 bps or ~28 bps over the GoC bench. The EIB 7-year, priced at MS -8 bps, was ~47 bps over the GoC pricing bond. Spreads may be tight globally, but excess yield is still being sought and bought, owing to the sheer amount of financial market liquidity pumped into markets by central banks focused on combatting the pandemic. In Canada's case, outsized central bank

QE has left the bond market imbalanced. Having immunized against a pick-up in GoC supply, the BoC has essentially crowded in other sectors/issuers… including SSAs. Tier 1 SSAs provide marginal spread vs. AAA-rated public sector comps, including CMB. Alternatively, the give to lower-rated provincial credit is currently 3-5 bps in 5-years or about a basis point per credit rating notch.

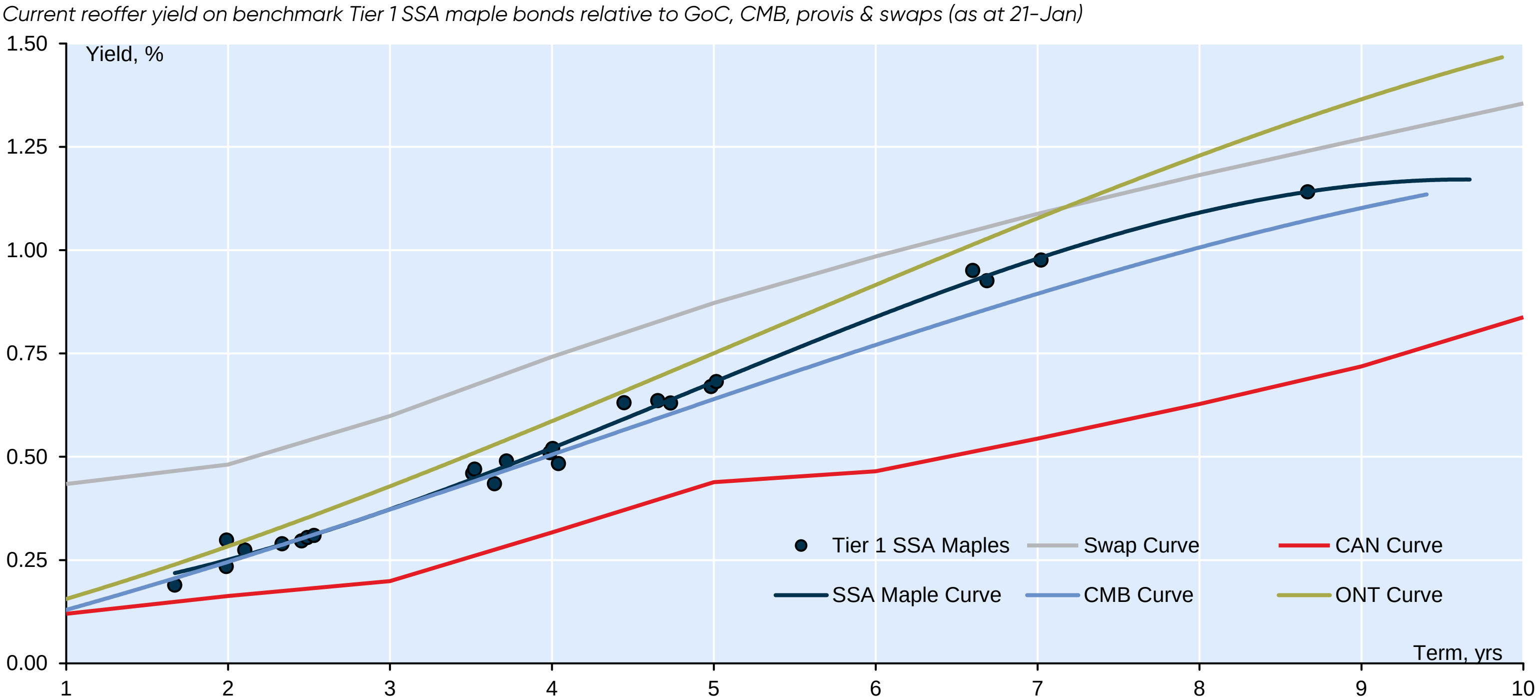
- Improved secondary liquidity – As a final point, we'd tend to highlight relative improvements in secondary market liquidity. We won't pretend that these bonds are as actively traded as benchmark provincials or CMBs. Nor do investors/dealers have as many outlets for their SSA maple bonds. But their relevance to investors is nonetheless growing. Looking at the FTSE Canada Universe Bond Index, the Supranational category (a subgroup of Federal bonds comprising the multilateral development banks) has a total Index weight of <1%. But investor holdings of these bonds have effectively tripled over the past three years (Chart 3, page 3) and will end 2021 higher still. Moreover, relative to the earlier, pre-GFC maple era, today's less-concentrated/broader syndicate structure has had the intended effect: more active market-making by a larger number of dealers with skin in the game. Today's larger deal sizes or, as in the case of the recent IADB deal, a willingness to build up the tradeable float via taps has helped. There remains a concerted effort to improve the repo-eligibility of these securities. Progress is being made, although there's some way to go. As third-party pricing visibility improves, we'd expect a greater willingness on the part of securities lenders to accept more SSA bonds on a less-restricted basis. (Think of this as a classic virtuous circle: more frequent issuance and/or larger deals leads to enhanced trading volumes with a growing number of counterparties; that generates more regular and reliable pricing information needed to fairly value the bonds in question; that in turn gives sec. lenders greater comfort when accepting SSAs as collateral.) As an aside, but consistent with the growing acceptance of SSAs as collateral, IBRD's USD bonds became acceptable collateral at the CME as of mid-2019.

Taken together, the above list speaks to a concerted effort on the part of many large SSAs to develop genuine and lasting investor demand in Canada. These efforts appear to be hitting their mark. Not to over-emphasize a handful of trades, but domestic investor participation on this year's maple SSAs has been broader and deeper than what we're used to. Sure, there's still been plenty of demand from overseas investors, including official institutions who naturally gravitate to these high-quality assets if not too long. Roughly 40% of IBRD's CAD 5-year went to EMEA and Asian accounts; the corresponding share was more than 45% of the EIB CAD 7-year. But led by domestic banks, Canadian investors are more engaged. The resulting expansion of buyers lists (>50 accounts on both the IBRD and EIB trades) has allowed for an upsizing of trades and/or tighter pricing relative to guidance—a win for these issuers either way. Refer to Charts 4-7 on page 3 for additional information.

At the moment, the path of least resistance for SSA maple issuers is perhaps the 7-year sector. Here, you'll find significant cross-over of international and domestic investor demand. Fives might theoretically appeal to the broadest possible array of accounts, but from an issuer's perspective, the current 5-year funding arb is relatively less attractive. Make no mistake, economics matter to these issuers. Look for SSAs to continue to cultivate greater domestic demand for maple bonds, by burnishing/emphasizing their already sterling ESG credentials, by encouraging bond performance through the right-sizing of deals, by incentivizing more active market making across the dealer community, and by generally demonstrating an ongoing commitment to the maple market. We see this effort as a necessary step to developing 10-year SSA maple supply of any size or frequency. To us, it's only a matter of time, and we'd look to one of the large established SSA maple issuers to play a leadership role in 10s. It's been an exciting year already but stay tuned. The SSA maple bond story looks very much to be continued…

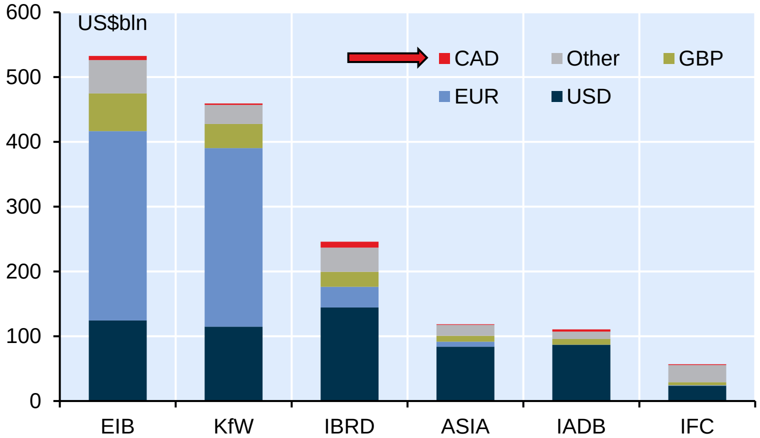
Chart 1: The valuation perspective on Tier 1 SSA maple bond curve

Current reoffer yield on benchmark Tier 1 SSA maple bonds relative to GoC, CMB, provis & swaps (as at 21-Jan)



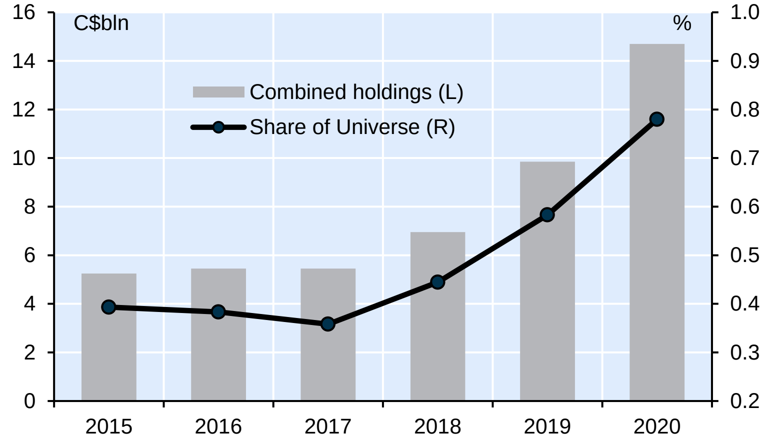
Source: NBF, Bloomberg | Note: SSA maple curve based on a subset of outstanding Tier 1 SSA CAD-denominated bonds, comprised of EIB, IBRD, IADB, IFC, KfW securities with final maturity ranging from Sep-2022 to Sep-2029 and outstanding size ranging from C$250 million to C$1.8 billion (average size of C$900 million); ONT & CMB reflect polynomial trendlines

Chart 2: CAD small but strategically important market
Distribution of current bonds outstanding by currency: Select SSA issuers



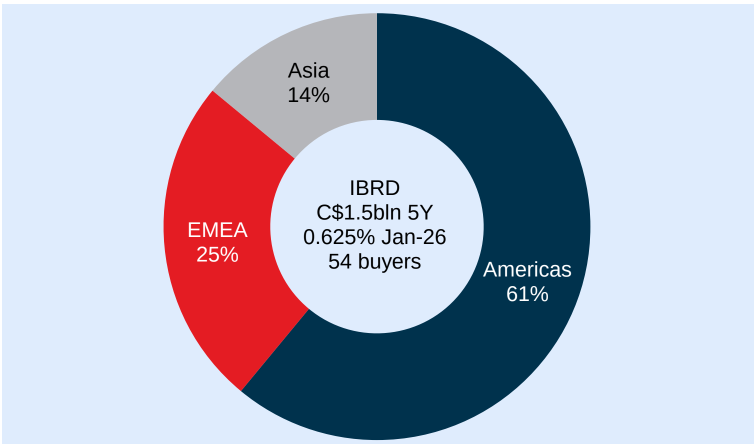
Source: NBF, Bloomberg | Note: Converted to USD at prevailing FX rates; as at 21-Jan

Chart 3: Supras become more relevant to indexers
FTSE Canada Universe Bond Index: Supranational bond holdings & weight



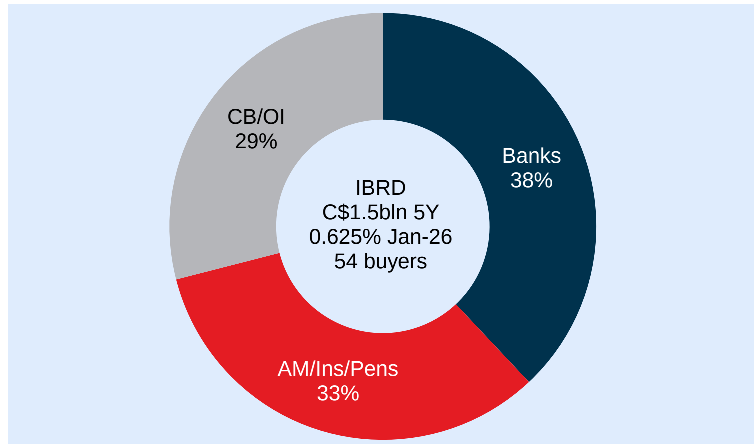
Source: NBF, FTSE Russell | Note: Based on final trading day of calendar year

Chart 4: World Bank's recent 5Y widely distributed
IBRD 5Y Sustainable Development Bond: Distribution by geography



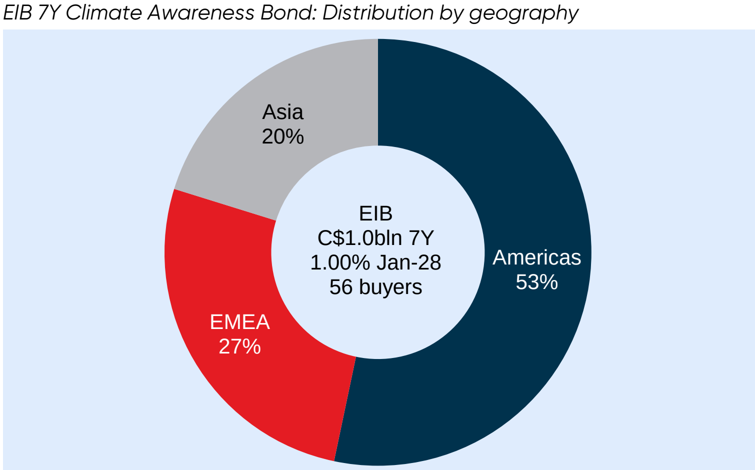
Source: NBF | Note: Bond priced 5-Jan-2021 @ MS -13 bps to yield 0.676%

Chart 5: Domestic banks & official money drove IBRD deal
IBRD 5Y Sustainable Development Bond: Distribution by investor type



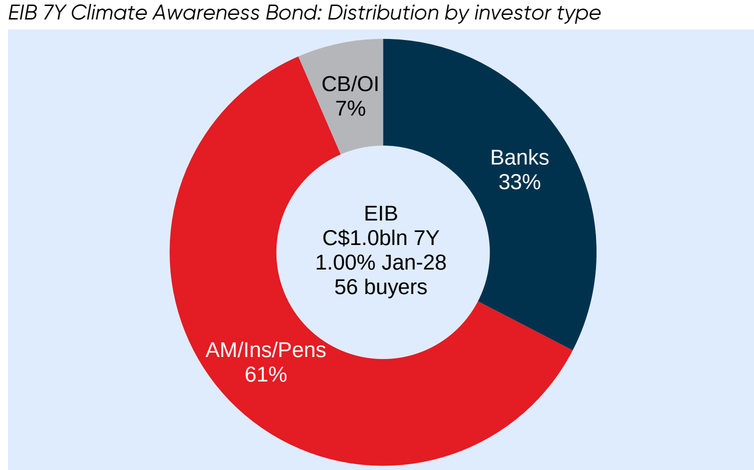
Source: NBF | Note: Bond priced 5-Jan-2021 @ MS -13 bps to yield 0.676%

Chart 6: EIB's oversubscribed 7Y attracts diverse buyer base
EIB 7Y Climate Awareness Bond: Distribution by geography



Source: NBF | Note: Bond priced 14-Jan-2021 @ MS -8 bps to yield 1.003%

Chart 7: Official money less involved in EIB, given longer term
EIB 7Y Climate Awareness Bond: Distribution by investor type



Source: NBF | Note: Bond priced 14-Jan-2021 @ MS -8 bps to yield 1.003%

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