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PBPP in its death throes!? Just how violent is this?

By Warren Lovely

Last week, we published a detailed *Market View* note ([Vol. V, No. 24](#)) on the Bank of Canada's Provincial Bond Purchase Program (PBPP). In a nutshell, we argued that while some were obviously still finding value in the program (as evidenced by recent operational take-up), it would likely be appropriate to let this program die (as originally intended) on May 6th. Not everyone agreed with us, but no offense taken.

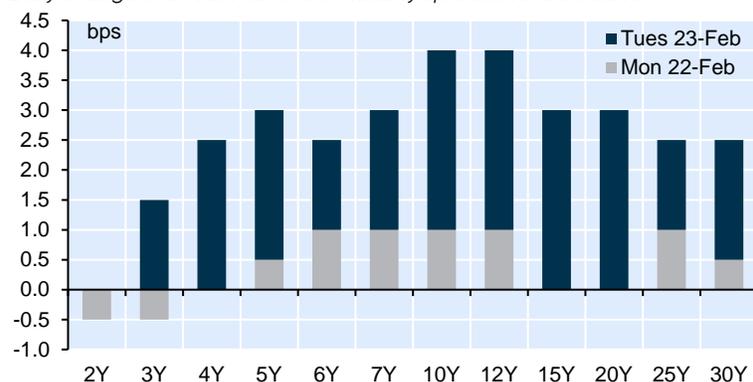
We'll try not to read too much in this, but the BoC has since announced that, starting this week, PBPP operations will moderate in both frequency (from 2X/week to Thursdays only) and size (target of C\$350 million). The line of argument from the BoC, which somewhat bizarrely appears to have come in response to a media request as opposed to a formal market notice, went like this: "Provincial markets are functioning well and as a result tenders are being reduced to only one a week... This is consistent with the gradual reduction approach for other programs that were introduced by the Bank to support market functioning as these markets improved." [Quote from BoC spokesperson via Bloomberg]

Given this news, we offer a short *Addendum* to our earlier note, keying on this week's market reaction. Have spreads widened? Yes. As one might expect, discounting the end of PBPP—which market participants are seemingly more willing to do now—was always going to be a negative for spreads, *ceteris paribus*. This morning, we indicatively saw Ontario's 10-year constant maturity spread out at +65 bps vs. the GoC curve, or 4 bps wider than last Friday (Chart 1). On its face, this widening appears consistent with the prospective spread fallout we flagged in last week's note ("less than 5 bps"). The move out in 30-year Ontario has initially been +2.5 bps, resulting in a modest flattening of Ontario's 10s-30s credit box—another entirely predictable result, given that the PBPP program extends no further than 10s.

But bear this in mind: North American credit has wobbled a bit, as inflation fears increasingly getting under investors' skin. A key risk proxy, U.S. 5-year investment grade CDX, has pushed out 2½ bps so far this week. Model Ontario spreads against IG alone and you'll find the residual in this single variable regression has increased 3.2 bps since Friday—a truer reflection of just how unsettled provincial bond investors were by the PBPP news (Chart 2). So wider yes, but not the most violent reaction in our opinion. Moreover, these new wider spreads have generated marginal investor interest, which should help keep new issue windows open. On the subject of provincial valuations, Chart 3 illustrates current 'fair value' in Ontario 10s. Go ahead, cherry pick your sample and variable set. Given the more generalized back-up in credit, current 'fair value' has re-set to the mid-60s vs. GoC (based on the last year or two of trading). We're still constructive overall, seeing provis as surviving a PBPP wind down. We'd note that attention will soon shift to federal-provincial budgets, Alberta being first up on Thursday, February 25th.

Chart 1: Gauging provi spread fallout on BoC PBPP news

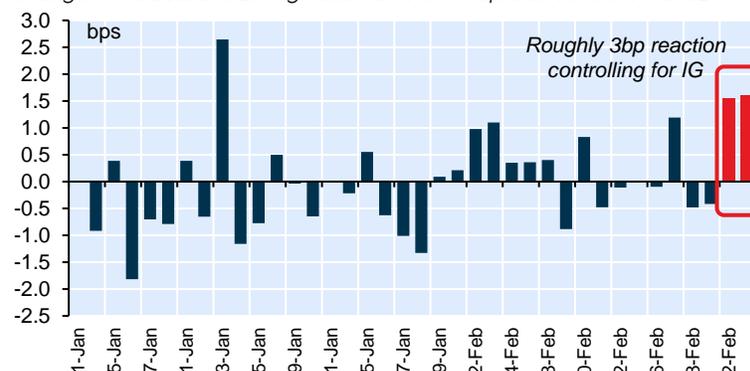
Daily change in Ontario constant maturity spreads vs. GoC curve



Source: NBF | Note: Based on start-of-day spread indications

Chart 2: Controlling for PBPP effect (one simple approach)

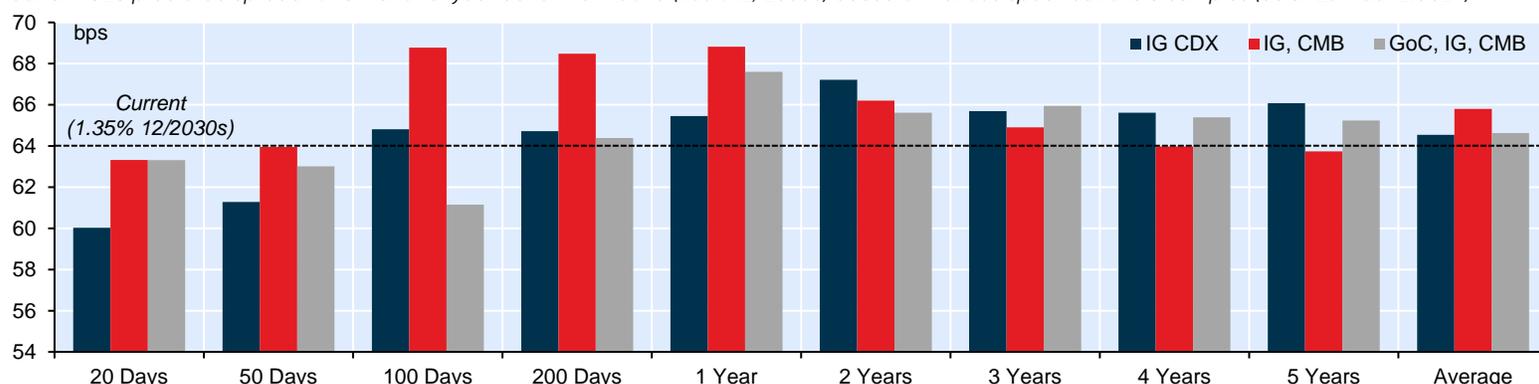
Change in residual of OLS regression of Ont 10Y spread vs. U.S. 5Y IG CDX



Source: NBF, Bloomberg | Note: OLS regression of secondary spreads over last year

Chart 3: Re-assessing current 'fair value' in Ontario's 10-year benchmark bond (not to be confused with NBF forecast)

Current OLS predicted spread for Ontario 10-year benchmark bond (1.35% 12/2030s) based on various specifications & samples (as at 23-Feb 12:00ET)



Source: NBF, Bloomberg | Note: OLS regression analysis of secondary provincial spreads; IG CDX refers to generic 5Y level; CMB refers to 10Y spread vs. GoC; GoC refers to 10Y yield



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