April 20, 2021 - (Vol. V, No. 46)

Diving deep into the DMS

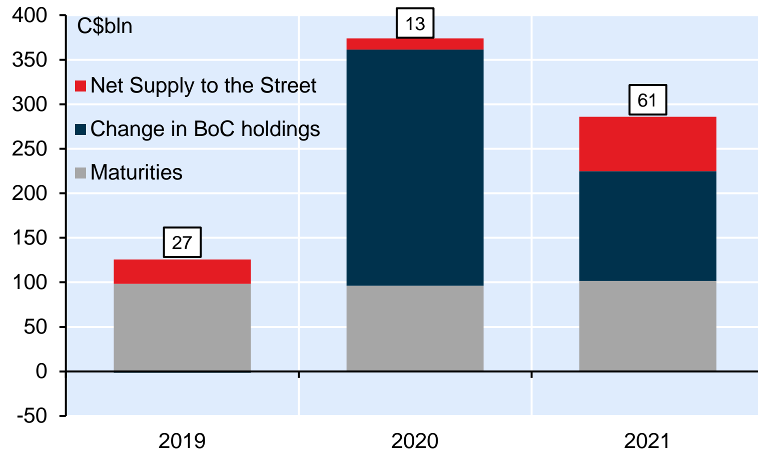
By Taylor Schleich

Yesterday's long-awaited budget brought alongside it an update on the federal government's borrowing program. We covered the *DMS* in our budget write-up, but here we've taken some time to dive deeper, presenting some of the more interesting takeaways in eight charts:

Breaking down the GoC's 2021-22 *Debt Management Strategy*

Chart 1: Gross issuance will fall… but net issuance will not

Breakdown of issuance by debt refinancing, BoC buying and non-BoC buying

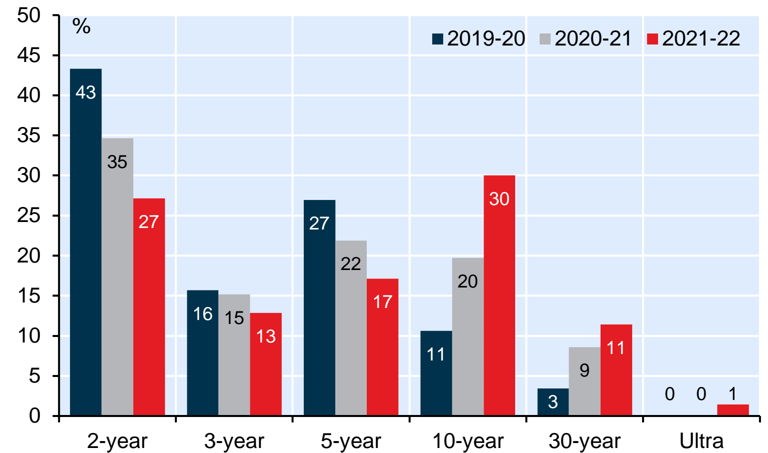


Source: NBF, NBF, Bank of Canada, GoC Budget 2021 | Note: Total bar = gross issuance

Yes, issuance is due to decline significantly in 2021-22—by $88 billion, or 23%, to be exact. But this ignores arguably the most important variable in Canada's sovereign bond market: the BoC. Last year, the Bank effectively absorbed 95% of net issuance thanks to its extraordinary bond buying. QE and auction purchases meant that the only $13 billion in net new bonds had to find their way to the street. This year, with the taper poised to continue, we estimate that the amount of bonds reaching the market will more than quadruple.

Chart 2: Visualizing the term out in relative terms

Share of gross issuance by sector, fiscal year

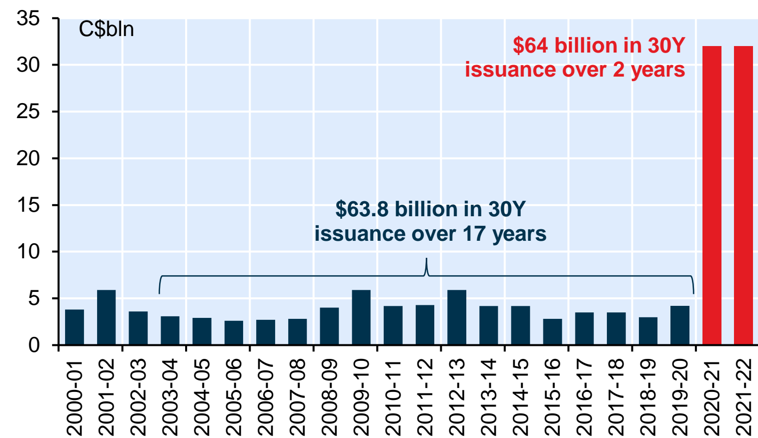


Source: NBF, Bank of Canada, GoC Budget 2021

You've seen the headlines. The term-out of the GoC bond stock continues. Despite a total issuance program that's $88 billion lower than last year, there will be $14 billion more coming out the curve (10Y+). There's been tremendous volatility in the total gross issuance done over the last three years so rather than focus on absolute issuance, let's look at shares. Relative to the 2019-20 pre-COVID year, the proportion of long-end issuance has tripled. The share of shorter-term supply? That's going to fall from 86% to 57% over 24 months.

Chart 3: Go long!

30-year issuance by fiscal year

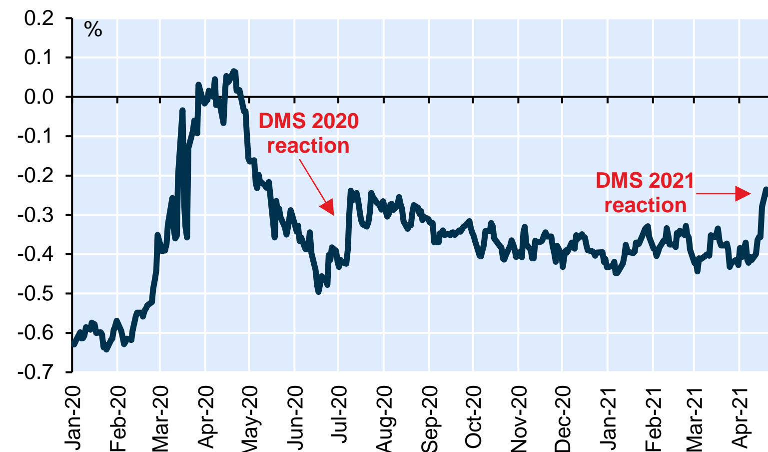


Source: NBF, IMF

Okay, maybe looking at shares doesn't really capture the magnitude of the shift. Consider that the amount of long bond issuance that will be done in the prior and current fiscal years exceeds 30Y issuance over the last 17 years combined. Pre-COVID we'd often argued that the long-end was undersupplied in Canada, but not *this* undersupplied. You can bet we'll be revising the term structure of our rates forecast. No longer should Canada be characterized by a significantly flatter curve vis-à-vis the US. Even with a supportive BoC absorbing some new supply, we could well breach what had earlier looked like resistance levels on the 30Y around 2.5% over the longer term.

Chart 4: Rethinking the Canada-US long bond relationship

30-year Canada-US yield differential since Jan-2020

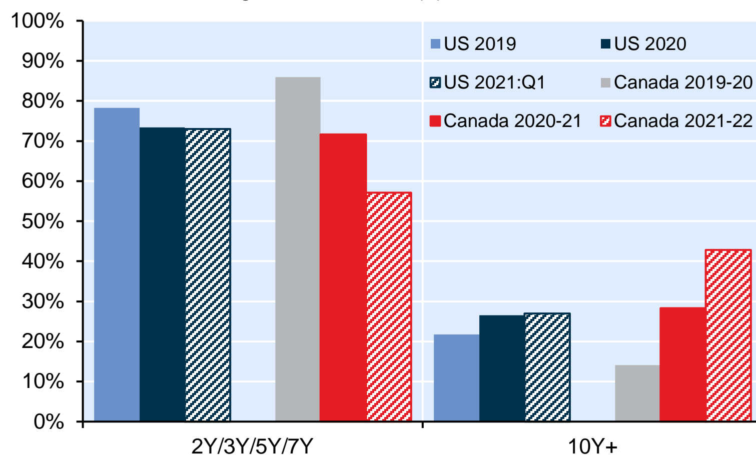


Source: NBF, Bloomberg

This week's 30Y underperformance vs. USTs represents a much smaller reaction than the move in July, when the GoC term-out was first announced. (We concede the starting point was a much richer level). Last July, we argued that BoC buying in the long end would mostly neutralize new supply, so the reaction was overdone. Indeed, in subsequent months, Canada outperformed. This time, we don't expect the same story. With the BoC taper underway and due to continue, net supply to the long end will no longer be neutralized. And with provi borrowing needs remaining elevated, there should be significant competition for issuing long. A 20 bp differential could well be the new normal.

Chart 5: Average GoC issuance term to exceed USTs this year

Share of short-term/long-term issuance by year: Canada vs. US

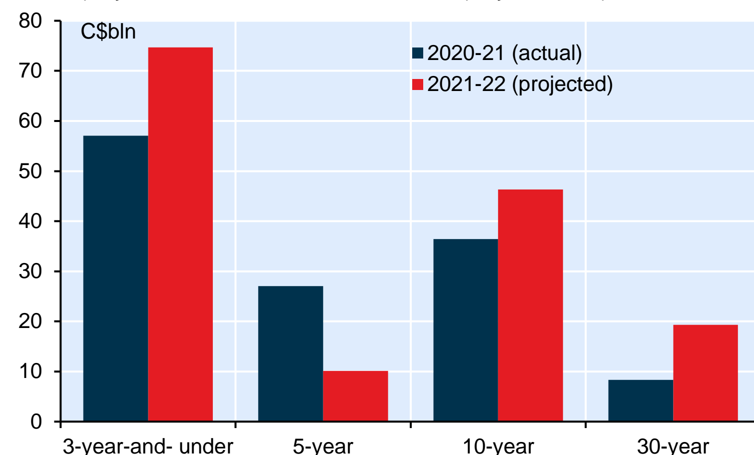


Source: NBF, BoC, GoC Budget 2021, US Treasury | Note: Excludes RRBs, TIPS, FRNs. US issuance by calendar year.

Another way of framing the structural shift in GoC issuance is via comparison to the US. Historically, there had been far more issuance coming out the curve in the Treasury market (absolute or relative basis). That quickly changed last year when GoC issuance moved roughly in line with UST issuance in its long/short mix. One more fiscal year later and the proportion of long-term (10Y+) issuance in Canada looks to exceed the US market by 16%-pts. This coming despite the fact that the US is also terming out its own debt stock with the addition of the 20-year auction. All told, the WAT of GoC issuance looks to be nearly a full year longer than that of USTs this year. Two years ago, UST issuance was 2+ years longer. Of course, on a proportional/per capita basis, total treasury issuance still dwarfs GoCs and that won't change anytime soon.

Chart 6: Less QE means more supply to the street

Actual/projected GoC issuance net of actual/projected QE purchases

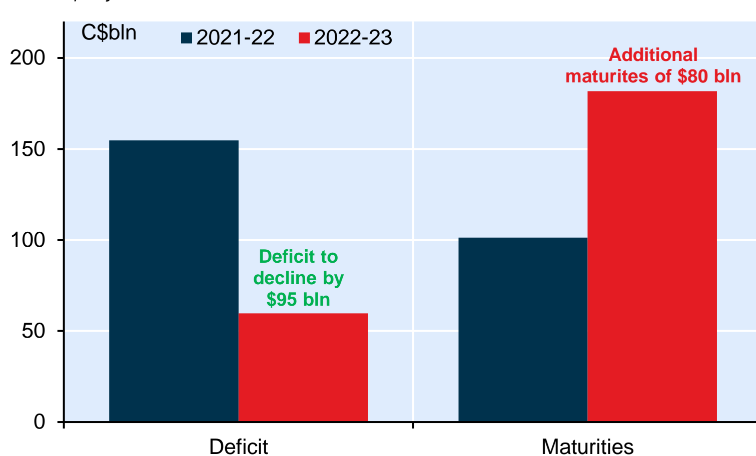


Source: NBF, BoC, GoC Budget 2021 | Note: Assumes $125 billion in total QE purchases. 3-year-and-under includes 2Y/3Y issuance and 2-year/'short-end' QE purchases.

When it comes to QE, we've assumed a reduction of the weekly pace, from $4 bln currently, to $3 bln after tomorrow's meeting and gradually reducing by $500 mln/week each quarter thereafter. That would have us at a steady state $1 bln/week this time next year. Importantly, we've also assumed a continued terming out of BoC purchases over the coming year. However, that won't be enough to offset still-elevated long-end supply. Indeed, it's the 30-year sector that will see the biggest relative rise in net supply to the market. The 2Y/3Y sector would see a net supply increase on reduced QE buying, while absolute levels of issuance should drive 10Y net supply to the street higher. Really, it's in 5s where there looks to be the most technical support based on our assumptions for the evolution of QE.

Chart 7: Outsized maturities to keep supply elevated in '22-23

Deficit projection and bond maturities in 2021-22 and 2022-23

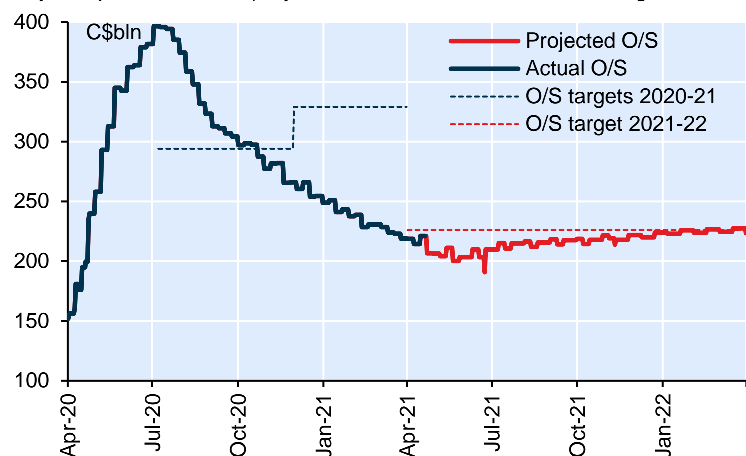


Source: NBF, BoC, GoC Budget 2021

The budget highlighted that there will be significant fiscal consolidation next year, with a nearly $100 bln decline in the deficit signaled. For what it's worth, the budget sees net financing needs falling by an even greater amount. While that may well transpire, don't expect a proportional drop in the bond program. Indeed, there are a record $182 bln bonds maturing next year that will need to be refinanced— an $80 bln increase over this fiscal year. While there are other factors at play in arriving at the size of GoC bond issuance (e.g. T-bill stock, cash balances), these two factors play the biggest role. These variables alone would imply a bond program well north of $200 bln in 2022-23. And depending on how the GoC manages bills, the drop in issuance could be even smaller. It's possible issuance could even remain unchanged if the feds choose to significantly wind down bills. Again, this is a bit of a simplistic approach but any way you slice it, we won't see *significantly* less issuance next year.

Chart 8: Will we have a more stable bill stock this year?

Trajectory of actual and projected T-bill stock with GoC EoY target levels



Source: NBF, BoC, GoC Budget 2021 | Note: O/S refers to outstanding bills.

The T-bill market has been on a wild ride over the past 12 months. From $150 bln to $400 bln and now back closer to $200 bln, it's evident why bills are known as the GoC's fiscal shock absorber. Judging from the DMS, it appears that we'll be enjoying much greater stability this year. While we don't know the intra-year evolution, the targeted endpoint for the bill stock ($226 bln) is just $5 bln above where we are today. That would imply average auction sizes of $18-19 bln over the course of the year. However, take this "target" with a grain of salt. Last year's outstandings target, set out in late November, missed the mark by $110 bln. Indeed, this figure is based on the government's current working fiscal/economic assumptions. Should conditions change over the course of this year, it's here where they will manifest. Given the greater overall certainty relative to last fall, we're not calling for another $100 bln miss but it would be prudent to put ~$50 bln wide confidence band on the $226 bln target.

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Paul-André Pinsonnault
Senior Economist
paulandre.pinsonnault@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King
Economist
daren.king@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Camille Baillargeon
Intern Economist
camille.baillargeon@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich
Rates Strategist
taylor.Schleich@nbc.ca

General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only.

This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA")which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright

This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.