

Diving deep into the DMS

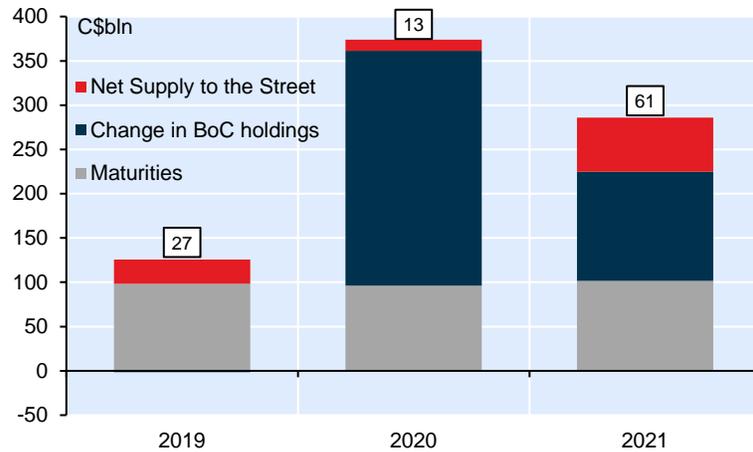
By Taylor Schleich

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

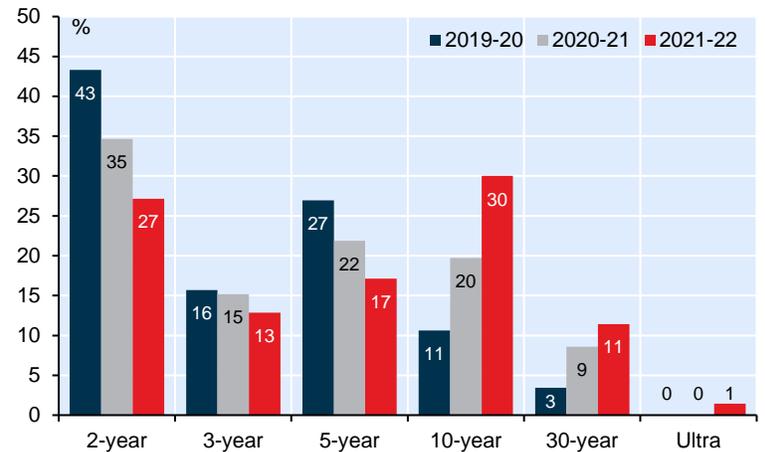


Source: NBF, NBF, Bank of Canada, GoC Budget 2021 | Note: Total bar = gross issuance

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

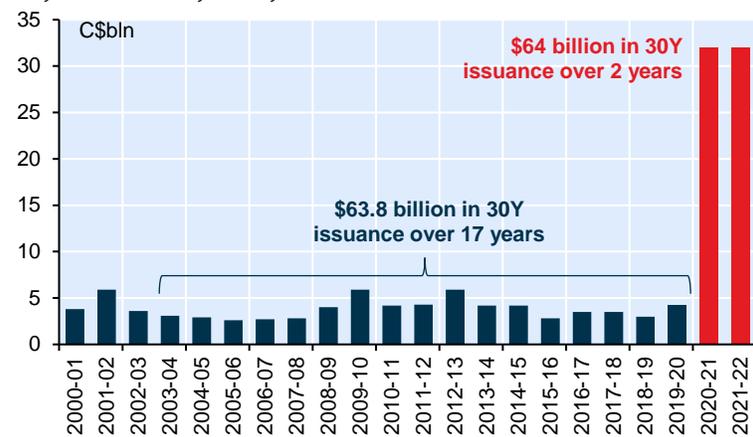


Source: NBF, Bank of Canada, GoC Budget 2021

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

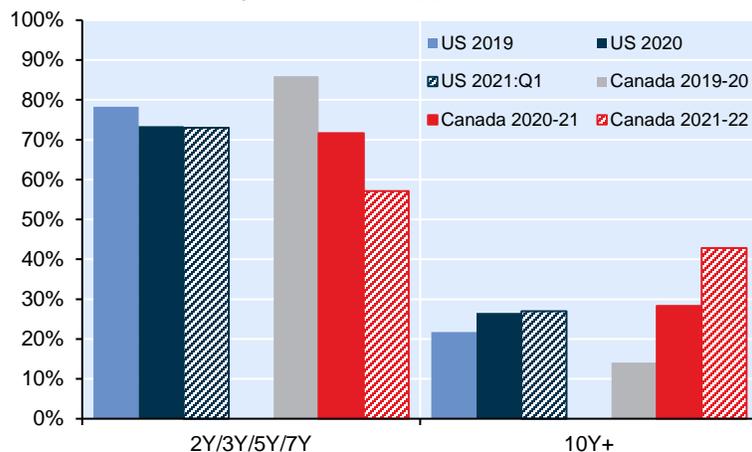


Source: NBF, Bloomberg

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

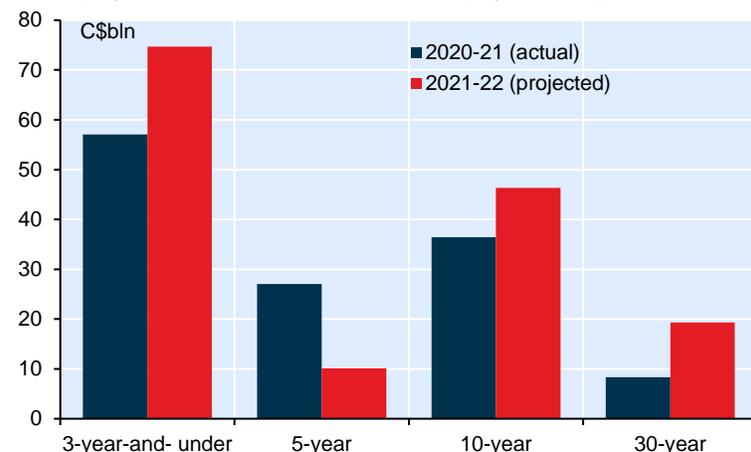


Source: NBF, BoC, GoC Budget 2021, US Treasury | Note: Excludes RRBs, TIPS, FRNs. US issuance by calendar year.

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

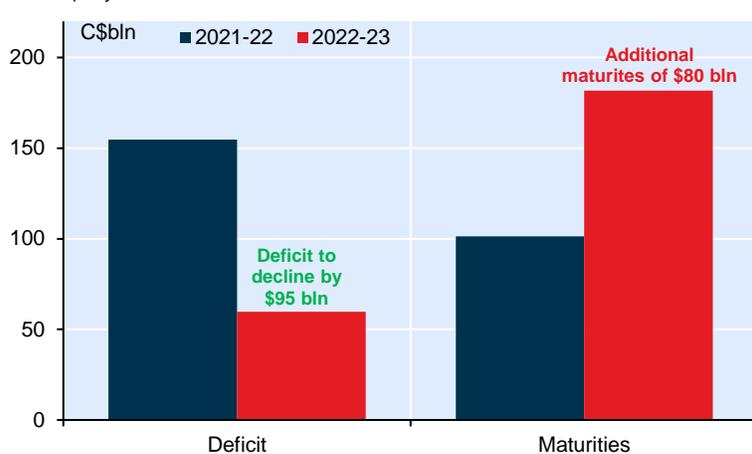


Source: NBF, BoC, GoC Budget 2021 | Note: Assumes \$125 billion in total QE purchases. 3-year-and-under includes 2Y/3Y issuance and 2-year/'short-end' QE purchases.

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

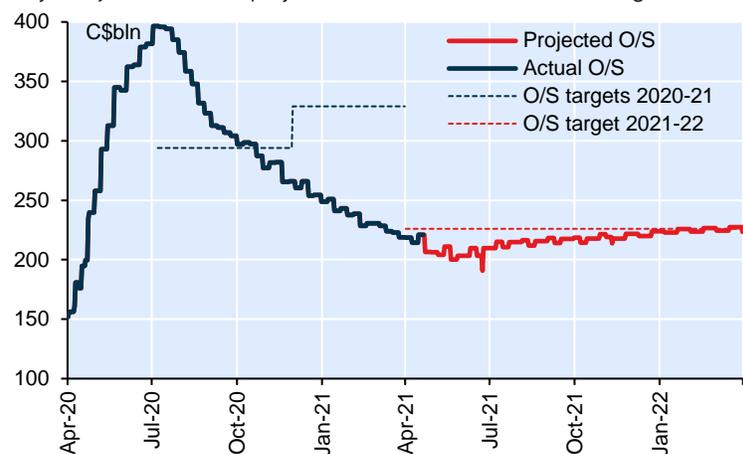


Source: NBF, BoC, GoC Budget 2021

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.

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General

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