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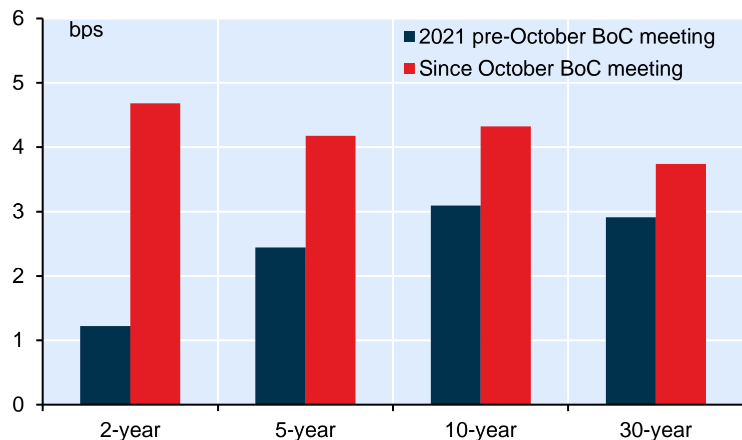
What the deuce is going on in 2s?

By Taylor Schleich

We're approaching a month since the BoC's fateful October meeting in which forward guidance was recast, leading to markets and forecasters significantly revising interest rate expectations. Still, the reverberations from last month's decision are being felt, perhaps no more so than in the short end of the curve. Indeed, we've seen volatility—as measured by the average daily absolute change in interest rates—accelerate the fastest and to the highest level in the 2-year sector, relative to 5s, 10s and 30s.

Chart 1: Volatility up across the curve, no more so than in 2s

Average daily absolute change in key rates: Pre-Oct BoC vs. post-Oct BoC

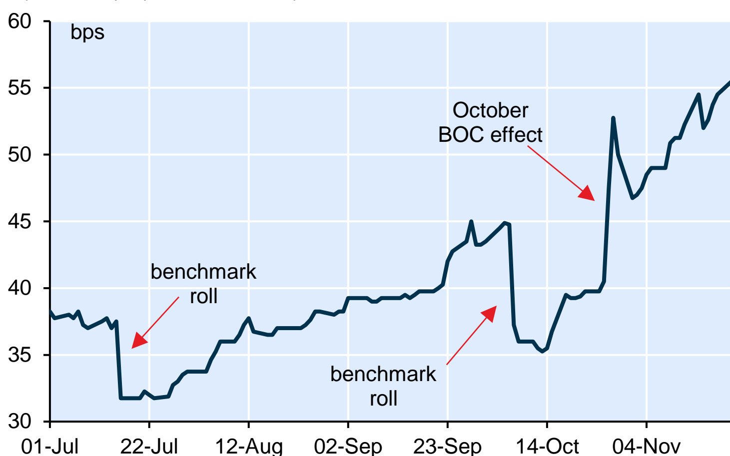


Source: NBF, Bloomberg

This result isn't particularly surprising. Given that the short-end of the curve is driven predominantly by monetary policy, we should expect a major change in central bank posture to result in greater relative volatility down the curve. However, what was perhaps less expected was the dislocation in short-term interest rates. While 2s understandably got whacked post-BoC, the sell-off was not nearly as dramatic as we saw in the BAX market. Futures are pricing no less than five rate hikes by the end of next year. This dislocation helped push the 2-year swap spread out to post-GFC wides. While this is at least partially a function of differing views between cash and futures markets (BAXs were already aggressively priced pre-October BoC), there is also more at play.

Chart 2: The ongoing swap spread blow out

2-year swap spread since July 2021

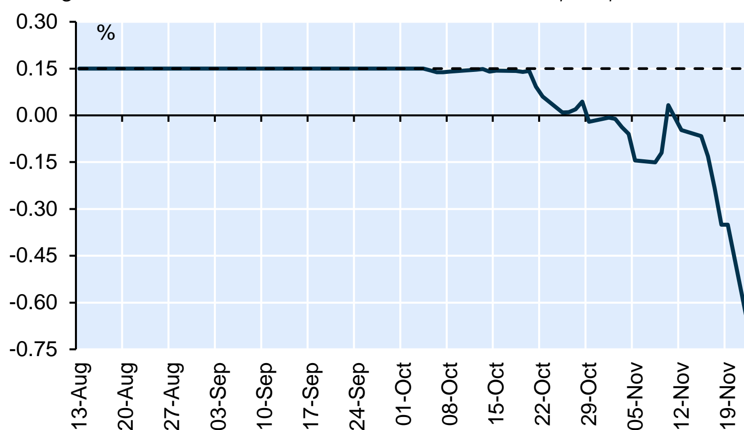


Source: NBF, Bloomberg

Indeed, look to the repo market and you'll see further evidence of market disfunction. To borrow the current on-the-run two-year benchmark (Nov23s) in the BoC's Securities Repo Operations you'll have to *pay* the Bank of Canada 0.67%, whereas borrowing general collateral will *pay you* 15 basis points for your cash. That's a difference of 80+ basis points, by the far the largest dislocation in the SRO era.

Chart 3: Nov23s blowing through zero bound in SROs

Average rate for Nov23s in Bank of Canada Securities Repo Operations

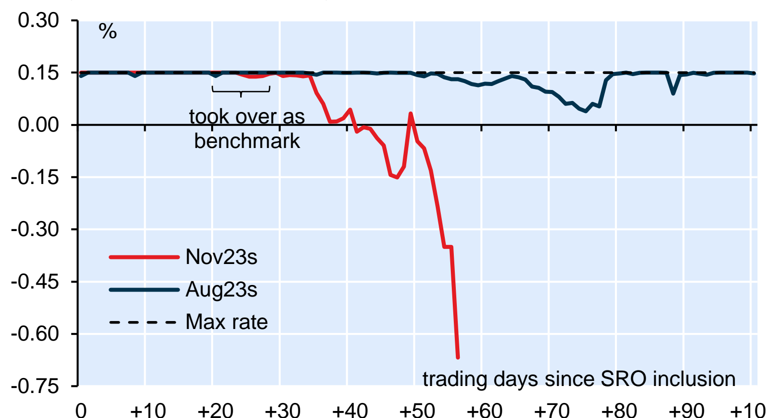


Source: NBF, Bank of Canada

To be sure, this repo premium isn't necessarily new. We saw the prior benchmarks—the Aug-23s—squeezed too. However, the extent of the earlier repo richness wasn't even close. At its most extreme, the Aug-23s cleared the SRO at an average rate of 0.04%. That's well below the maximum bid rate (0.15%) but still nearly 70 basis points above the rate Nov 23s cleared this morning. Go outside the BoC's SRO facility and you'll have to pay 75+ bps to borrow the benchmark 2s in repo.

Chart 4: Repo specialness nothing new… just not like this

Average rate for Nov23s and Aug23s in SROs indexed to SRO inclusion date

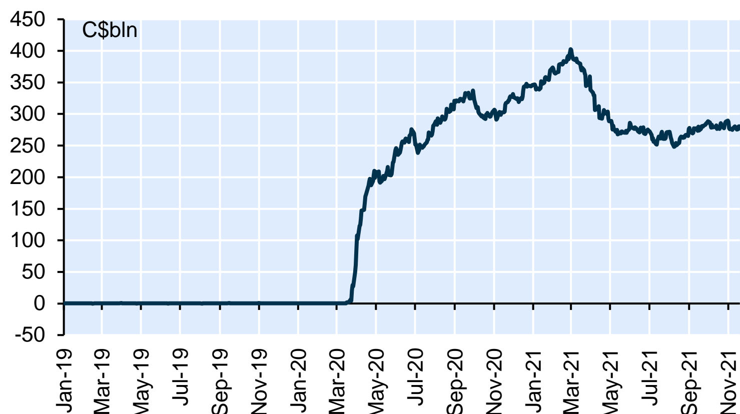


Source: NBF, Bank of Canada

This all begs the question, what is going on here? Why is this bond in so much demand? Importantly, it's not anything inherent in the Nov-23s itself. It's the fact that it is the benchmark 2-year and the most liquid point on the Canada curve. Thus, it's in high demand by dealers for hedging inventory. If one wants to buy an off-the-run short Canada or short-term credit product, the natural inclination is to hedge with the on-the-run, liquid 2-year. Of course, the Bank's large-scale asset purchases injected a tremendous amount of cash into the

system (cash that still is sloshing around even after the BoC officially wrapped up QE). That cash is chasing a finite product base and that product base has to be hedged.

Chart 5: Cash in the system remains elevated
LVTS settlement balances since 2019

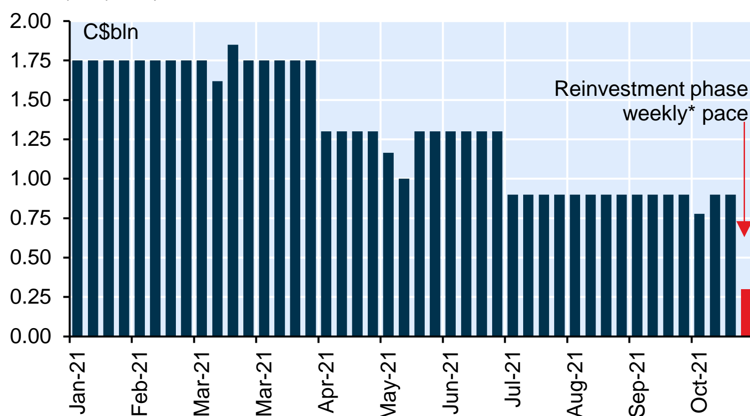


Source: NBF, Bloomberg

Somewhat paradoxically, while the Bank's asset purchases are partially to blame for these ongoing issues, the QE program at the same time did provide relief. Weekly 2-year buybacks allowed dealers to sell short-term bonds that would've otherwise been more difficult to transact in. This allowed them to take on inventory and not need to hedge with the benchmark 2-year bond as much.

Now, the BoC secondary market purchases have been slashed. Following the Bank of Canada's October policy meeting, we've gone from the BoC buying $900 million in the 2-year sector every week to $600 million every *two* weeks. That's a two-thirds reduction in the amount of weekly buying. And if you go back to earlier in the year, the pace of weekly 2-year purchases was $1.75 billion—nearly 6 times the current pace.

Chart 6: QE ending means less support for less-liquid bonds
Weekly 2-year purchases in 2021



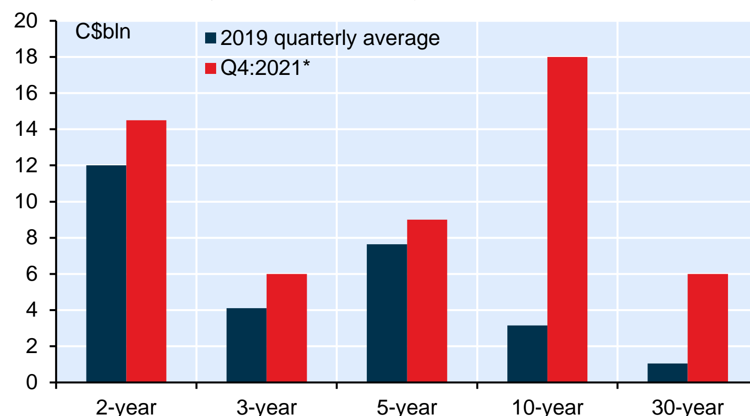
Source: NBF, Bank of Canada | Note: Red bar is "reinvestment phase" implied pace based on a $600 million biweekly purchase

And of course, earlier in the year rate hikes still looked to be a long way off as we were still in the depths of COVID lockdowns. As evident in Chart 1, there was much greater stability in interest rates, particularly in 2s, and thus, less incentive to put on curve trades (e.g. a 2s-5s flatteners), which also limited 2-year short interest. Fast forward to today and rate hikes look to be getting ever closer. There's more demand to express views on the shape of the interest rate curve as the uncertainty presents potential opportunities.

Meanwhile, the supply side of the equation is only exacerbating the issue. Just as the monetary policy stimulus impulse has waned, federal fiscal support has decelerated too. Of course, that means fewer bonds being placed in the market, which has been ongoing over the past year. Moreover, last year Finance Canada radically recast its borrowing strategy, pushing issuance out the curve to 10s and 30s at the (relative) expense of 2s, 3s and 5s. You can probably see where we're going here. We've reached a point where there isn't enough 2-year product out there anymore.

Now of course, issuance is still well above pre-COVID levels and it really isn't even close. But this is where the Government of Canada's term-out comes into play. Issuance in 10s and 30s is still well, *well* above where it was pre-COVID. Down the curve, this isn't really the case. Fourth quarter 2-year issuance looks to come in at $14.5 billion assuming recent auction sizes remain intact. Pre-COVID, 2s were running at a $12 billion/quarter clip.

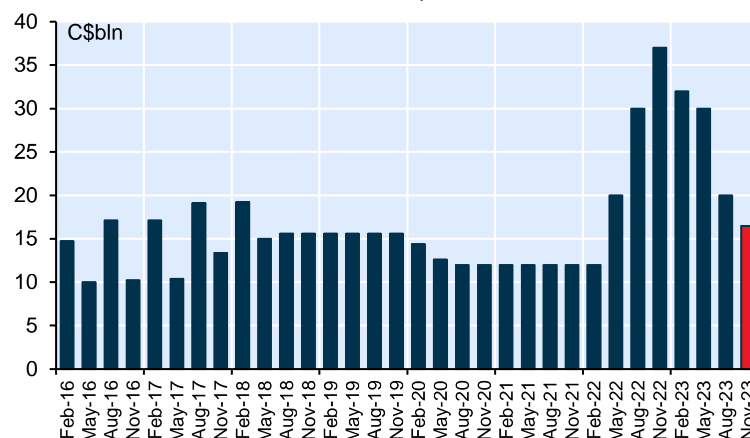
Chart 7: Issuance close to pre-COVID levels in 2s and 5s
2021:Q4 issuance trajectory versus average quarterly issuance pace in 2019



*Source: NBF, Bank of Canada | Note: *Assumes recent auction size remains intact in Q4*

By the same token, 2-year benchmark sizes have been in freefall. The high watermark Nov-22s hit $37 billion last year. The current benchmark, Nov-23s, are less than half that at $16.5 billion. Some 2-year bonds issued 5 years ago had a bigger float than this and that was in an era when there wasn't nearly $300 billion being parked in at the BoC via LVTS each day. Technically, April's Debt Management Strategy put a floor on the 2-year benchmark size at $16 billion so the issue might not significantly worsen when we roll to the Feb-24s, but it's unlikely to improve barring intervention and/or issuance changes.

Chart 8: 2-year benchmarks back near pre-COVID sizes
Total issue size as of last auction for all 2-year bond issued since 2014



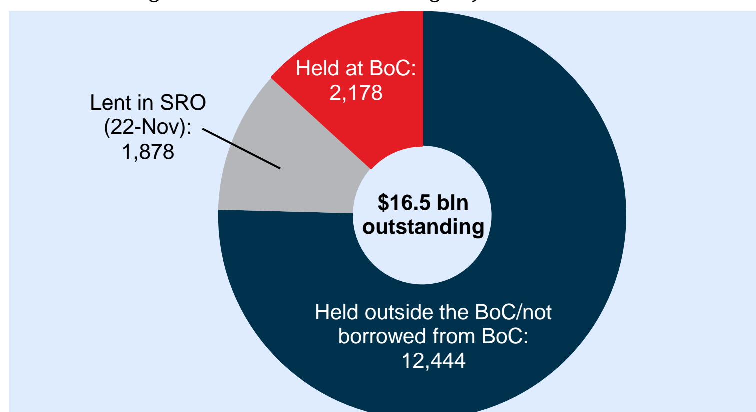
Source: NBF, Bank of Canada

This is where we find ourselves—2s getting squeezed on both the demand and supply side creating major market disfunction. So what is the solution?

There are a few in our view. Firstly, and perhaps most easily, the Bank can lend more of its Nov23 inventory. Currently the Bank only offers 50% of a given position in its SROs, leaving half of its holdings immobilized. The reason for this is out of caution in case a dealer fails to deliver the bond at SRO maturity. Though there does appear to have been some fails, revising the limit to 75% would still leave a decent-sized buffer and free up an additional $1 billion that could be lent out.

Chart 9: Where are the Nov-23s?

Ex-BoC holdings of Nov23s and BoC holdings by lent/non-lent status



Source: NBF, Bank of Canada | Note: Figures in C$mlns. Data as of 22-Nov-21

While providing more balance sheet would help, at the end of the day it's just an extra $1 billion ($2 billion if the Bank opted to lend it all out). It would surely provide some relief but the issue is larger in our view and this probably wouldn't be the ultimate solution. Instead, we'd argue a change is needed on the debt management strategy side, a decision that would have to come in conjunction with Finance Canada.

A partial reversal of the 'term-out' would allow more debt to be issued in 2s, likely at the expense of 3s, 10s and 30s (5-years are already near pre-COVID levels and we risk having issues here if this supply is brought down any further). Another option would be a re-implementation of switch operations, in which dealers could sell off-the-run 2s in exchange for the on-the-run benchmark. This tool had been regularly used pre-COVID to keep liquidity in the relatively small 30-year benchmark and could be relaunched in the 2-year sector today. Even if no major structural changes come, it's not too late to mitigate the issue for the building benchmarks—the Feb24s. Ideally, the Bank would issue on the upper end of the Government's target benchmark size range ($16-22 billion). Moreover, continuing to not buy the bond as part of its "reinvestment phase" purchases (in addition to reduced primary purchases) would leave more for the street and require less reliance on the SROs when it takes over as benchmark.

Stay tuned. We expect some change to be made, particularly if this issue continues to worsen. Additionally, a *Fall Economic Statement* is expected to drop in the coming weeks and might provide us with a *Debt Management Strategy* update. Relief could come here. Until then, or until an expansion of the SROs (or some other adjustment by the BoC), don't expect this 2-year repo issue to ease.

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