June 10, 2022 - (Vol. VI, No. 51)

What Canada's ultra-long bond cancelation tells you (and what it doesn't)

By Warren Lovely

The announcement: At 3pm ET on Thursday, June 9th, the Bank of Canada announced (via a somewhat cursory *Market Notice*) that ultra-long (UL) bond issuance was being canceled with immediate effect. That means the latest planned offering of the CAN 2.75% 2064s just one week out (June 16th) is being rescinded and all future UL issuance is on hold until further notice.

The immediate reaction: Cue a significant bull flattener. Bonds were already drawing some support from a mid-afternoon equity market stumble and generalized risk-off tone. The announced removal of UL supply keyed a serious technical bid for long Canadas. The GoC curve flattened a few bps quite quickly. Canadas, after having roundly underperformed U.S. Treasuries since a distinctly hawkish BoC rate statement back on June 1st, snugged up notably (Canada-U.S. 30s snapped in roughly 8 bps by the end of day).

At least initially, Friday morning data kept the flattener and nascent GoC outperformance intact, as steamy U.S. core inflation triggered a relatively larger selloff in Treasuries. This even as Canadian jobs data built (at the margin) a growing case for an ultra-aggressive 75 bp BoC hike come July. Note: On the 50 vs. 75 debate, vital Canadian CPI data, due in a week and a half (June 22nd), could well decide matters.

Some context on ultras: For those less familiar with the federal government's borrowing program, ultras were meant to form one part of the GoC bond program. As per the latest *Debt Management Strategy*, $4 billion in UL issuance had been planned for fiscal 2022-23. That was to be one part of a 35% share of the $212 billion gross bond program being steered to the 10Y or longer end of the curve.

When it came to Ottawa's broader funding strategy for 2022-23, the *DMS* noted that "the government will maintain its long-term emphasis in the debt management strategy." Obviously, with their longer duration, ultras were intended to make a non-trivial contribution to the ongoing increase in the weighted average term of the GoC debt stock.

Our take on the announcement: For a four sentence *Market Notice* containing barely 50 words, there's actually a fair bit one might infer from Thursday's announcement. Some elements of our interpretation:

(1) For starters, above-plan revenue continues to pour in, which is reducing net financing needs. This is the stated reason for canceling ultra-long supply: "This decision reflects Canada's declining borrowing needs *generally*." [Our italics]

To be clear, revenue/fiscal windfalls are nothing new, nor is this situation unique to the federal level of government. We've spent the better part of a year digesting (in some cases extraordinary) federal-provincial budgetary upgrades. Judging from a record-low unemployment rate and double-digit nominal GDP growth, economic and fiscal momentum has carried over to 2022-23. That suggests budgetary targets set down in 2022 budgets could be beat, in some cases handily.

We don't have much formal guidance on fiscal revisions yet. For their part, the feds provide some colour via the monthly *Fiscal Monitor*, the next version of which is due no later than July 29th (covering the first two months of the fiscal year). But it won't really be until the *Fall Economic Statement* that we get a more definitive word on how the federal fiscal trajectory has been altered. For now, it's simply 'better'. And if you thought extra revenue was accruing nicely in Ottawa, just image what the picture looks like in Alberta (or Saskatchewan for that matter), as oil prices continue to run *way* above budget planning assumptions.

True, rate hikes are already slowing the housing market, creating economic risks for Canada. At least for now, however, governments are basking in bonus revenue. Even assuming that a good portion is steered to priority investments, there's simply less funding to do than previously envisioned.

(2) Following from #1, this likely won't be the only adjustment to the federal borrowing program. Indeed, the one word that caught our attention in the uber brief *Market Notice* was "generally", which was used to describe the reduction in borrowing needs.

If financing requirements are "generally" lower, than it stands to reason that other borrowing lines will be leaned on less heavily too. Simple math reinforces this point; if revenue is flowing in the door fast enough to trigger an abrupt change in the borrowing strategy just 20% of the way into the fiscal year, then the $4 billion of planned UL supply isn't really much of a shock absorber.

Consider: $4 billion is barely 1% of federal revenue and a bit less than 2% of planned bond issuance. So nuking this segment doesn't sop up a lot of extra revenue. As a result, we expect other tenors of the GoC bond program could well be adjusted. That could be achieved via few planned operations and/or reduced auction sizes. On the former (i.e., auction frequency), the upcoming *Quarterly Bond Schedule* (arriving before the end of June) will be informative. On the latter (i.e., auction sizes), we'll really need to watch the individual *Call for Tenders*.

(3) When it comes to the GoC bond program, nixing ultras is the most 'natural' place to start from the government's point of view. Look, ultras are a bit of a special case when it comes to GoC issuance. CAN 2064s never really formed a core element of the GoC bond program. We won't necessarily call them a novelty act, but even when ultras were getting done, no one confused them with the larger and more frequent 2-, 5-, 10- or 30-year operations.

Again, if borrowing needs are lower, better to maintain supply in these legit benchmark tenors. That's simply got to be a higher priority. Liquidity and market-making in ultras has never been great. And more recently, ultras haven't exactly been giving off a great vibe. Just look at the coverage ratio the last couple of times out. Coverage dropped below 2X last November and set a new low-water mark of 1.6X in March 2022. (Compare that to the 2.7X coverage ratio observed back in 2017.) Market participant feedback, one presumes, has likely not been great.

Clearly, inflation anxiety is taxing investor demand for nominal bond exposure out the curve. That's understandable. On its own, tepid demand argued for reduced UL auction size and/or frequency. Add in the bonus cash situation and collapsing this segment of the bond program just made sense, even if the timeline for communicating the change left a bit to be desired.

(4) At this point, T-bills have little more to offer in terms of cash-absorption potential. If you've followed Ottawa's funding strategy over the years, you might have gathered that the T-bill program has traditionally been the quickest and easiest way to absorb fiscal surprises. Need extra dough? Gross up T-bill tenders to growth the program. Have extra cash? Do the opposite and drive the T-bill stock lower. It's been a consistent strategy… up until now that is.

While we could debate the exact minimum level of outstanding T-bills required to maintain good market functioning, at roughly $200 billion, we're presumably not far off this notional floor. Notwithstanding BoC rate hike anxiety, earlier feedback (repeated in the *DMS*) had pointed for underlying demand for T-bills. There's still excess liquidity in the system. Moreover, there might just be a need for T-bills to substitute for a prospective reduction in other short-term paper (e.g., BAs) as market reforms take hold. Could there be a market for say a 1-month T-bill? This is a question worth debating.

Suffice it to say, drawing down T-bills as a means of absorbing bonus revenue just isn't a particularly viable option at present. That makes a smaller bond program the necessarily adjustment factor for now.

(5) Don't interpret the UL announcement as a wholesale abandonment of the government's longer-term funding strategy. You may recall that the feds went all-in on a term-out in fiscal 2021-22. As for 2022-23, the *DMS* walked things back a bit, but still professed a "long-term emphasis" when it came to planned bond supply.

Assuming other tenors of the bond program get their own haircuts, the 35% intended share of issuance steered to 10Y+ maturities might not be that far off the mark in the end. In other words, we still expect that the longer-term share of issuance and resulting weighted average term of new supply will remain relatively long, at least vs. the pre-COVID funding model (which generally saw a scant 20% of gross supply printed beyond 5-years).

(6) Nor should the axing of the UL program be confused with an imminent boost to RRBs. As noted, inflation anxiety is weighing on nominal bond demand, helping to explain the lack of enthusiasm for the last few offerings of the CAN 2064s. Does that mean the feds are about to steer more supply into the inflation-linked market? Not so fast.

Again, the key driver behind Thursday's change is extra revenue/lower borrowing needs. That suggests that few, if any, segments of the GoC borrowing program will be increased. Rather, it's all about degrees of reductions. RRBs, like ultras, are a bit of a special case to us, having a more limited investor audience (at least historically). You could argue that investors have alternatives for getting inflation protection, including a deep and well-developed U.S. TIPS market to say nothing of less-liquid real assets.

When it comes to RRBs, it may well be a case of "if you build it (i.e., auction it), they will come", so don't be surprised if Finance Canada and the BoC probe on primary dealer and investor enthusiasm for an enlarged RRB program in future consultations. But we don't necessarily see that translating into a near-term increase in linker supply… not in this fiscal environment anyway.

Bottom line: Clearly, federal and provincial governments continue to benefit from Canada's extraordinary nominal income generation. This takes the form of unplanned revenue and allows for budgetary beats vs. plan. That in turn means lower-than-expected borrowing needs.

No question, having fewer bonds to offer is a technical plus, not just for the federal government but for many provinces as well. It's particularly comforting given ongoing inflation-related anxiety in fixed income markets and balance sheet reduction efforts now underway by many major central banks (including here at home by the Bank of Canada).

Are we surprised that Ottawa needs to issue fewer bonds? Not in the least. Did everybody love the way this change was communicated? Not likely, given it came so close to the planned 2064 operation. Will there be other reductions in bond supply? That seems almost certain, and we'll be looking for hints in this direction via June's *QBS*.

We don't necessarily see the federal government as having made a market call here. And to us, nuking ultras may not signal a wholesale abandonment of the government's longer-term strategy (vs. the pre-pandemic funding model at least). In other words, it might not be appropriate to interpret this as supporting a structural curve flattener. Nor do we expect the recent apathy towards nominal long bonds to translate into enhanced RRB supply. There's likely some convincing that needs to be done before Ottawa enhances RRB supply. (In recent years, they've actually gone the other way, trimming what had already been a fairly modest amount of RRB supply further.)

All else equal, fewer GoC bonds are obviously a technical tonic for Canada-U.S. yield differentials. Still, relative performance is likely to be more clearly driven by the policy rate path ultimately adopted by both the BoC and the U.S. Fed. Notwithstanding housing risks, we could make a case for economic resilience in Canada, which in the final analysis may allow the BoC to go further on the policy rate (and to hold on longer) than the Fed. Imagine that. That would certainly buck the trend observed during the last North American monetary tightening episode and could argue for cheaper levels on Canada-U.S. than we've grown accustomed to. So take this for what it is, a fiscally inspired tweak to the GoC bond program, but not the only change in funding that will be needed and not necessarily grounds for a permanent re-pricing on the curve or on a cross-market basis.

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

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King
Economist
daren.king@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@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

Ethan Currie
Sales & Trading Intern
ethan.currie@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 70 St. Mary Axe, London, EC3A 8BE.

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.