Market View
Economics and Strategy

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BoC QT: Chapter 1

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With mid-year just around the corner, the first official quarter of Bank of Canada Quantitative Tightening (QT) is nearly complete. Think of this as 'Chapter 1' in what—at least in an ideal, still-growing world—is meant to be a lengthy balance sheet reduction book. You could just as well label the last couple of months a 'preface' to the more significant (albeit passive) GoC bond run-offs coming our way over the coming months/quarters. But let's set the literary analogy aside and get to the main points, of which there are four:

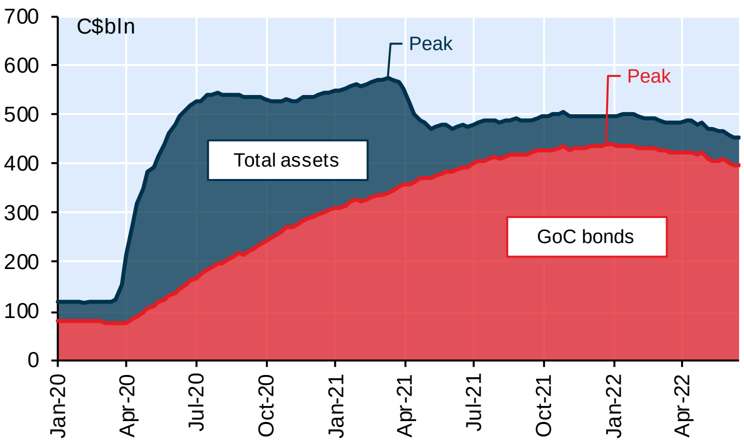
So far, so good? (In a sense, yes) ➢ While the last Bank of Canada purchase settled April 25th, the central bank's holdings of GoC bonds technically peaked in late 2021/early 2022. In a sense then, Q1 produced the first tentative net reduction in BoC bond ownership, with holdings dropping more noticeably in Q2. So we're now at the stage where end investors, rather than the monetary authority, comprise the market-clearing flow. Canada's admittedly stale national balance sheet data (with data to March out recently) show a host of domestic investor types have begun to step into the BoC's vacuum. And at least through April (the latest data print available), non-residents had remained net buyers of GoC bonds, even if their year-to-date purchase pace had moderated vs. the year-earlier period.

Reduced domestic bond supply a happy coincidence ➢ While the restoration of end-investor participation in the GoC market is just getting going, it certainly helps that the federal government's funding needs are stepping down at the same time… perhaps appreciably. Notwithstanding a recent stumble, still-lofty commodity prices have buoyed Canada's terms-of-trade and by extension nominal GDP. That in turn has seen bonus/unplanned revenue pour into government coffers. What does an improving fiscal position mean for borrowing? Rather than solely cutting the T-bill stock (the traditional financial shock absorber), Ottawa's bonus cash means fewer bonds too. Ultra-long bonds were recently canceled and further adjustments to the bond program can be expected. QT then meets with reduced GoC bond supply… perfect timing. We hasten to add that provincial government borrowing requirements have also receded (in some cases significantly), further lessening public sector supply anxiety in the domestic market.

QT impacts (so far) hard to isolate & clearly dwarfed by major re-think on policy rates ➢ As it stands, you would have a hard time defining a statistically significant 'QT impact' on term premia and/or yield differentials. After all, it's still early days for the BoC, while the Fed is only now getting its own QT initiative off the ground. At present, movements in bond yields, curves, flies and cross-market levels—to say nothing of the generalized deterioration in financial conditions, equities and credit spreads—are more clearly a function of absolute and relative policy rate expectations, which themselves remain fluid. Assuming rapid-fire rate hikes don't totally derail the expansion and the monetary policy focus shifts more fully to balance sheet management in 2023, we might then be able to more clearly isolate the liquidity draining effects of BoC and Fed QT programmes. But we need to survive at least a few more rounds of aggressive rate hikes first.

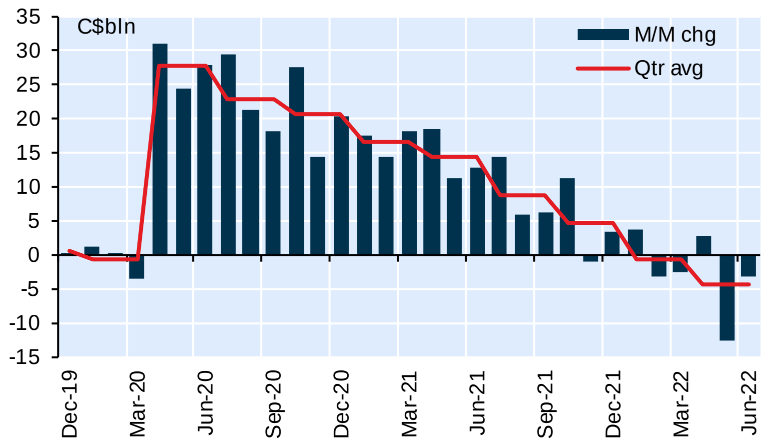
The real test lies ahead ➢ As we turn the page on 'Chapter 1', fair to say that there are many more chapters/volumes yet to be written. The BoC has C$92 billion of GoC bonds running off its sheet in the next 12 months alone and fully C$170 billion maturing over the coming two years. The Fed, as noted, is just getting started on QT and will remain in a notional 'ramp-up phase' until September. But at $95 billion in run-off per month thereafter, the Fed would be slashing over a trillion dollars from its balance sheet on an annualized basis. As we saw during the Fed's inaugural QT foray, there comes a point (i.e., a pain threshold) where things start to break down. Of course, as both Macklem and Powell might be willing to concede, identifying the breaking point may not even be possible. So even if the opening pages were a bit dull/less-than-shocking, this QT book could yet prove hard to put down.

Chart 1: BoC past the peak on asset *and* GoC holdings…
Bank of Canada total assets & holdings of GoC bonds: Weekly



Source: NBF, BoC | Note: Weekly Wed values; market value basis to 15-Jun-22

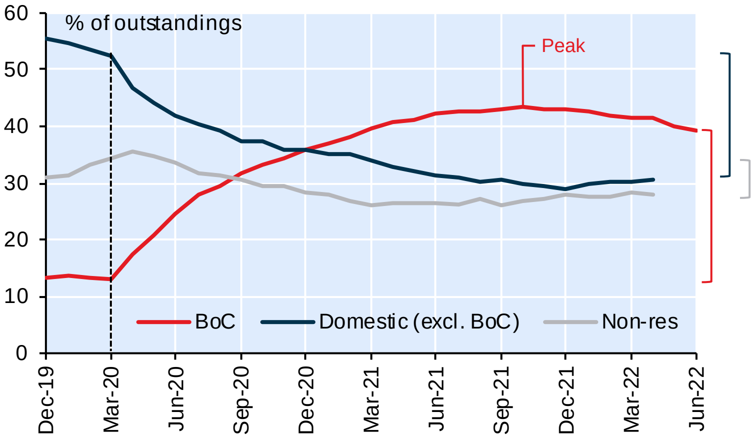
Chart 2: … as taper transitions to outright bond run-off in 2022
Monthly change in BoC holdings of GoC bonds



Source: NBF, BoC | Note: Monthly chg in par value basis; Jun-22 is NBF estimate

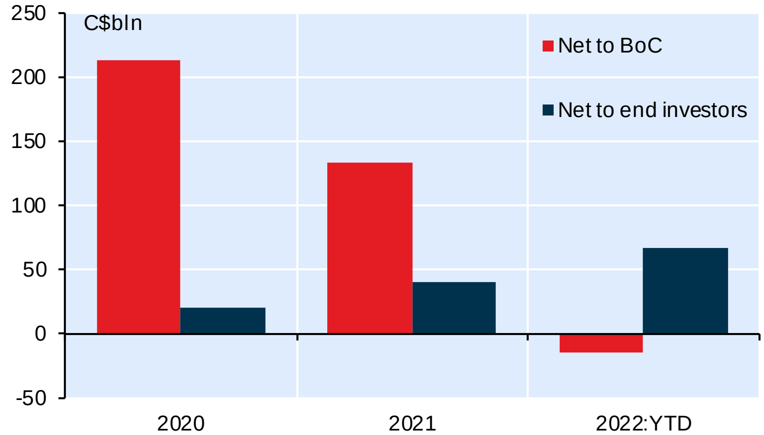
Technically, the BoC's balance sheet peaked in early 2021, when it was still flush with repos and other short-term assets. But the focus has really been on their GoC holdings. As purchases here wound down over the course of 2021, GoC holdings hit a crescendo north of $400 bln. Starting in April, all purchases ceased, and we're thus seeing holdings move down. This is just the beginning.

Chart 3: BoC ownership of GoC market starting to ease…
Share of GoC bonds held by BoC, domestic investor & non-res investors



Source: NBF, BoC, StatCan | Note: Non-BoC to Apr; BoC Jun value is NBF estimate

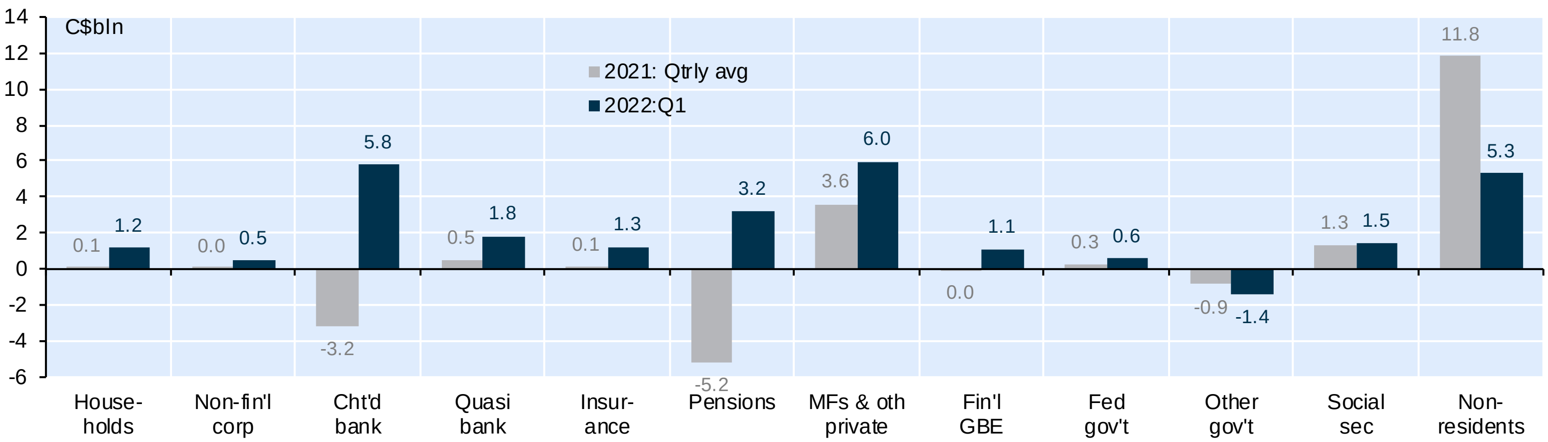
Chart 4: … with end investors now the market-clearing force
Net GoC purchases by calendar year: BoC vs. all other investors



Source: NBF, BoC | Note: 2022:YTD based on NBF estimate to Jun

Garnering much attention last year was the BoC's soaring ownership share of the GoC market, bounding comfortably above 40%. Net purchases by foreigners weren't significantly cannibalized by the BoC, but relative domestic ownership plunged. Now, with the BoC vacating the market, end investors are solely tasked with supply absorption. It's meant to be that way for a few years at least.

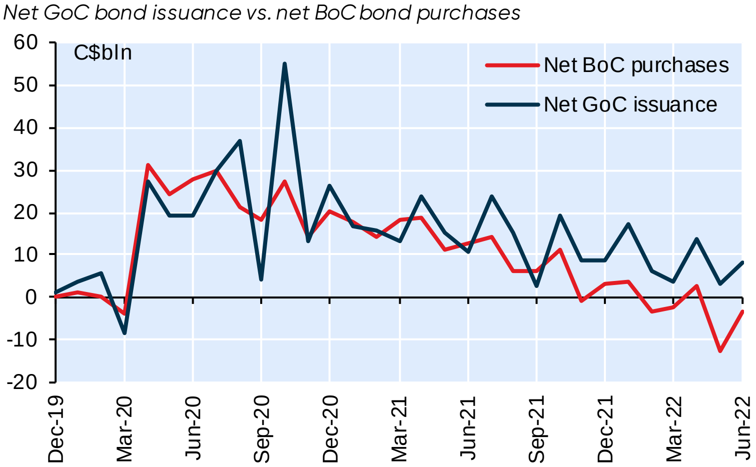
Chart 5: The return of the domestic investor to the GoC bond market
Net GoC bond purchases by economic agent/investor type: 2022:Q1 vs. prior year's quarterly average



Source: NBF, StatCan

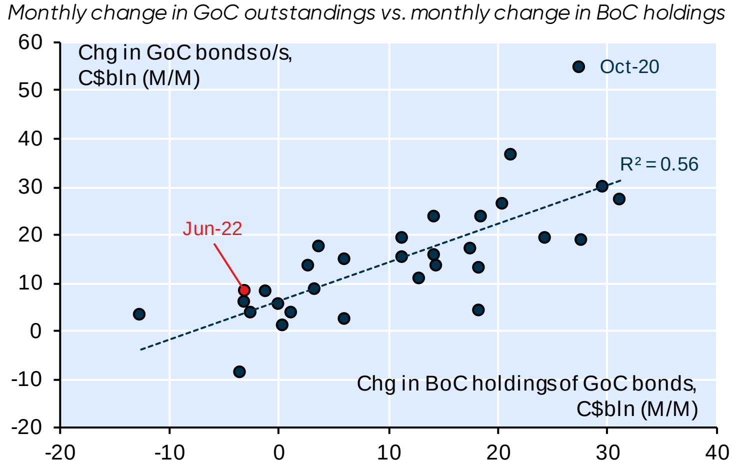
Through Q1, before QT had officially begun, we'd started to see the return of domestic investors to the GoC market. While non-resident demand is always welcomed, it can be a double-edged sword as foreign flows can leave just as quickly as they come. With the BoC sidelined, we'll be increasingly relying on Canadian institutions to absorb a still-elevated (yet rapidly declining) issuance profile.

Chart 6: The BoC was there to absorb the surge in issuance…
Net GoC bond issuance vs. net BoC bond purchases



Source: NBF, BoC

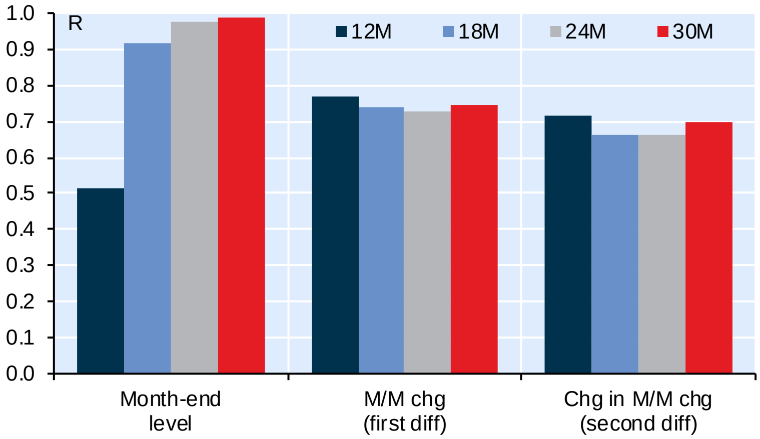
Chart 7: … and they've withdrawn as debt growth moderates
Monthly change in GoC outstandings vs. monthly change in BoC holdings



Source: NBF, BoC

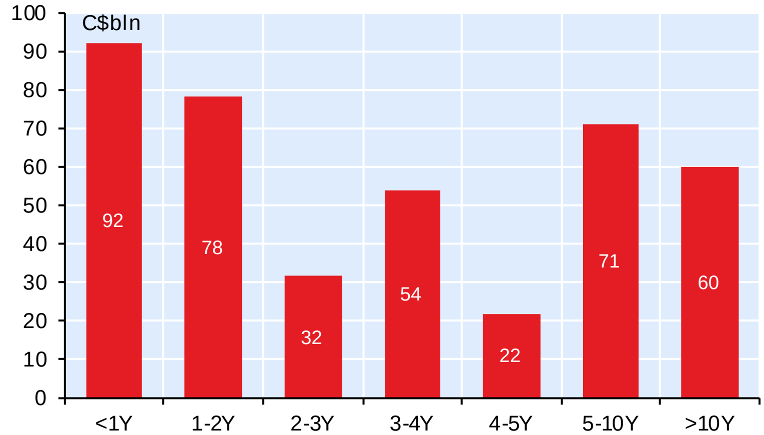
Conspiracy theorists, these charts (6-8) are for you. During the COVID crisis, net BoC purchases closely mirrored net GoC issuance. This was especially true in 2020, when the Bank took down over 90% of net GoC supply. By 2021, BoC purchases weren't fully keeping up with net new issuance, although they were clearly moving in the same direction. The resulting correlation is striking…

Chart 8: GoC issuance and BOC purchases closely linked
Correlation between GoC net issuance & BoC purchases: Level, 1st diff, 2nd diff



Source: NBF, BoC

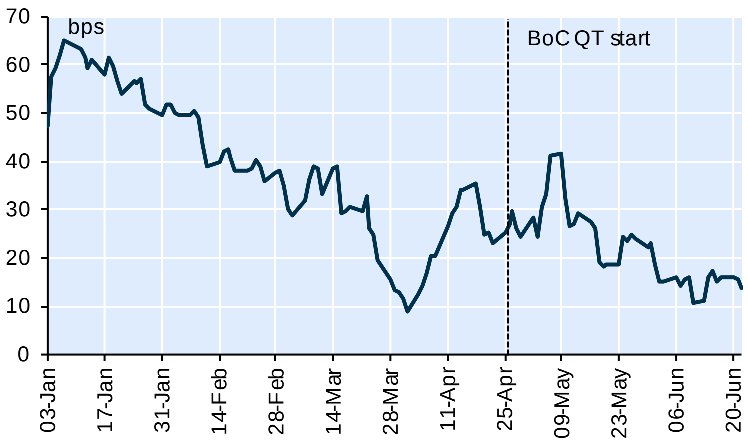
Chart 9: ...but QT should mean the correlation weakens
BoC holdings of GoC bonds by time to maturity



Source: NBF, BoC

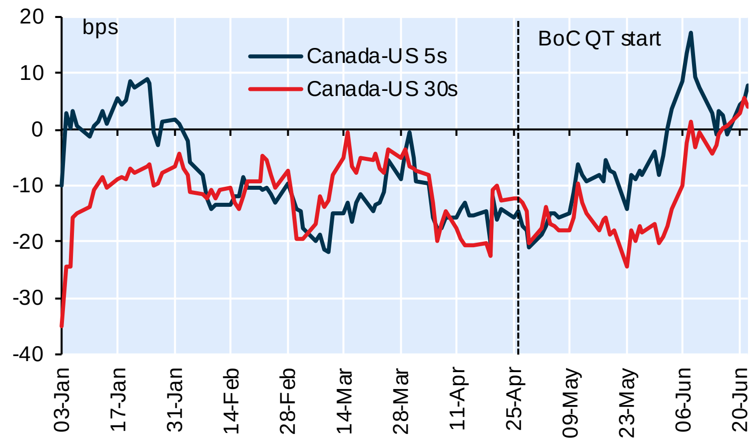
...striking on a level *or* change basis. To be fair, these variables were meant to be positively correlated (as both the BoC/GoC opted for counter-cyclical policies to combat the pandemic). Such a tight fit is nonetheless ammunition for independence critics. Looking ahead, BoC holdings will decline while GoC debt won't. Thankfully, still-roaring nominal growth suggests fewer GoC bonds to issue.

Chart 10: QT hasn't stopped the curve from moving flatter
GoC 2Y-10Y yield curve: 2022 year-to-date



Source: NBF, Bloomberg

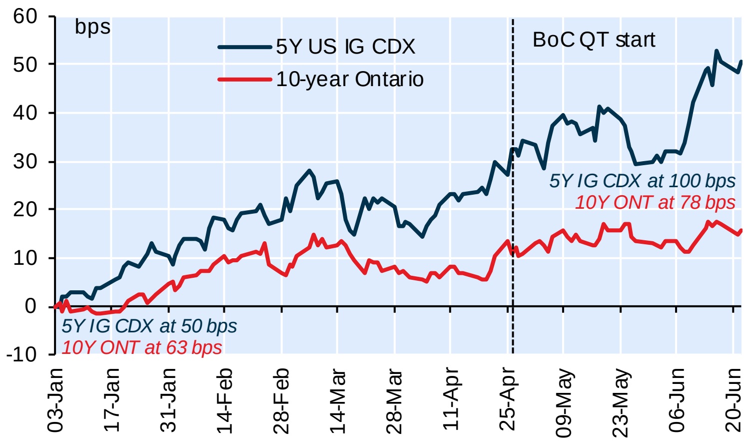
Chart 11: GoCs have underperformed but we don't credit QT
GoC-UST 5Y & 30Y yield differential: 2022 year-to-date



Source: NBF, Bloomberg

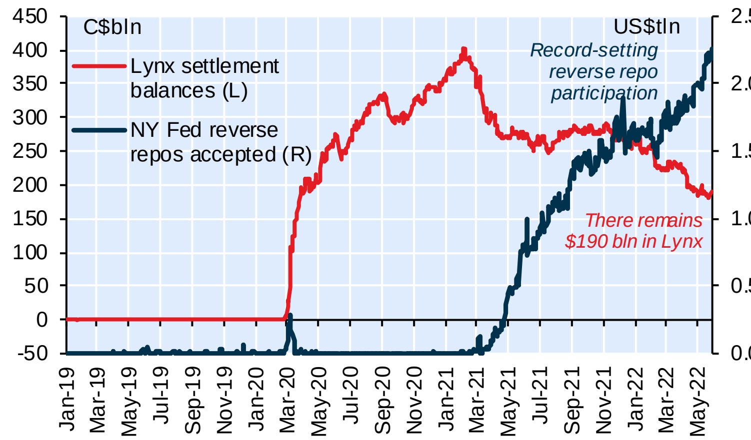
Conventional wisdom would suggest that the curve should steepen during QT, as the central bank adds duration to the market. That may be true in a vacuum but the current environment, driven by a rapidly evolving policy rate outlook, is clearly the driving force of curve structure today. While Canadas have underperformed USTs since QT started, we credit that to a relative policy rate re-think.

Chart 12: Despite QT, Canadian credit has outperformed
Change in US 5Y IG CDX vs. Ontario 10Y spread: 2022 year-to-date



Source: NBF, Bloomberg

Chart 13: Excess liquidity in North American financial system
Canada Lynx settlement balances (L), NY Fed reverse repos accepted (R)



Source: NBF, Bloomberg

QT, on its own, hasn't been a disaster for Canadian credit. Although wider, provincial credit spreads have registered notable outperformance vs. key US comps. Again, we believe fiscal fundamentals and related supply technicals (still immensely positive for many Canadian governments) can blunt QT impacts. And at least for now, there's still excess liquidity sloshing in the system. Could be worse.

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