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The ‘other’ vol (no, not VOLatility, but VOLume)

By Warren Lovely

In Canada, as elsewhere, secondary market bond trading volumes tend to be derivative of primary market supply. After all, you can’t trade a bond that doesn’t exist. At the margin, however, supply clearly isn’t everything when it comes to trading activity/strategy. This becomes increasingly apparent when examining the latest MTRS trading stats (covering the month of June and thus extending to Q2 and/or H1).

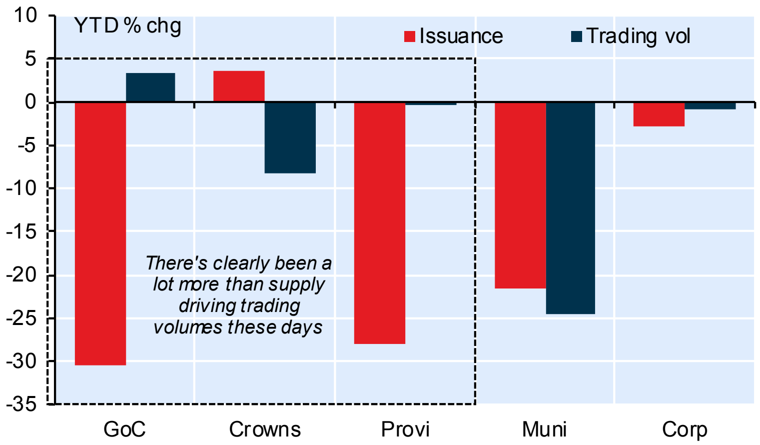
Fiscal consolidation has driven federal-provincial issuance down, and yet volumes have held up. In the GoC market—comprising ~80% of total bond trading—Q2 and H1 volumes were higher year-on-year. The 0-3Y sector accounted for the vast majority of that increase, keying a second observation: Front-end volumes reflect a dramatic re-pricing of central bank expectations. Trading of short GoC bonds popped 20% higher year-on-year in the second quarter, as markets came to terms with extraordinary BoC rate hikes—a process that is very much ongoing.

Don’t misinterpret high(er) volumes with genuinely healthy *two-way* liquidity. Bond yields were on a one-way street higher in the first half, liable to gap on any given day, such was the fear of getting caught the wrong way in a fast-moving market. As it relates to liquidity, investors have surely had their expectations managed. Investor anxiety, alongside the leading edge of a liquidity draining QT exercise, may help explain reduced trading in shorter-dated sub-sovereign bonds. Volumes in 0-3Y Crowns slumped more than 50% in Q2 (vs. the prior year), with shorter-dated provi flow contracting at a double-digit rate. For some, ‘yield enhancement’ has been supplanted by ‘capital preservation’.

If you’re looking for a supply-volume link, you can find one in the longer end of the provincial market. That’s where issuers have steered supply of late. Not coincidentally trading of >10-year provis established a new high (for the MTRS 2.0 regime). It might not be a tremendous stretch to say there’s nearly as much liquidity in longer provis as there is long Canadas. Of note, non-resident engagement in provincials remains evident, with related sub-volumes (absolute and relative) stepping up. Again, lofty volumes don’t preclude provincial spread weakness, as we’ve seen of late. While spreads look to remain unsettled in the second half, we favour provinces vs. corporates on both a fundamental and technical basis. Despite some re-pricing, we’d remain overweight names with resource leverage and/or reduced exposure to a rapidly contracting housing market. As for relative liquidity, provis tend to press their advantage vs. corps in times of stress—a trend likely to extend from here.

Chart 1: Despite falling supply, portfolios need repositioning

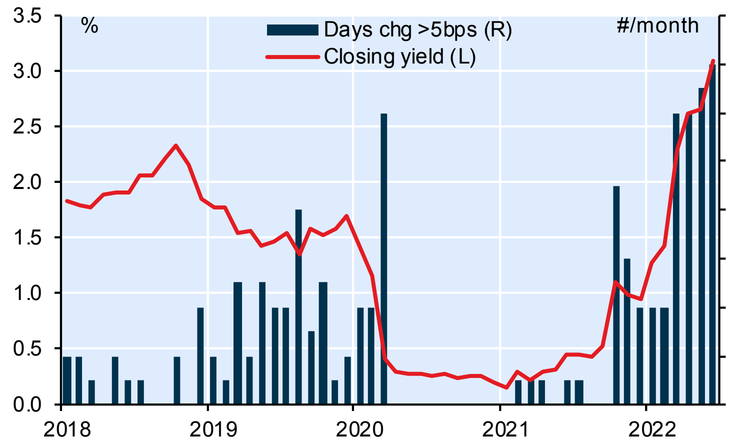
Change in domestic bond issuance & trading volumes: 2022:YTD vs. 2021:YTD



Source: NBF, IIROC | Note: Year-to-date issuance & supply based on Jan-Jun

Chart 2: Two-way liquidity not great in a one-way market

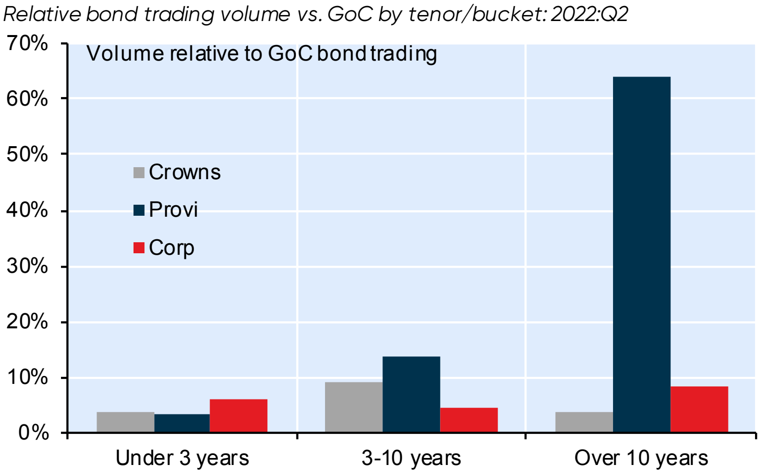
GoC 2-year yields & count of days where yields moved by more than 5 bps



Source: NBF, IIROC, Bloomberg

Chart 3: Long provis a relatively deep market

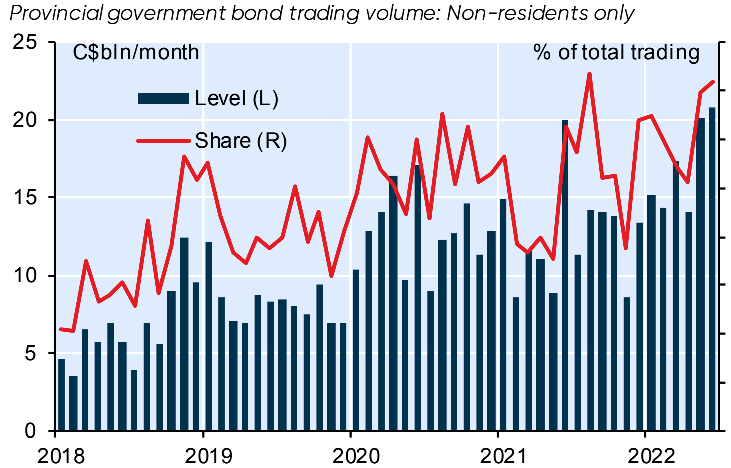
Relative bond trading volume vs. GoC by tenor/bucket: 2022:Q2



Source: NBF, IIROC

Chart 4: Non-residents remain plenty active in provincials

Provincial government bond trading volume: Non-residents only



Source: NBF, IIROC

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

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