Rain down on me (Canada’s December bond market cash)

By Warren Lovely & Taylor Schleich

Bond market cash flows come and go, but a couple of times each year they are simply too large to ignore. As it happens, an extraordinary amount of cash is set to rain down on Canada’s bond market in December, triggering secondary market adjustments and creating scope for primary issuance too. In particular, December 1st and 2nd are at or very near the top of the list of cash flow days to watch and prep for, December 15th coupon and roll adjustments also of the non-trivial variety. As we write this, December 1st is precisely 20 week days away. That means we are entering a traditional ‘performance window’ for Canadian bonds, one that has historically extended towards the end of the calendar year.

This Market View report highlights key elements of the December cash flow effect, dissecting the performance record in Canadian rates (yields, curves, flies and cross-market). We draw attention to the most consistently profitable aspects of cash flow seasonals. At the same time, however, we urge caution and would resist placing blind faith in empirical tendencies. Today’s market location is nothing like what we’ve seen in the past, yields having vaulted higher in 2022 as central banks attacked inflation, curves diving into inverted territory as recession risks mounted and cross-market levels moving to extremes as relative risks were recalibrated. Nor are cash flows the only thing holding sway in the days to come. Important data loom (jobs, inflation and growth being top of mind), which will help clarify thinking on upcoming policy rate decisions (BoC December 7th; FOMC December 14th). In the immediate near term, a federal government Fall Economic Statement should re-set GoC bond supply expectations lower, hinting at technical support. All that to say, one should season this seasonal analysis with a grain of salt.

Projected FTSE Canada Universe Bond Index cash flows: 2022 by month

When it comes to bond index cash, June & December stand out above the crowd, where cash flows tend to be at least 3X the monthly average. 2022 is no different, a slug of cash looming.

1. All else equal, December seasonals support flatter curves & relative performance of Canadas vs. USTs. Success rates (pre or post cash flows) aren’t necessarily 100%, however. Looking at moves in the days leading up to 1-Dec, Canada-USs 5s, 10s & 30s have been consistently tighter.

2. December’s cash is heavily concentrated on the 1st, 2nd & 15th of the month, where coupon & roll effects drive waves of duration extension. We’ll detail specific index effects in a separate report.

3. Today’s curves are relatively flat (in some cases deeply inverted) relative to where we’ve often been this time of year. Duration extension may add flattening fuel, but policy rate re-pricing remains a major wildcard. Another caution: Canadas are relatively rich to USTs vs. past periods.

An empirical examination of Canada’s December cash flow effect, based on 12Y sample from 2010-21

1. Source: NBF, FTSE Russell | Note: Based on estimated cash flows at start of year

2. Source: NBF, FTSE Russell | Note: Asterisk denotes a day that falls on weekend in 2022

3. Source: NBF, Bloomberg | Note: Success rates based on 12Y period from 2010-21

4. Source: NBF, Bloomberg | Note: Prior 12Y average based on 2010-21
We've tended to observe material & sustained outperformance of Canada vs. the US heading into December's large cash flows. When it comes to post-December 1st performance vs. the US, the historical record (based on 2010-21) appears best in 5s & 10s. We caution that past performance is no guarantee, particularly with Canada trading at noted premiums across the curve.

Reflecting on 2021, Canada enjoyed a degree of outperformance in the lead-up to December 1st. But cross-market performance was more broadly based & observable after the cash started to flow, Canada tightening an outsized 14-27 bps over the course of Dec-2021. There's plenty to keep our eyes on this go round, with upcoming data helping to fine-tune thinking on both the Fed & BoC.
Historically, there's a distinct tendency towards flatter curves as investors positioned for duration extensions in around December 1st. Most curves have flattened no less than two-thirds of the time in the 10D heading into December, Canada 2s-30s seeing the most consistent & significant flattening. As noted, however, we’re at relatively extreme levels today, all but 10s-30s curve now inverted.

In the past, seasonal cash supported Canada vs. US, even when starting from notionally ‘rich’ territory. Saying that, we haven’t seen Canada this rich to Treasuries in our post-GFC sample. Market directionality remains another key consideration. Canada outperformed as yields surged this year. A less hawkish BoC has supported this trend, the FOMC as yet unwilling to blink.

Chart 9: Canada performance impervious to location?
Change in Canada-US 10s relative to prevailing level 10D before 1-Dec

Source: NBF, Bloomberg | Note: Current -78 bp level as of 2-Nov

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Chart 10: Underlying market level & direction a consideration
Canada-US 5s relative to underlying US yield level 20D before 1-Dec

Source: NBF, Bloomberg | Note: Current levels 4.25% & -82 bps as of 2-Nov

Chart 11: The flattener has, on average, been in vogue in the lead-up to 1-Dec
Cumulative change in key Canada yield curves relative to 1-Dec, based on prior 12Y average (2010-21)

Source: NBF, Bloomberg | Note: Cumulative change in yield differentials based on generic benchmarks; horizontal axis reflects weekdays relative to 1-Dec (which is set to 0)

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Chart 12: This is what 83% success looks like (for Cda 2s-30s)
Net change in Canada 2s-30s curve in 20D leading up to 1-Dec

Source: NBF, Bloomberg | Note: Based on relative changes in generic 2Y/30Y benchmarks

Keying on 2s30s, this curve flattened in 10 of the past 12 years going into December 1st. That included a significant flattening last year, which continued right up to calendar year-end.

Chart 13: Caution: Curve flatter (more inverted) than prior years
Change in Canada 2s-30s curve relative to level prevailing 20D before 1-Dec

Source: NBF, Bloomberg | Note: Current level -64 bps as of 2-Nov

In the past, the flattener tended to work irrespective of starting location. But we’ve never kicked off the seasonal cash flow trade from such inverted levels, which is a potential complication.
Deviation from trend is the theme for this year. Today’s 5Y cross-market premium to USTs, at 82 bps, stands 1.6 standard deviations inside of the mean for this time of year (based on our 12Y sample). The Z score on Canada’s 2s30s curve is even more extreme, the current 64 bp inversion, almost 3 standard deviations flatter than average. Extreme levels argue for caution when positioning for cash.
### Table: Average moves & detailed performance record in Canadian rates

*Average move & success rates in Canada interest rates (outright yields, curves, butterflies & vs. US) leading up to & following December 1st (based on 2010-21)*

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<thead>
<tr>
<th>Wk days</th>
<th>Canada Outright</th>
<th>Canada Curves</th>
<th>Canada Flies</th>
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<td></td>
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<td>10-year</td>
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**Success rate (%)**

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<tr>
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<td>58%</td>
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<td>42%</td>
<td>58%</td>
</tr>
<tr>
<td>+20</td>
<td>25%</td>
<td>58%</td>
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</tbody>
</table>

**Test:**

- **Lower yield:** Relative outperformance of Canada
- **Flatter curve:** Relatively greater flattening in Canada
- **Belly outperformance vs. wings:** Relative outperformance of Canada belly

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**More to come...**

This Market View report kicks off our analysis of December’s cash flow effects. Supplemental analysis will include a closer look at the specific bond index adjustments we see coming on three key days: December 1st, 2nd & 15th. We will also offer an empirical assessment of credit spread seasonals, focusing on Canada’s high-grade public sector credit markets and controlling for current valuation.
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