January 7, 2019 - (Vol. III, No. 1)

Quick Hit — Reflecting on provi spreads after exceptional December

As the first full week of 2019 kicks off, it's natural enough to reflect on some exceptional market action in the prior month/year. Consider the plight of provincial credit spreads, as judged by the generic 10-year benchmark bond spread for our most prolific provincial issuer. Ontario's current 10-year benchmark (ONT 2.9 Jun-2028s) ended 2018 at +86 bps vs the corresponding GoC benchmark. That spread moved a handful of basis points wider last week, touching +90 bps at one point, before settling back to +84-85 bps today. What do we make of this level?

Let's state the obvious for starters: provincial credit spreads, as with other risk-correlated assets, have cheapened substantially and quite quickly relative to most post-crisis yardsticks. Based on monthly averages, Ontario 10s gapped more than 14 bps wider in December alone, the single worst monthly performance since way back in May 2010, amounting to a >3 standard deviation event (based on post-crisis monthly moves) (Chart 1). Spreads have seriously bucked traditional seasonal trends too (Chart 2). Outsized December cash flows (most concentrated at the start of the month) failed to lend much in the way of support. Nor were we treated to the traditional rally in provincial credit spreads in the final few trading days of the calendar year (Chart 3), even though the provincial bond supply tap was firmly shut off for the holidays.

All told, December's cheapening capped an entirely forgettable 2018, credit spread-wise. Looking back, Ontario 10s traded in the mid-50s vs Canadas at the start of 2018, getting as tight as +54 bps almost precisely one year ago (on 9-Jan-2018). The near-30 bp or fully 50% widening in the Ontario 10-year spread over the course of calendar 2018 was easily the worst full-year performance since the global financial crisis, even if absolute spread levels had previously been wider. For reference, 10-year Ontario spreads got as wide as ~115 bps in early 2016, at the tail end of what was another global growth scare (Chart 4). So it's the rate of change that is today extreme, if not the spread level itself.

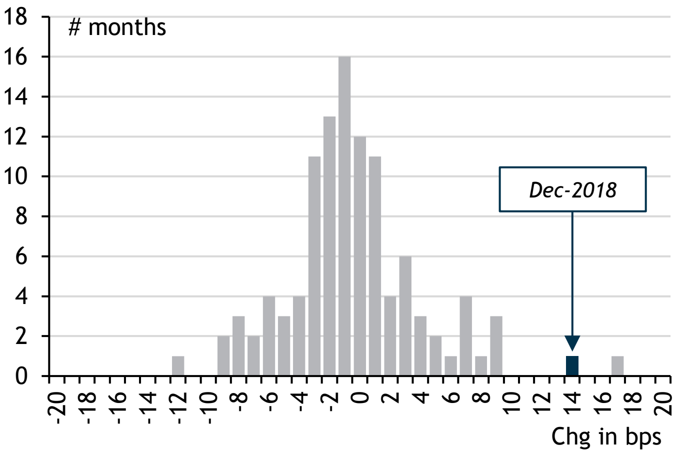
Granted, rapid/violent re-pricing has hardly been limited to provincial credit. Key North American equity indices have been on something of a roller coaster of late, still well underwater on a 1-, 3- or 12-month basis despite a post-Christmas bounce. On either side of the Canada-US border, the rates complex rallied smartly over the last month or so, as rate-hike expectations (from both the Fed and the BoC) have been significantly (if not fully) unwound. As for broader measures of high-grade corporate credit—US 5-year IG CDX being our preferred measure—volatility has likewise been the name of the game.

It's these latter two measures (risk-free yields and US IG credit indices) that possess the greatest explanatory power when deriving so-called "fair value" in our provincial bond market (Chart 5), although other factors like credit ratings, relative bond supply and economic momentum also play a roll. And it's here that we'll end on a tentatively positive note; OLS regression analysis would put "fair value" in Ontario 2028s at ~80 bps (Chart 6). In other words, the recent cheapening in provincial credit, extreme in every sense of the word, might just be a bit overdone. Yes, there's a heavy dose of provi supply to digest in 2019 and a litany of risk factors still to navigate, but we're still seeing massive inflows in the ETF space, which would generally be deemed credit positive/supportive.

A final word: While our focus here has been Ontario 10-year spreads vs GoC, one could easily extend valuation analysis to other parts of the term structure. To that end, we'd be remiss if we failed to note that a steeper underlying 10s-30s Canada curve has failed to illicit a materially flatter 10s-30s provincial credit curve… a development some see as counter intuitive but one that reflects a statistically insignificant relationship in this part of the curve. It's the type of move that could encourage certain investors (insurers for instance) to extend out the curve, generating demand for long-term high-grade provis which our large issuers would presumably be only too happy to oblige.

Chart 1: December widening very much extreme

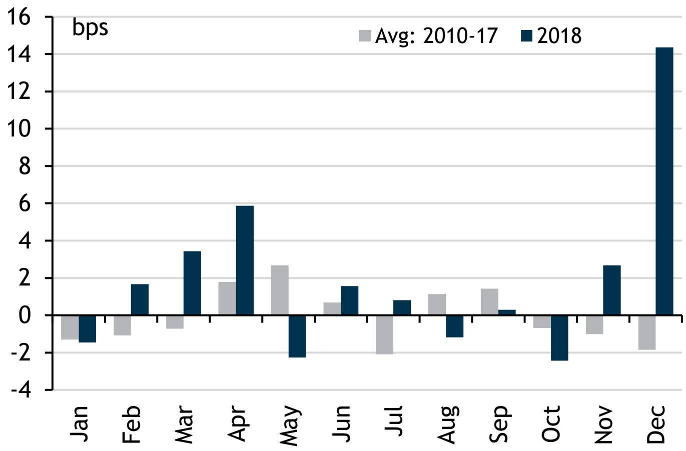
Distribution of average monthly changes in Ontario 10Y spread



Source: NBF, Bloomberg | Note: Monthly changes since 2010; based on Ontario 10-year generic benchmark bond spread vs GoC

Chart 2: Spreads buck seasonal trend

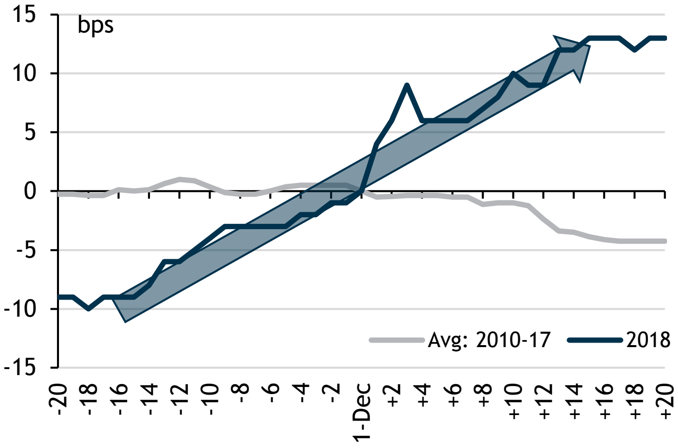
Average monthly change in Ontario 10Y spread: 2018 vs prior trend



Source: NBF, Bloomberg | Note: Based on Ontario 10-year generic benchmark bond spread vs GoC

Chart 3: So much for end-of-year rally

Cumulative change in Ontario 10Y spread in/around 1-Dec



Source: NBF, Bloomberg | Note: Based on 20 trading days prior to/following December 1st

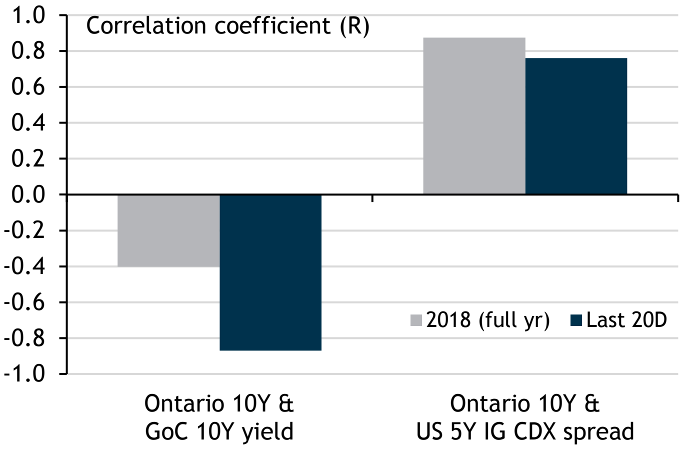
Chart 4: Credit punished during last growth scare

Ontario 10Y spread (end of month)

Source: NBF, Bloomberg | Note: Based on Ontario 10-year generic benchmark bond spread vs GoC, month-end levels

Chart 5: Keying on two provi spread drivers

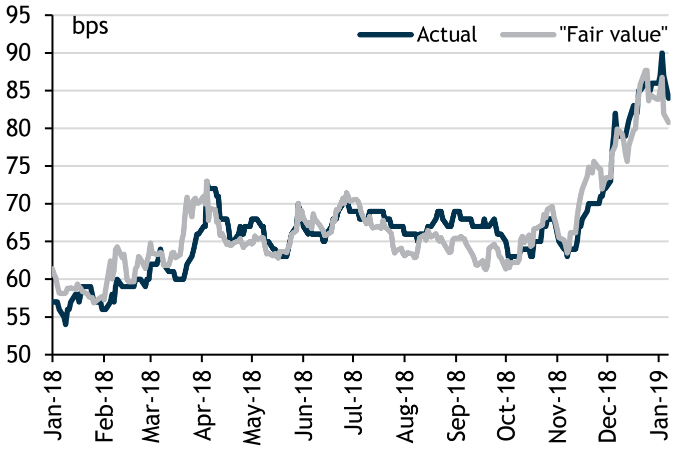
Correlation btw Ontario 10Y spread & GoC yields/US IG CDX



Source: NBF, Bloomberg | Note: Ontario 10-year refers to generic benchmark bond spread vs GoC

Chart 6: Provi spread widening overdone?

*Ontario 10Y spread & simplified "fair value" model**



Source: NBF, Bloomberg | Note: Simplified model based on GoC 10Y yield, US 5Y IG CDX, controlling for benchmark/series roll; daily data from 1-Jan-2018

FICC Strategy

Public Sector Debt
Warren Lovely
+1 416-869-8598 | Warren.Lovely@nbc.ca

Catherine Maltais
+1 514-879-2270 | Catherine.Maltais@nbc.ca

Taylor Schleich
+1 416-869-6480 | Taylor.Schleich@nbc.ca

Corporate Credit
Connor Sedgewick
+1 514-879-3182 | Connor.Sedgewick@nbc.ca

Pete Metzger
+1 416-869-8607 | Pete.Metzger@nbc.ca

Relative Value Models
Drew Lloyd
+44 (0)20-7488-9379 | Drew.Lloyd@nbc.ca

Important Disclosures

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.

Any opinions expressed herein reflect a trading perspective. NBF, or its affiliates may publish fundamental research on the subject issuer(s), which may reflect a different opinion. This Report is not produced by the NBF Research Department and has not been reviewed by the NBF Research Department.

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.

National Bank Financial Inc. or an affiliate thereof, owns or controls an equity interest in TMX Group Limited ("TMX Group") and has a nominee director serving on the TMX Group's board of directors. As such, each such investment dealer may be considered to have an economic interest in the listing of securities on any exchange owned or operated by TMX Group, including the Toronto Stock Exchange, the TSX Venture Exchange and the Alpha Exchange. No person or company is required to obtain products or services from TMX Group or its affiliates as a condition of any such dealer supplying or continuing to supply a product or service.

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 71 Fenchurch Street, London, EC3M 4HD.

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.