



Holiday party in Canadian public sector credit?

By Warren Lovely

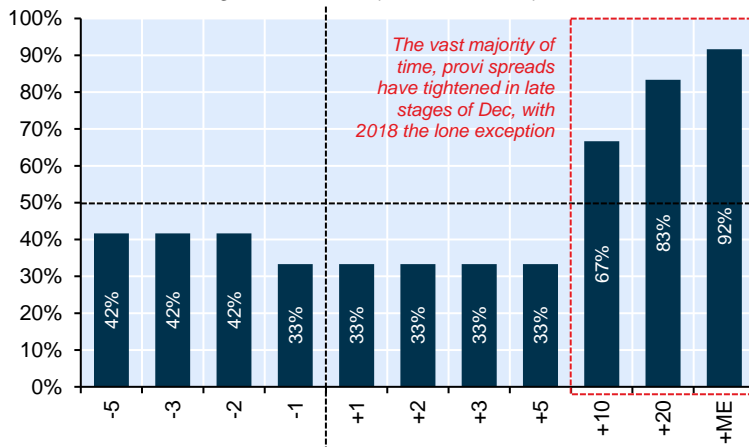
Is it too early to be thinking about holiday party season? Not if the 'holiday party' in question refers to the solid seasonal performance often registered in Canada's high-grade public sector credit markets into calendar year-end. Here we break down the typical traditional gift bestowed on provincial bondholders from multiple perspectives (some old, some new). Based purely on the empirical record, one might advise a degree of patience. With issuers traditionally steering new bond supply into the deep pools of cash that flow at the start of the month (and the related demand for duration), spread performance in/around December 1st has been something of a mixed bag in the post-GFC era. History shows spreads generally move sideways this time of year (on average). As new issue activity winds down, however, spreads often find notable traction in the thinner trading sessions characterizing the back half of December. With rate locking/paying often pushing swap spreads wider into year-end, the historical performance record is even more compelling on an asset swap basis. An examination of relative bond index total returns generally reinforces our narrative. As always, we advise caution when expressing seasonal views. As impressive as the late-December performance record has been, there will be much to control for in the days and weeks ahead... not least of which will be BoC and FOMC interest rate decisions, which could well alter the thinking on terminal rates and related pivot probabilities. So be careful this holiday season. Note: This *Market View* is an extension of our earlier analysis of December's chunky seasonal cash flows, including the following:

[Rain down on me: Canada's December bond market cash \(3-Nov\)](#) | [Simulating stuff \(4-Nov\)](#) | [December cash flows: Lucky number 13? \(14-Nov\)](#)

Happy holidays for provincial credit: The seasonal perspective on relative spreads, returns, supply

Chart 1: Success in provi credit tends to come late in year

12Y success rate for 'tighter' ONT 10Y spread vs GoC up to/after 1-Dec

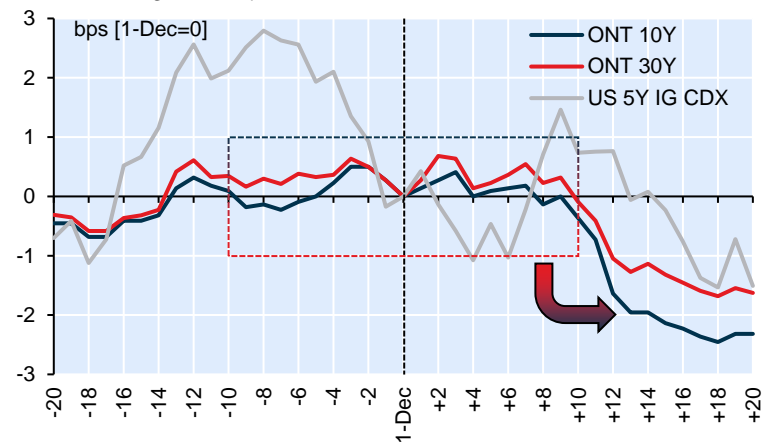


Source: NBF, BBG | Note: Based on chg in generic BM from 2010-21; +ME is to month end

Based on historical success rates, the track record for provi spreads isn't exactly stellar in/around Dec 1st. Often we've seen spreads come under a bit of pressure to start the month...

Chart 2: Visualizing the average/seasonal pattern in spreads

Cumulative chg in ONT spreads vs GoC & US IG CDX relative to 1-Dec

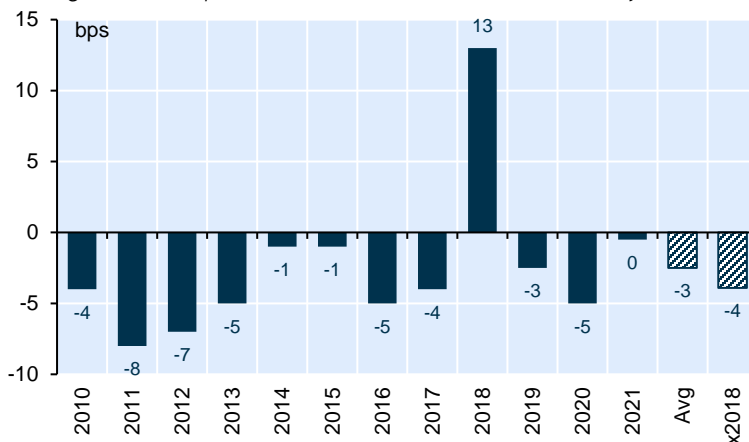


Source: NBF, BBG | Note: Based on avg chg in generic BM/index from 2010-21 (12Y)

... But the back half of Dec is another story, where provi spreads (vs Canadas) have chalked up an impressive track record (in the admittedly thin markets that characterize the holiday season).

Chart 3: 90% of time, spreads tighten in Dec (with 2018 an outlier)

Net chg in ONT 10Y spread vs GoC from 1-Dec to end of month/year

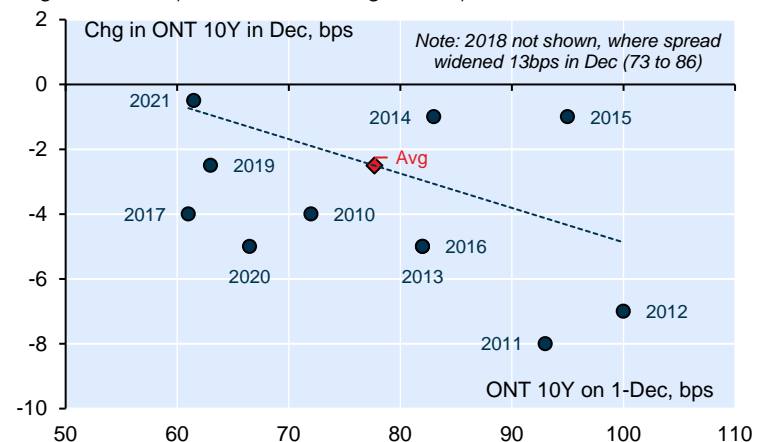


Source: NBF, BBG | Note: Based on net chg in generic BM from start to end of Dec

Looking at the net chg in provi spreads from the first of Dec to the end of the month, ONT 10s widened only once in the past dozen years. That was in 2018 as tighter policy was biting. Yikes.

Chart 4: Scale of Dec rally partly a function of starting spread

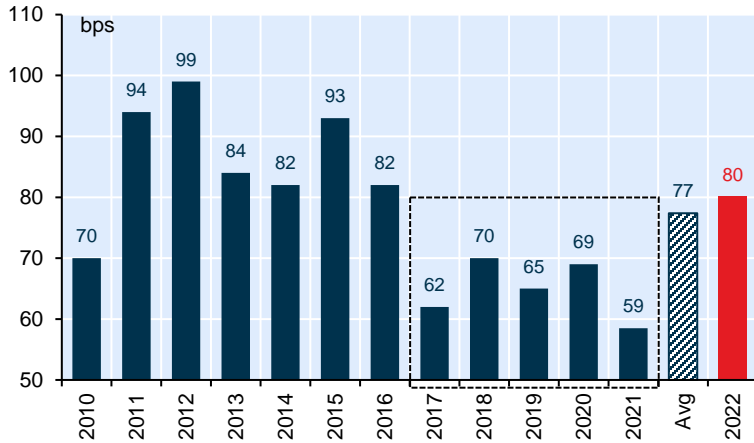
Chg in ONT 10Y spread vs GoC during Dec & spread level as at 1-Dec



Source: NBF, BBG | Note: Net chg & level for generic BM

There's some evidence that spread location influences the scope of the rally. This relationship isn't iron clad, however, with spreads having done alright even when starting from tight(er) levels.

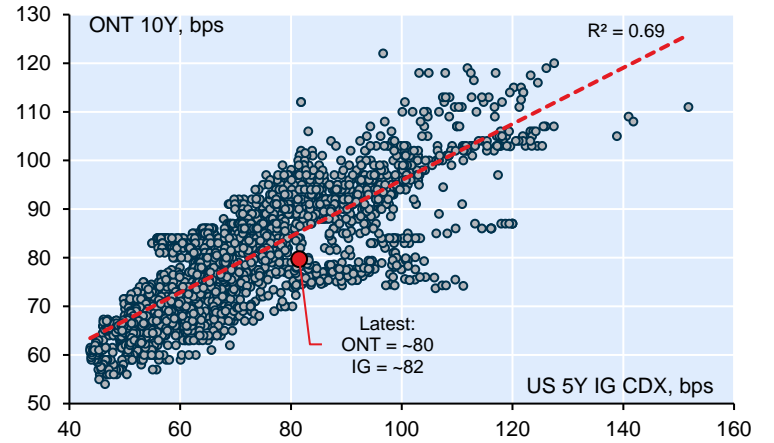
Chart 5: Spreads wider than in recent years (& yields higher too)
Current vs. historical ONT 10Y spread vs GoC in lead up to 1-Dec



Source: NBF, BBG | Note: Generic BM spread as at T-8 vs 1-Dec, which for 2022 is 21-Nov

At -80bps, ONT 10s are wider than the level prevailing in each of the 5 prior years. Meantime, 10Y provi yields, at -3.85%, have been massively recast vs. 2021 (2.15%) & 2020 (-1.45%).

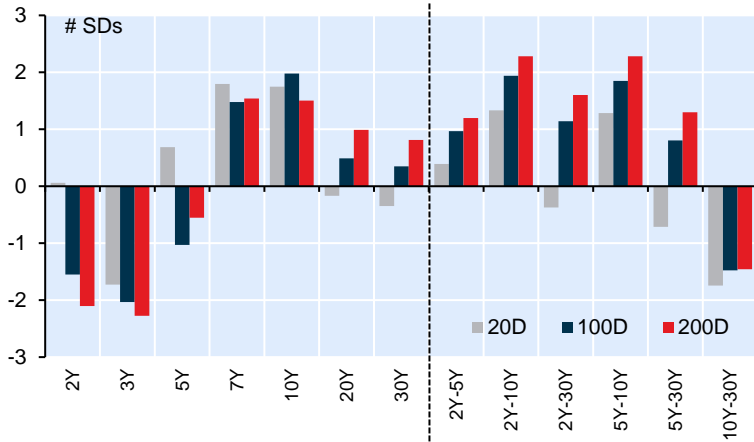
Chart 6: Provis may not look that cheap vs. corporates...
ONT 10Y spread vs GoC & US 5Y IG CDX (daily from Jan-2012)



Source: NBF, BBG | Note: Based on generic BM/index; >2800 obs; latest refers to 21-Nov

A simple RV screen vs US IG CDX notionally flags provi credit as modestly 'rich' relative to the typical level observed this time of year or the 'full monty' sample of 10+ years of daily levels.

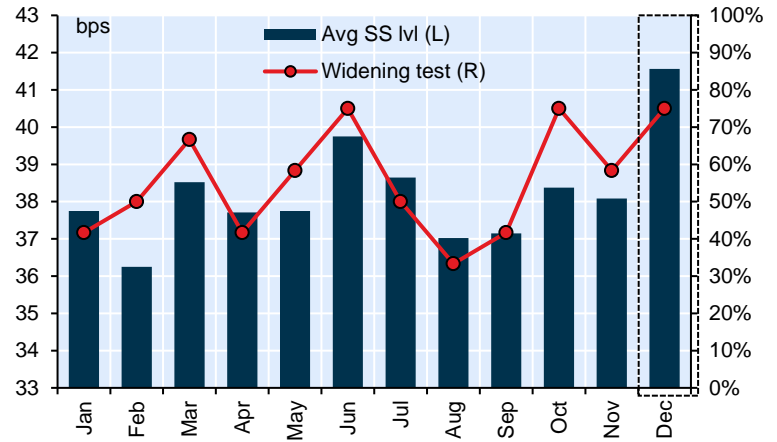
Chart 7: ... but 10Y spreads may offer value on the curve
Current Z-scores for ONT constant maturity spreads & credit curves



Source: NBF | Note: Based on constant maturity NI indications vs GoC curve as at 21-Nov

So low-beta provis may be a touch snug to corps & short-dated spreads are no bargain. Still, ONT 10s look more compelling on the curve, trading 1.5 to 2 SDs removed from recent averages.

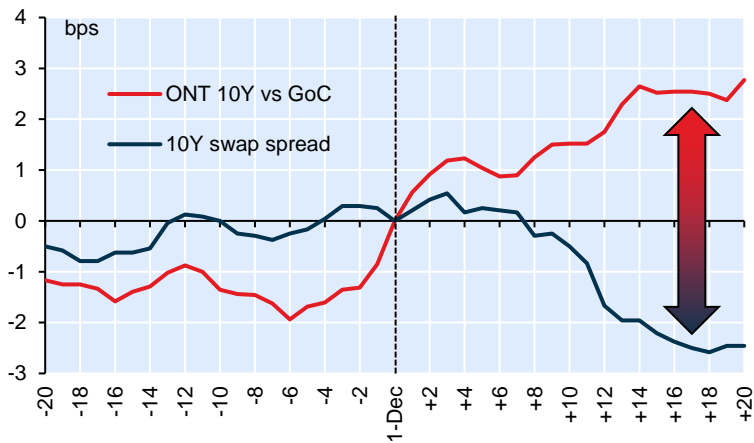
Chart 8: Valuations influenced by swap spread seasonals
Avg Cdn 10Y swap spread & share of time swap spread widened by month



Source: NBF, BBG | Note: Based on 12Y sample from 2010-21

When thinking about ASW levels, note the tendency for Cdn swap spreads to widen in Dec. We've seen this 75% of the time, partly reflecting rate-locking going into calendar year-end.

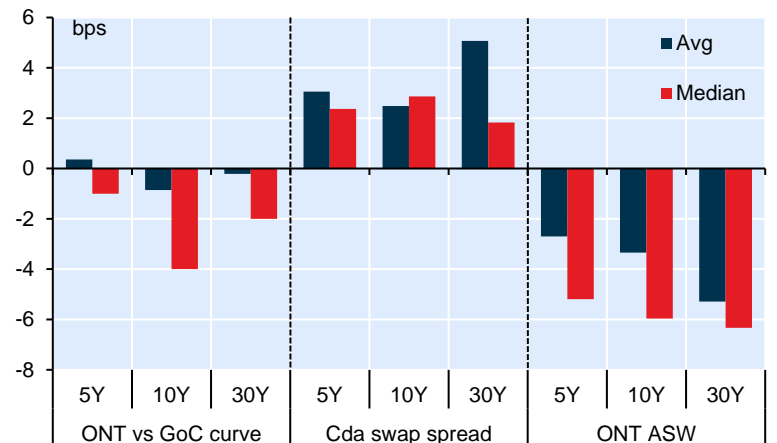
Chart 9: Given seasonal tendency in swaps...
Cumulative chg in ONT 10Y vs GoC & 10Y swap spread relative to 1-Dec



Source: NBF, BBG | Note: Based on avg chg in generic BM from 2010-21 (12Y)

Overall, the historical record shows fairly consistent performance of provis vs Canadas in the final days of the year alongside broad-based widening of swap spreads in Dec...

Chart 10: ... provincial ASW levels into year-end often striking
Net chg in ONT spread vs GoC & ASW basis from 1-Dec to end of month/year

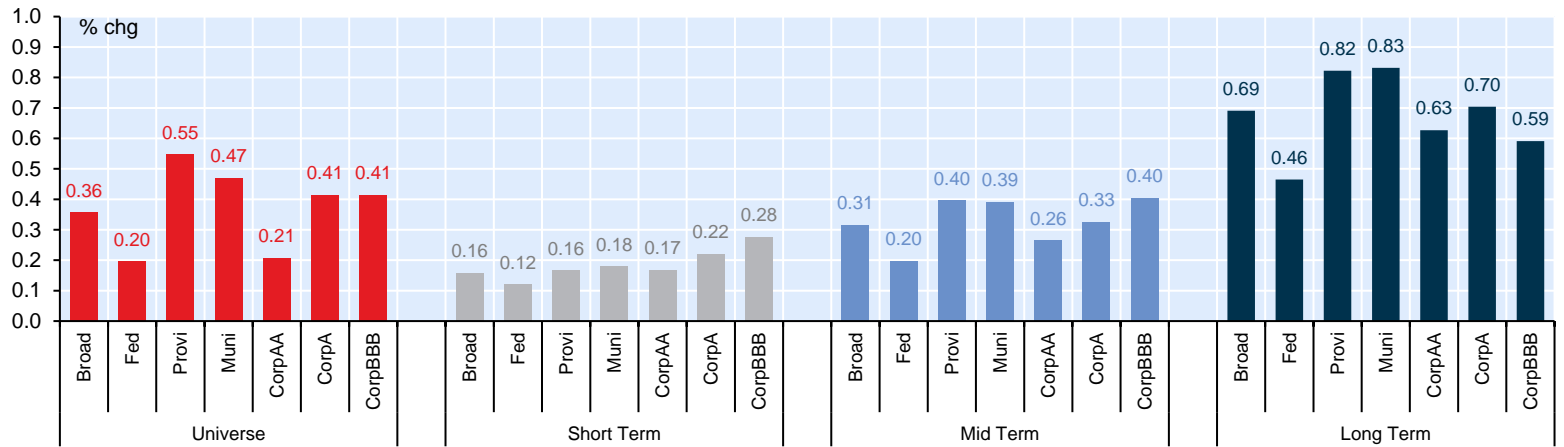


Source: NBF | Note: Based on avg chg in constant maturity indications from 2015-21 (7Y)

... The net result has been serious performance of provi credit on an ASW basis, the median Dec move -6 bps for ONT 10s based on a 7Y sample from 2015-21—nothing to sneeze at.

Chart 11: 'Provincial' sector of Canadian bond index tends to enjoy above-average returns in December

Average total return for FTSE Canada Universe Bond Index by bucket & select sector: December only (2010-21)

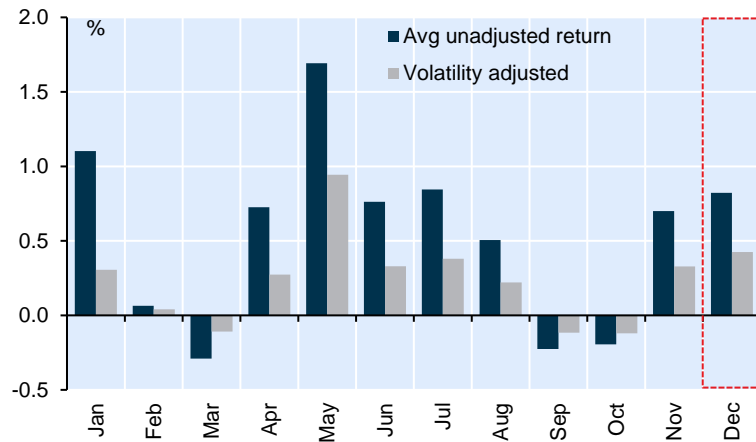


Source: NBF, FTSE Russell, BBG | Note: Based on unadjusted change in TR index from end of November to end of December; 12Y sample from 2010-21

Extend the analysis to total returns and you'll see provincials generally outperforming most other sectors of the Canadian bond market during December. This is evident in FTSE Canada Universe Bond Index and is equally apparent in the Long Term bucket. There's even more index cash arriving this December relative to prior years, which should key demand for duration, all else equal.

Chart 12: Dec generally a good month for long provis...

Avg total return of FTSE Canada Long Term Provincial index by month

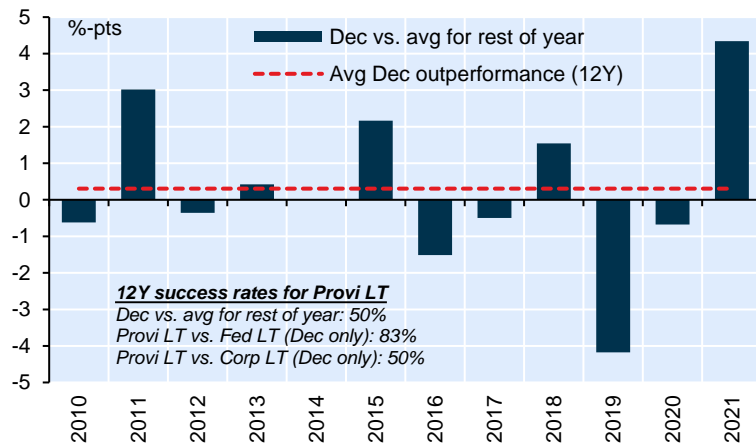


Source: NBF, FTSE Russell, BBG | Note: Based on 2010-21; vol adj divides by std dev

Based on simple, unadjusted returns, Dec might not be the very best month for long provi bonds. However, on a vol-adjusted basis, the average Dec gain trails only May in the post-GFC period.

Chart 14: Caution: Returns can be choppy year to year...

Relative return of FTSE Canada Long-Term Provi index: Dec vs rest of year

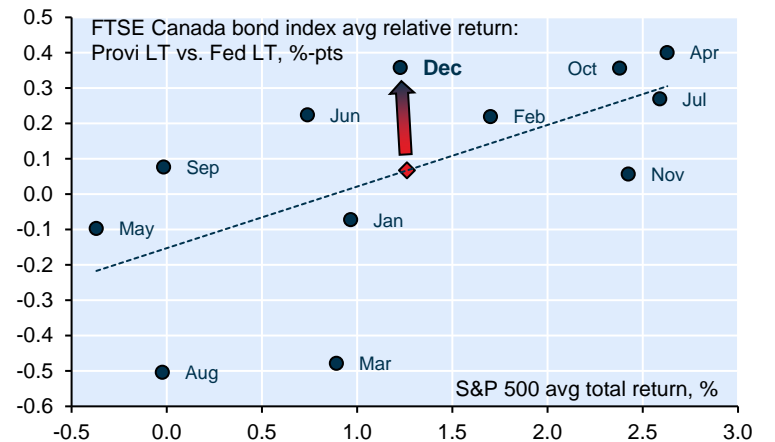


Source: NBF, FTSE Russell, BBG | Note: Based on Dec return vs avg for other 11M each yr

Caution: Bond market returns are hardly stable/steady, the FTSE Canada Universe Bond Index off nearly 12% YTD. Provi returns for the month of Dec, while +ve overall, aren't super consistent.

Chart 13: ... particularly once you control for average risk tone

Avg relative return of Long Term Provi index & S&P 500 total return by month

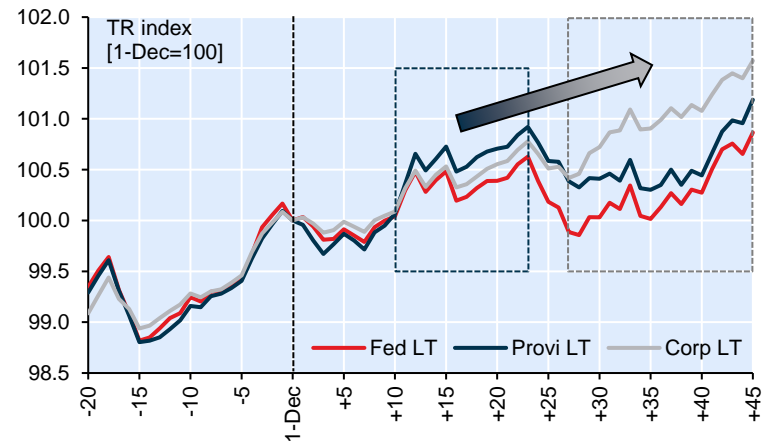


Source: NBF, FTSE Russell, BBG | Note: Based on avg returns from 2010-21

As for relative bond returns (e.g., LT provi vs LT federal), cash/coupon heavy Dec & Jun stand out positively after controlling for underlying risk sentiment (proxied here by US equity returns).

Chart 15: ... with leadership switching to corps in new year?

Evolution of total return of FTSE Canada Long Term indices relative to 1-Dec

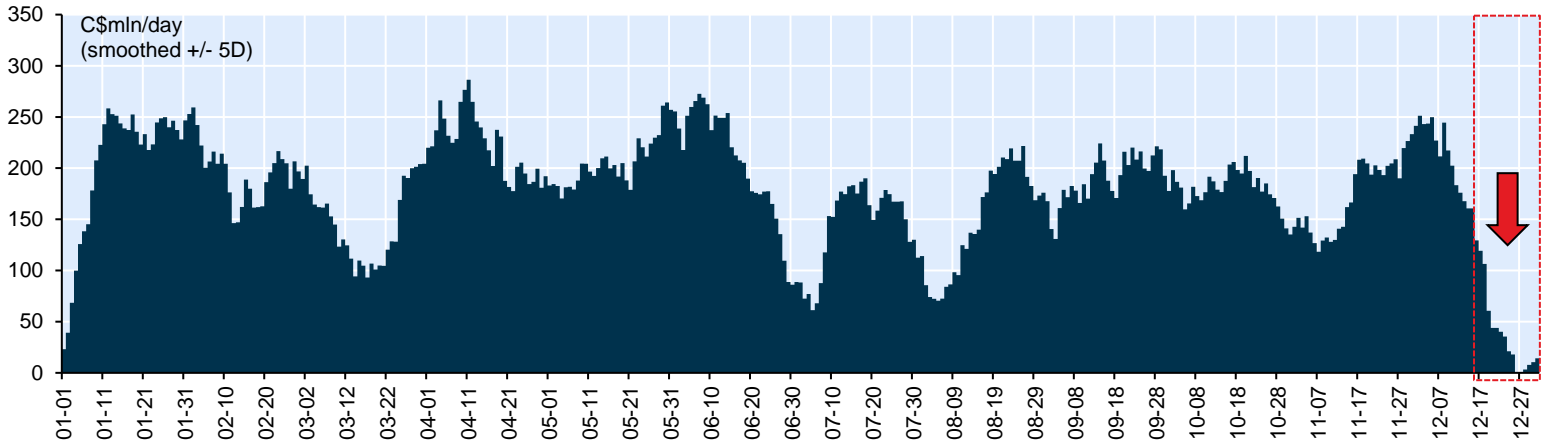


Source: NBF, FTSE Russell, BBG | Note: Based on avg TR index from 2010-21

In the past, credit market leadership often transitioned from provis late in the year to corps early in the new year. As it stands, the near-term outlook is clouded by policy rate uncertainty/anxiety.

Chart 16: Seasonal shut down in provincial supply in back half of December

Average daily CAD provincial bond supply (gross) over course of calendar year

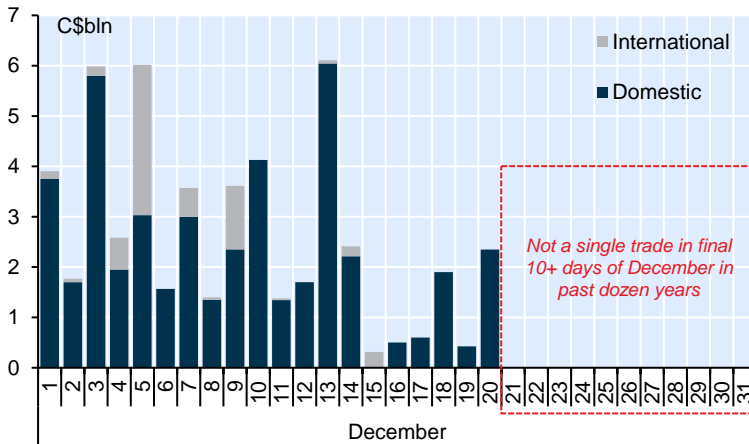


Source: NBF, BBG | Note: Domestic issuance only; smooths daily issuance by +/- 5D; based on marketable bond issuance from 2010-21

As noted, you can put some of the late-year performance of provincial credit down to a supply void. Provincial bond supply is seasonal by design. The clustering of budgets/financial reports and summer breaks influence primary activity. But no period is as quiet as the final two weeks of Dec, the temporary NI draught coinciding with tighter cash spreads and richer ASW valuations on average.

Chart 17: Generally nothing doing last 10+ days of year

Distribution of gross provincial bond issuance over course of December

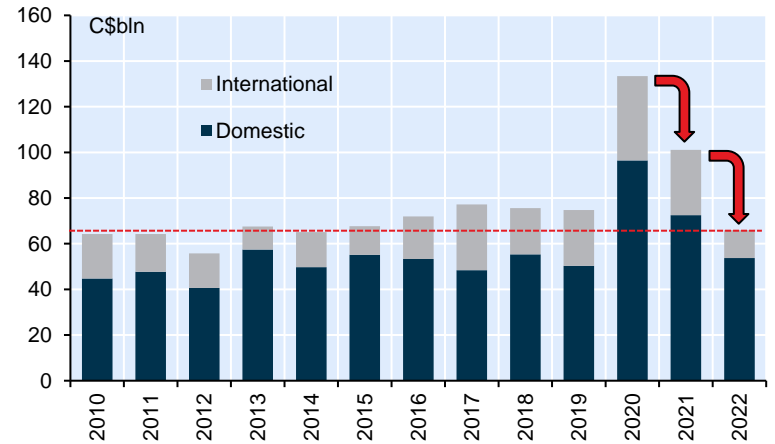


Source: NBF, BBG | Note: Distribution of C\$52bln of supply from 2010-21 by issue day

We often see healthy provi bond supply in the first half of Dec as piles of cash are put to work. But in the post-GFC era, you won't find a single marketable bond deal after the 20th month.

Chart 18: Provi supply has stepped down big time

Gross provincial bond issuance: YTD basis

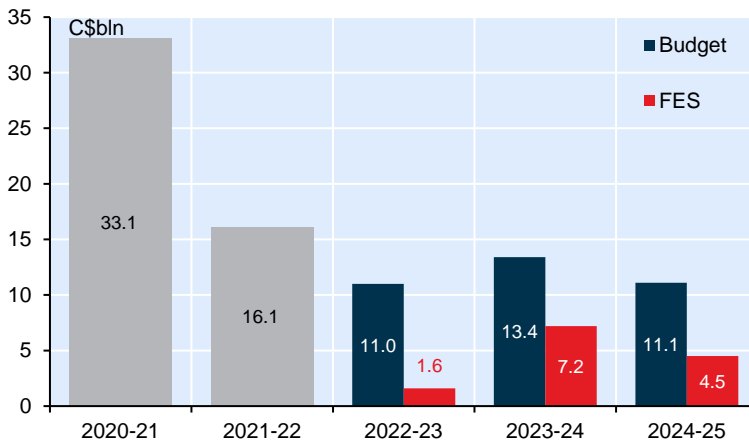


Source: NBF, BBG | Note: YTD refers to Jan-Oct period

Despite economic risks, the near-term supply outlook is hardly scary. Rather, fiscal upgrades have slashed cash requirements, with YTD issuance back to (if not below) the pre-virus trend.

Chart 19: After maturities, little net borrowing to do

Ontario net long-term borrowing (i.e., after maturities/redemptions)



Source: NBF, Ontario | Note: Gross long-term issuance less maturities/redemptions

After maturities, net provincial issuance has crashed lower & should remain contained in 2023. That's a constructive development given the BoC is (passively) running off its balance sheet.

Box: Plenty of near-term wild cards/events to keep in mind

Select events/releases going into & coming out of December 1st

In addition to the outsized Canadian bond market cash due to arrive on December 1st, 2nd, 15th & 18th there will be no shortage of items/reports/developments to keep investors on their toes. Here's a sampling, which should serve as a caution that 'all else is not necessarily equal':

- Nov-Dec: Mid-year provincial fiscal updates (specific dates vary)
- 29-Nov: Canada GDP report (Q3)
- 30-Nov: Fed Chair Jerome Powell speech
- 1-Dec: US PCE inflation (October)
- 2-Dec: US & Canada jobs reports (November)
- 7-Dec: BoC rate decision
- 8-Dec: BoC Deputy Governor Sharon Kozicki speech
- 12-Dec: BoC Governor Tiff Macklem 'fireside chat'
- 13-Dec: US CPI report (November)
- 14-Dec: Fed rate decision & updated Summary of Economic Projections
- 15-Dec: ECB rate decision
- 15-Dec: BoE rate decision
- 21-Dec: Canada CPI report (November)



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