Market View
Economics and Strategy
NATIONAL BANK OF CANADA FINANCIAL MARKETS

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A not-so-unhappy anniversary in some corners of credit market

By Warren Lovely

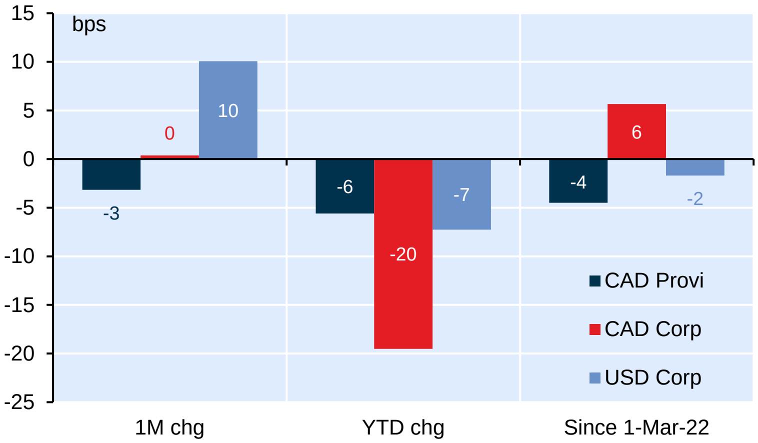
Note: This Market View focuses on relative value in credit markets, leveraging analysis from NBF's corporate credit strategist, the intrepid Piper Kerr. Piper provides regular credit market insights & commentary. Contact NBF to be added to her dedicated distribution list.

What were you doing a year ago? Well, if you were an active participant in Canadian debt capital markets, chances are you were digesting the first of what would go on to be eight Bank of Canada interest rate hikes. Reminder: The BoC kicked things off on March 2nd, 2022 with a 25 bp-er and has to-date jacked the policy rate by a sum total of 425 bps—massively outgunning, in pace and magnitude, prior BoC tightening episodes. Of course, it didn't take long for the FOMC to join the fray, Powell & Co. ushering in their own first hike two weeks later (on March 16th).

In a sense then, central bankers have turned our financial world upside down in the past year. Reflecting on this (un)happy occasion—the onset of tightening—it appears that some sectors of North American credit markets have fared better than others under the strain of higher policy interest rates. Perspective, as they say, is everything. One can often cherry pick a sample to support a given bias but to be clear, we're not trying to choose an arbitrary reference period. Moreover, for major components of North American credit markets—provincials and Canada/U.S. investment-grade corporates—performance has ebbed and flowed in the last year. But looking back to where things stood immediately prior to the inaugural BoC hike, it's 'advantage provis'. Indeed, the Bloomberg Canada aggregate provincial bond index spread, at 66 bps, is setting new lows. Not so for IG corporates, where spreads are 5-10% above the past year's tights on either side of the border.

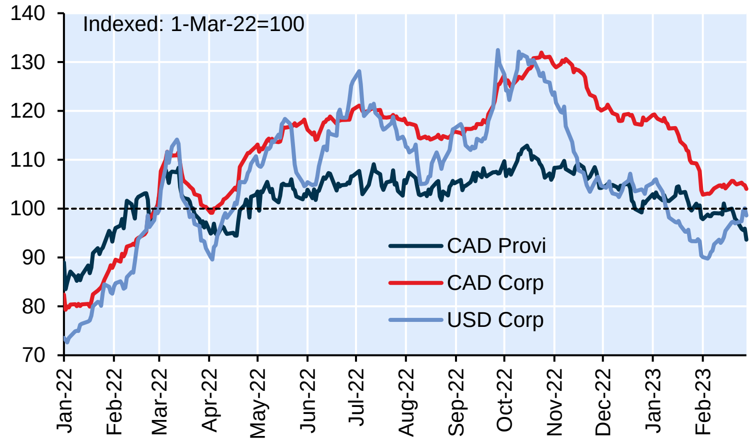
To us, there are any number of ways to illustrate the relative outperformance of provincials vs. Canadian or U.S. corporates. Check out Charts 3-6 for instance. For one reason or another, be it their lower-beta/more defensive nature, relatively solid liquidity profile, demonstrated fiscal traction, limited net bond supply—provincials have found some relative favour with credit investors. Can't say that we necessarily blame them. Sure, at today's tight(ish) spreads, any simplistic RV screen will tend to flag provincials as 'rich'. But in an environment of increasingly strained earnings growth and rising probability of default, with QT programs draining liquidity, we like the ability of provincials to sustain outperformance.

Chart 1: In credit (as elsewhere) perspective is everything
Net change in spread for major bond index aggregates over select periods



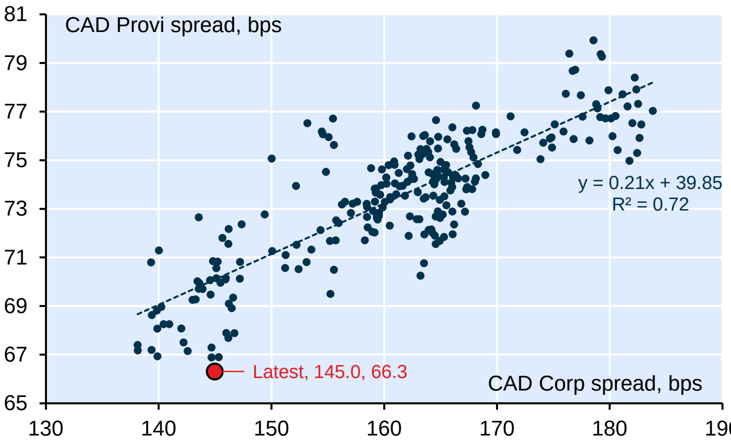
Source: NBF, Bloomberg | Note: Change measured up to 2-Mar-23 closing levels

Chart 2: Fallout relatively limited for lower-beta provincials
Evolution of spread for major bond index aggregates (scaled to 1-Mar-22)



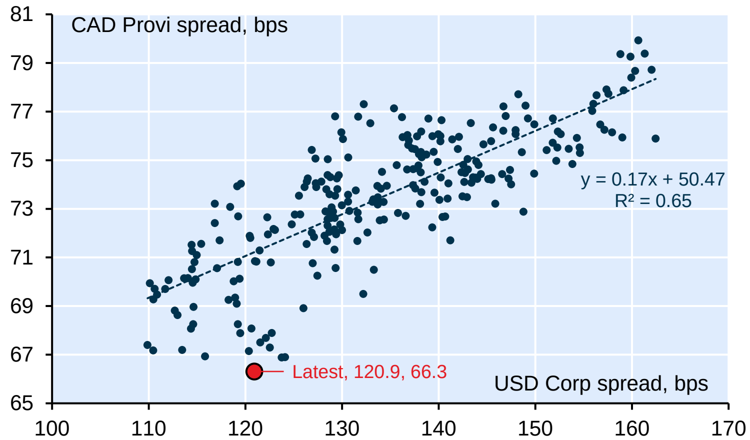
Source: NBF, Bloomberg | Note: Scaled to 1-Mar-22 to gauge proportionate change

Chart 3: Provis have demonstrated worth vs. Cdn corps...
CAD provincial index spread vs. CAD IG corporate spread: Since 1-Mar-22



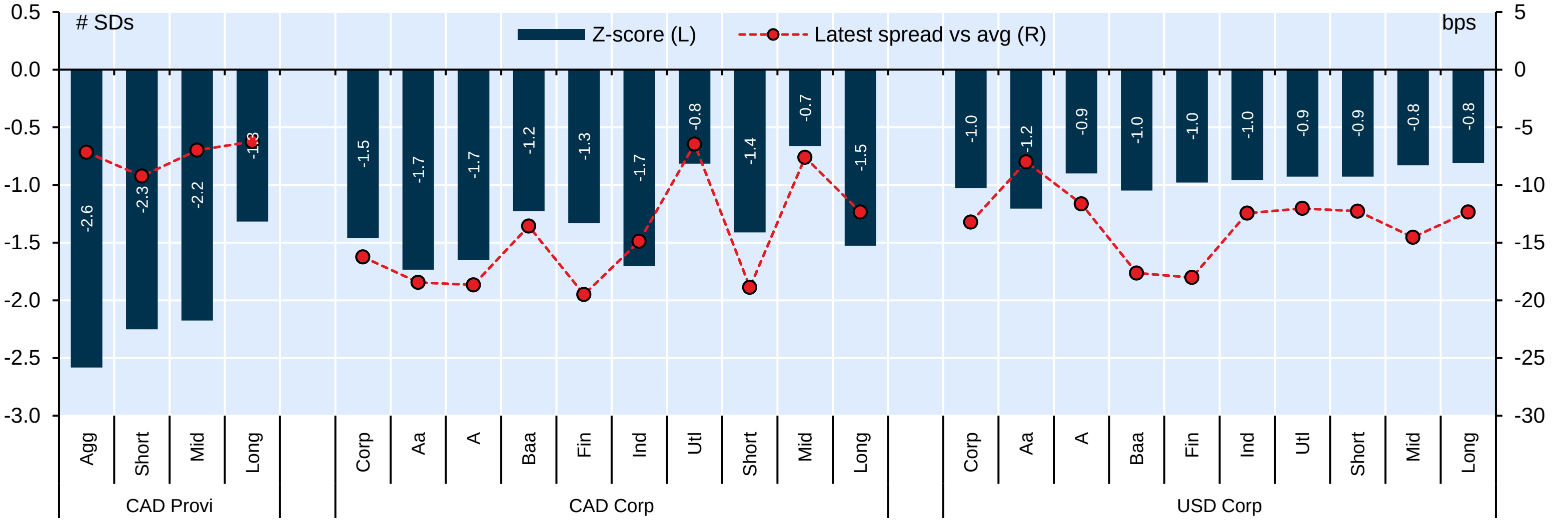
Source: NBF, Bloomberg | Note: Latest refers to 2-Mar-23 closing levels

Chart 4: ... and have also outperformed US corps of late
CAD provincial index spread vs. USD IG corporate spread: Since 1-Mar-22



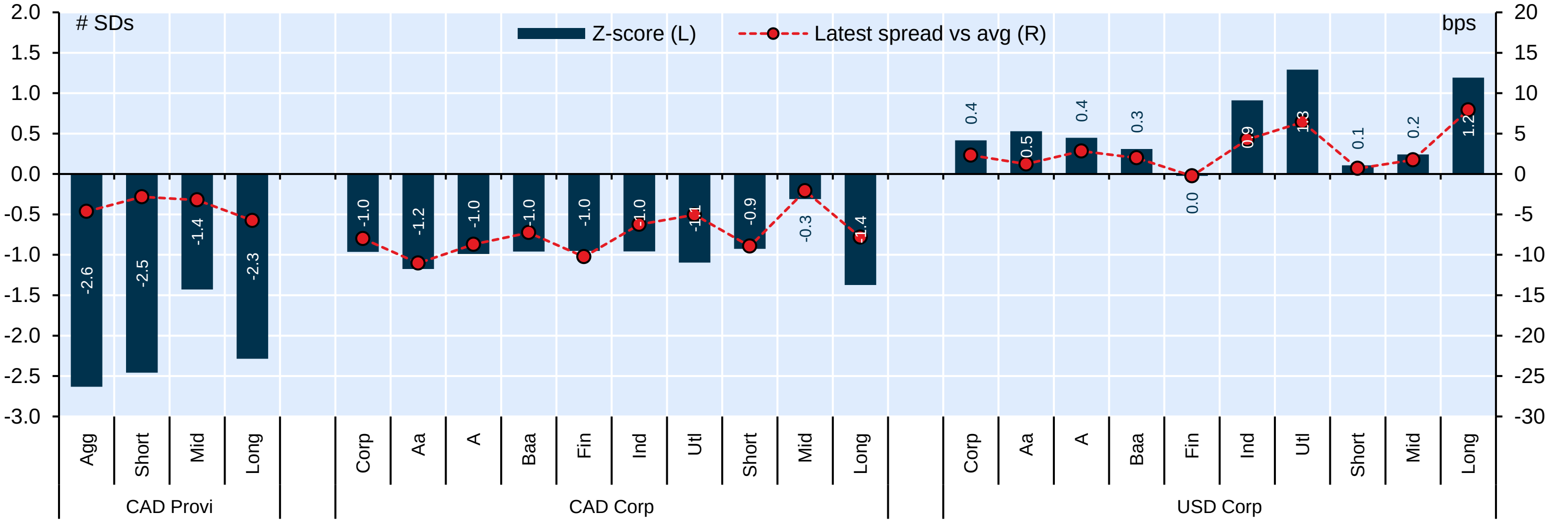
Source: NBF, Bloomberg | Note: Latest refers to 2-Mar-23 closing levels

Chart 5: The 1-year perspective on North American credit markets (i.e., focusing on performance since first BoC hike)
Bloomberg bond index spread deviation from period average & Z-score | Focal period [A]: Since first BoC hike | 1-Mar-2022 to 2-Mar-2023



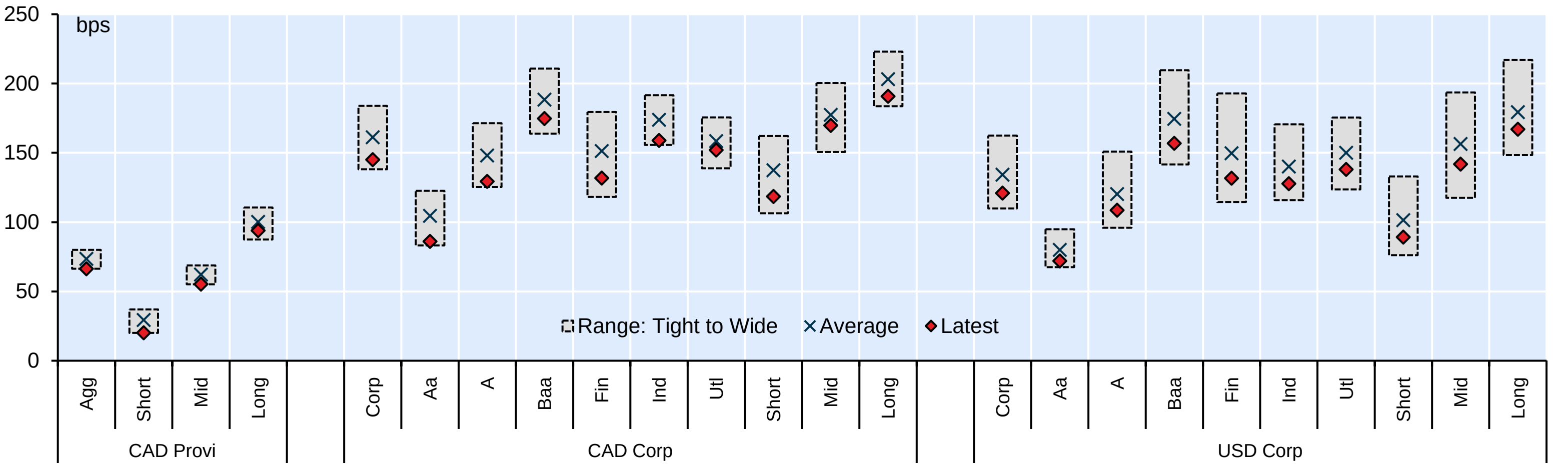
Source: NBF, Bloomberg | Note: Z-score calculated as: (Latest – Mean) / Standard Deviation; latest refers to 2-Mar-23 closing levels; total sample of 251 trading days

Chart 6: Provincial outperformance on display on YTD basis too, when you control for relative volatility (e.g., via Z-score)
Bloomberg bond index spread deviation from period average & Z-score | Focal period [B]: 2023:YTD | 30-Dec-2022 to 2-Mar-2023



Source: NBF, Bloomberg | Note: Z-score calculated as: (Latest – Mean) / Standard Deviation; latest refers to 2-Mar-23 closing levels; total sample of 42 trading days

Chart 7: Another perspective on bond index spreads since the BoC got rolling (on rate hikes) one year ago
Bloomberg bond index spread: Latest vs. period average/range | Focal period [A]: Since first BoC hike | 1-Mar-2022 to 2-Mar-2023



Source: NBF, Bloomberg | Note: Latest refers to 2-Mar-23 closing levels; total sample of 251 trading days

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, CFA
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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