RATES STRATEGY

CIBC FICC Strategy
March 23, 2021

Message Received, Loud & Clear

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Bank of Canada Deputy Governor Gravelle spoke today, providing the clearest insight to-date as to the future intentions of the Banks unconventional monetary policy programs. In the event, the Bank announced the cessation to programs it deems 'market functioning' facilities, as well as 'hinting' that a reduction of bond purchase from the Government Bond Purchase Program (GBPP) is likely, very soon – which we think occurs at the April confab.

Parting Ways

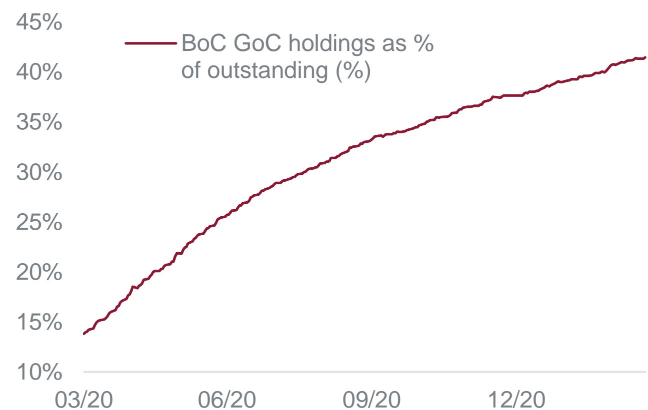
In terms of what was announced, today the Bank confirmed that the Corporate Bond Purchase Program (CBPP) and the Provincial Bond Purchase Program (PBPP) will expire as per their originally announced end dates (April 2nd for the CBPP and May 7th for the PBPP). Recall, both programs were introduced in the spring of 2020 and were meant to be active for a term of 12m. This should come as no surprise to market participants. As of Friday, the Bank owned some C$18.2bn of provincial paper and just C$185.0mn of corporate credit.

To the degree that this action was largely expected, there should be minimal impact, particularly for corporates. For both programs, the CBPP & the PBPP, it is important to note that the Bank has no – near term – intention of selling its stock of holdings.

But for provincials, the secondary impact that has a potential market influence will come from any reallocation of issuance to the back-end of the curve. Remember that the Bank did not purchase provincials in excess of 10yrs. And, unsurprisingly, since the start of the PBPP we have seen a reduction in the average weighted duration of issuance. To that end, it is possible that we see the average term of provincial issuance extend out the curve and thus exert some steepening pressure to the credit boxes.

In addition, the Bank also informed market participants that it would be halting the bi-weekly Term Repo operations effective May 10th. Again, this should not come as any surprise to market participants given the limited usage of operations seen since last summer. While this facility was crucial in providing liquidity at the start of the pandemic, the growth in excess settlement balances, as well as the growth in system-wide deposits, means little demand for term funding. This was already slightly suggested by the fact the current term repo maturities have not been rolled over.

Figure 1: It is time to 'right size' the QE program



Source: Bank of Canada, Bloomberg, CIBC Capital Markets

Lastly, the Contingent Term Repo Facility (CTRF) will be deactivated effective April 6th. Similar to the CBPP and the PBPP, this facility was also scheduled to run for a period of 12m, so no surprise in this regard either. As a refresh, the CTRF was a program designed to provide CAD funding, 1m term, on a standing, bilateral basis against securities issued or guaranteed by both federal and provincial governments.

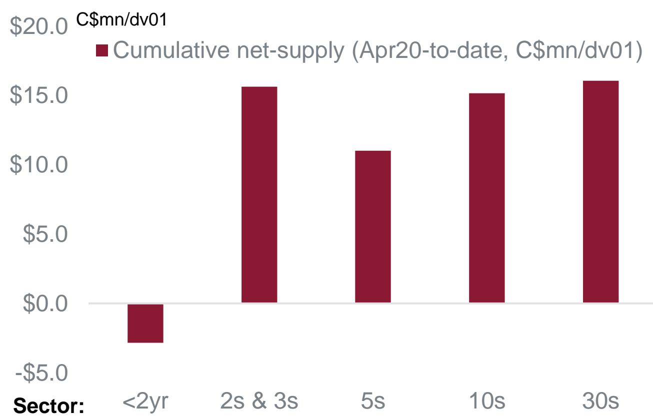
All of these announcements reflect the fact that market functioning has improved markedly from the time these facilities were introduced until today. It is also crucial to recognize the Bank had not viewed these programs to be stimulative in nature, rather they provided a backstop to ensure the system remained liquid and operational.

The Real Juice

Aside from these largely 'operational' announcements, Deputy Governor Gravelle suggested what the future path of Canadian QE could look like. Currently, the balance sheet is amidst its largest period of shrinkage, reflecting the nearly C$120.0bn of term repos that will mature over the subsequent month. This will reduce the size of the Banks balance sheet from its current C$575.0bn level.

As time progresses and, the recovery gains strength, the Bank will be in a position to further reduce the pace of purchases. That was the messaging coming out of both the January and March meetings, and was reiterated today.

Figure 2: Net-supply footprints



Source: Bank of Canada, Bloomberg, CIBC Capital Markets

Indeed, Deputy Governor Gravelle noted that the Bank has seen two consecutive inter-meeting periods of positive surprises, and that a new projection will be released in April. At the same time, he stressed that a reduction in purchases does not mean a reduction of stimulus. We agree with that assertion, as it simply means the 'stock' of holdings is more important than the 'flow' of purchases. That is broadly consistent with most academic literature about the impact that large central bank balance sheets have on the economy. The message is very clear – the Bank wants to "be easing off the accelerator, not hitting the brakes".

And as purchases continue, they will be done so in 'net' terms. Meaning that, until the "recovery is well underway", GBPP purchases will be conducted in such a way as to ensure whatever is purchased exceeds what is maturing. We have done the math, and that means a breakeven pace of purchases of C$2.0bn/w in 2021.

Our Expectations

That breakeven math means we'll get the first taper soon, which we believe will occur in April. As highlighted in our Weekly Curve publication from two-weeks ago, we expect a C$1.0bn/w reduction, from C$4.0bn/w to C$3.0bn/w, largely facilitated from lower 2yr & 3yr sector purchases.

We look for the second taper, worth another C$1.0bn/w, to occur sometime in Q4-21. After that, we look for a complete cessation of new purchases sometime in H1-22, with a move to reinvestment only (i.e. the Bank will reinvest its maturities and coupon payments across the curve).

Technical in nature

The reason why this signal, and eventual taper, won't have a huge impact on the level of CAD yields is twofold. First, the selloff has been so rapid that any likely reaction was always going to be more benign; there is simply less to reprice, especially with term premia in the long-end now positive. Second, the Bank reiterated today that this is largely a technical consideration with 'some' semblance of policy adjustment.

That reflects the size of the program, which is too large relative to the market it is trying to serve. Indeed, Deputy Governor Gravelle noted that while the Bank's balance-sheet as a proportion of GDP is lower than most, its outright holdings as a proportion of the bond market is the largest.

For context, today the Bank owns 41.4% of the outstanding GoC market. Left unchanged, the pace of purchases (assuming current deficit figures are 'about right') would ensure the Bank owned nearly 60.0% of the market by the end of FY21/22. That is a level of proportional ownership that portends real risks to the market, both through impaired liquidity and a loss of bond market signalling.

Trading the Taper

Given our view on 'how' the taper will be conducted, the purest opportunities are those that take direct advantage of the distortions created by QE.

For example, confirmation that the PBPP is being retired together with a reduction of purchases should begin to pressure seasoned June-dated bonds between 3yrs-to-5yrs. We like selling these bonds versus matched-maturity OIS. The recent SLR announcement in the Untied States portends a meaningful year-end premium in 2021, which exacerbates the scope of the Northbound arb (with 3m FX-OIS currently sitting at -21.0bps).

Additionally, given that most of the taper will be facilitated through the front-end, we expected cash to underperform swaps, particularly for issues like the Mar24s and Apr24s. Currently, we own Mar26s versus Feb23s against a 2s5s steepener in the U.S.; today's developments should further sponsor this position.

Without Budget 2021, we have no visibility as to the borrowing plans for the federal government. So while we see very little of the C$1.0bn reduction coming from 5s-to-30s, there will be some impact on these sectors. This complicates net-supply estimates, meaning for now

we do not have a strong view on how the taper interacts with the curve, though we are biased to expect a flatter term structure over the coming months even with 5yrs nearly ‘fully priced’. As discussed on Monday, the path of repo priced into the OIS forwards pegs 5yr fair-value closer to 1.15% at present.

Bottom Line

The Bank of Canada is seeing enough progress in the economy that it feels it can begin reducing outdated programs, as well as slowly begin to remove some of the considerable stimulus in the system. There should not be too much impact from the cessation of select market functioning facilities directly.

The bigger news today is the strongest signal yet that the Bank is ready to conduct a taper, and begin ‘right sizing’ the QE program. This is also the first time we have been shown what the future sequencing looks like, which is: i) taper to a net-zero purchase profile; ii) enter a reinvestment phase, and; iii) normalize rates.

The best trades to take advantage of this are micro in nature, though also put ‘bigger’ macro trades like receiving 2yr-to-4yr forwards versus the U.S. at risk.

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