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Carney Turns Off Liquidity as Fed Embarks on QE2: Canada Credit
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By Greg Quinn

Nov. 2 (Bloomberg) -- Governor Mark Carney is closing the door on liquidity programs the Bank of Canada started during the credit crisis, just as the Federal Reserve may expand asset purchases to sustain the U.S. economic recovery.

Canada's central bank will reduce the relative amount of bonds available to securities dealers at government auctions, reversing steps it took in 2008 and 2009 that aimed to increase market liquidity. All 18 primary dealers that trade with the Fed forecast officials will announce a resumption of U.S. Treasury purchases though so-called quantitative easing when a two-day policy meeting ends tomorrow.

Bond prices may rise in Canada as there will be less supply for private investors to buy, said Michael Gregory, senior economist at Bank of Montreal in Toronto. Demand for Canadian bonds is rising this year, with record purchases by foreign investors on signs the country will eliminate its budget deficit before other Group of Seven nations.

"The auctions may become a little bit tighter because the bank's taking down a little bit more," said Gregory. The Bank of Canada announcement "has some impact in that it's a slightly larger share."

The bank will auction C$3.5 billion ($3.45 billion) of bonds maturing June 1, 2016, tomorrow and keep a minimum of C$525 million, or 15 percent, of the bonds on its books. The bank had cut its participation in government bond auctions to as little at 5 percent, as part of an effort to offset assets added to its balance sheet when it supported liquidity through temporary purchases of other securities from bond dealers.

'Interesting Contrast'

"It is an interesting contrast," between Canada and the U.S., said Eric Lascelles, chief economics and rates strategist at Toronto-Dominion Bank in Toronto. "At the margin it would send yields a little lower" in Canada, he said.

Elsewhere in credit markets, Canadian government yields ended yesterday at 2.24 percent, up from 2.23 percent Oct. 29, according to Bank of America Merrill Lynch data. The Merrill index has generated a return of 7.3 percent so far this year, compared with 8.59 percent for U.S. Treasuries.

Canadian 10-year bonds yielded 21 basis points more than their U.S. counterparts yesterday, down from a high for the year of 39 basis points on April 2.

The extra yield investors demand to hold the debt of Canada's corporations instead of its federal government rose to 143 basis points, or 1.43 percentage points, from 1.42 percentage points on Oct. 29. So-called spreads were as tight this year as 114 basis points in March, then widened out to as much as 154 basis points in June on concern over European sovereign debt.

Financement Quebec

In provincial bond markets, relative yields were little changed at 53 basis points yesterday from last week.

Financement Quebec, which seeks loans on behalf of schools, universities and hospitals, added C$100 million to its bonds due in June 2016, with a floating-rate coupon set quarterly at 27 basis points greater than the Canadian Dealer Offered Rate known as CDOR.

Statistics Canada on Nov. 5 will probably report that employment rose by 15,000 in October and the jobless rate was unchanged at 8 percent, according to the median of 16 economists surveyed by Bloomberg News.

The Bank of Canada's announcement last week is proof that Canada's won't mimic any U.S. action in the bond market, said David Watt, a senior foreign exchange strategist at Royal Bank of Canada's RBC Capital Markets unit in Toronto. "Without the announcement, chatter about stealth easing would likely blossom," he said.

Market Neutrality

The change allows the Bank of Canada to resume a goal of neutrality in the bond market, where its holdings of treasury bills and bonds mirror the relative weight of each security in the market. That policy was upset in 2008 during the credit squeeze when the bank sold some of its treasury-bill holdings while making temporary purchases of securities from bond dealers. The bank then cut its percentage of bond purchases to match the reduction of treasury bills.

The bank's announcement means "you have a bigger buyer.
The question is, does that take other buyers out of the market by creating a richness in the sector" compared with other terms, said Benoit Lalonde, vice president of fixed income at Laurentian Bank of Canada in Montreal.

In making the announcement last week, the bank said " this change is for balance-sheet purposes only and has no implications for monetary policy."

The Fed will probably begin a new round of unconventional monetary easing by announcing a plan to buy at least $500 billion of long-term securities, according to economists surveyed by Bloomberg News. In contrast, the Bank of Canada's entire balance sheet was C$58.2 billion on Oct. 27, down from
C$75.2 billion a year earlier, central bank data show.

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