Market View
Economics and Strategy

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

September 23, 2022 - (Vol. VI, No. 71)

Funding fables

By Warren Lovely & Taylor Schleich

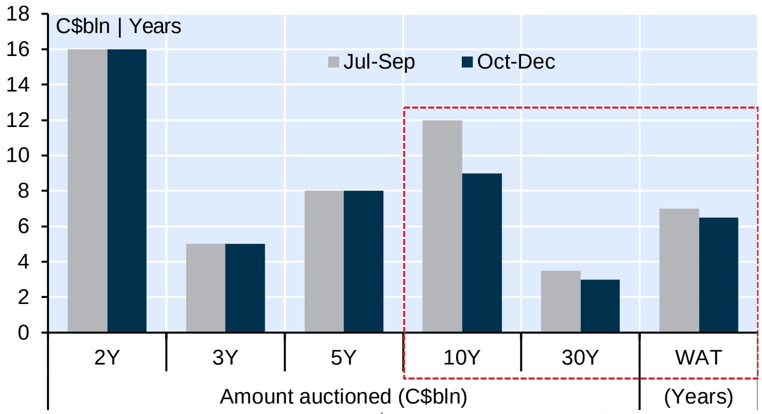
The U.K. offered something of a cautionary tale Friday, as fresh and significantly expansive budgetary measures were seen as complicating efforts by the Bank of England to wrestle inflation under control. At this point in the cycle, with labour markets tight and inflation elevated, marginal fiscal stimulus (and the bonds required to fund it) could require extra rate hikes… extending or accelerating an already violent monetary tightening episode. If the recent U.K. experience highlights the perceived danger of marginal fiscal stimulus, Canada has—at least until now—shown the opposite can hold. For in Canada, observed budgetary consolidation (and the corresponding drop off in net bond supply) may not dramatically alter the near-term inflation outlook, but provides a technical impetus to rate re-pricing all the same.

Consider Canada's fresh Quarterly Bond Schedule. For the October to December quarter, we'll get 13 nominal bond operations. Based on prevailing auction sizes, that could translate into $41 billion of gross supply. Net off the $37 billion maturing in November and the sovereign bond stock will edge up just $4 billion in the final quarter of 2022. Above-plan revenue means the GoC bond stock hasn't seen any growth since July, with extra cash likewise steered to the T-bill market (where outstandings are well below target).

The weighted average term (WAT) of GoC bond supply has eased from the levels that characterized the 'peak term out' period (close to 10-year WAT this time last year). But with a roughly 6.5-7.0-year WAT today, issuance will still be comfortably longer than the ultra short-term strategy that prevailed pre-COVID (5-year WAT). Going forward, we may see some stabilization in the average term of funding. While deeply inverted curves make long-end issuance relatively attractive, there remains a need for deep liquid benchmarks in core tenors down the curve.

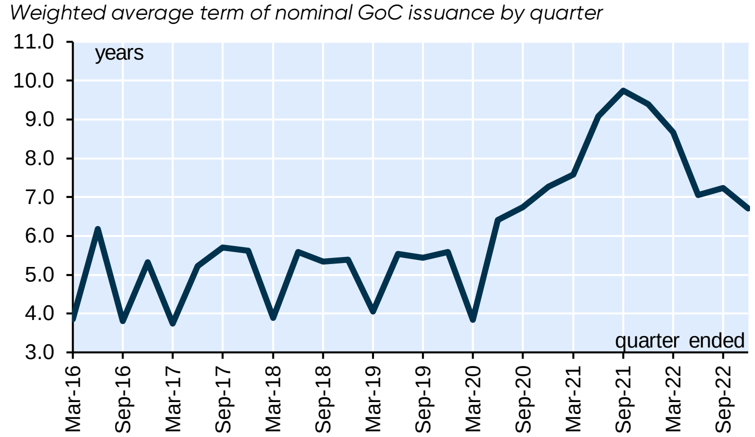
Bond supply dynamics are hardly the only thing driving curves or cross-market levels, but the drop-off in net bond issuance (at the federal and provincial levels of government) has, at the margin, made BoC QT more manageable and eased supply anxiety out the curve (with XLs nuked and the regular GoC program shortening up). That in turn has supported a flatter curve and cross-market outperformance. The trick of course, will be staying the budgetary course. Some may find it tough to be austere (or less-than-stimulative) given the size of the revenue bonanza. Meantime, politicians know well that many Canadians are strained by elevated inflation. But the U.K. perhaps provides an example of how markets might react to serious fiscal stimulus (far beyond Trudeau's recently proposed $4.5 billion inflation relief package). For a stressed-out bond market, the tolerance for incremental fiscal generosity appears limited. How our politicians react to this warning remains to be seen.

Chart 1: More downward duration adjustments in new QBS…
Actual/projected gross GoC issuance & weighted average term: Q3 vs. Q4



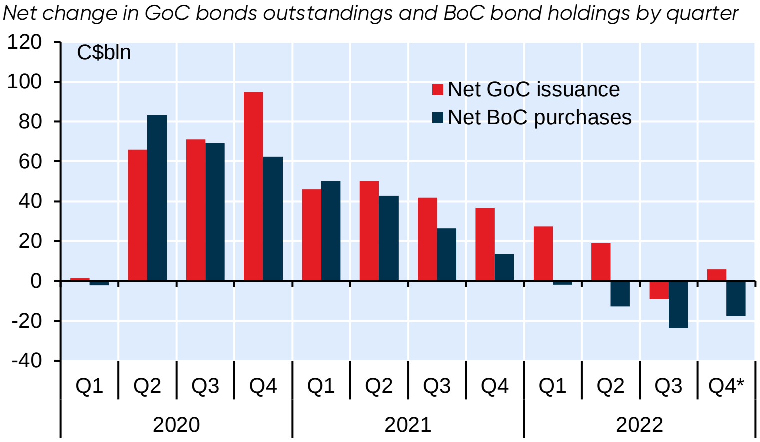
Source: NBF, BOC | Note: Q4 gross issuance/WAT estimated based on latest auction size

Chart 2: …keeping the weighted average term moving lower
Weighted average term of nominal GoC issuance by quarter



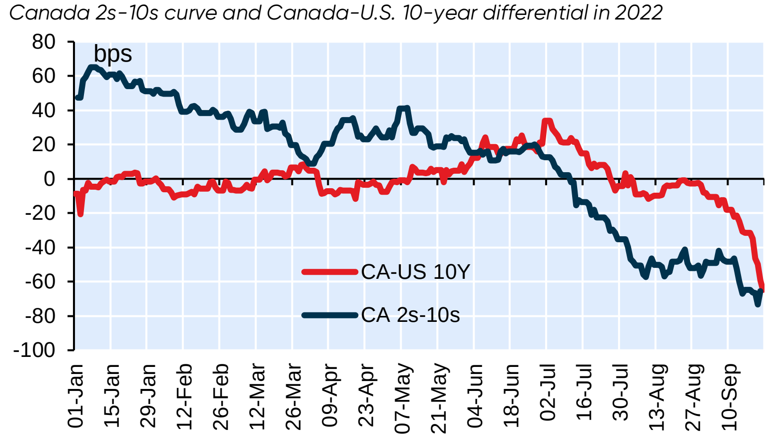
Source: NBF, BoC | Note: Q4 WAT based on latest auction sizes

Chart 3: *Negative* net issuance in the second half of 2022…
Net change in GoC bonds outstandings and BoC bond holdings by quarter



*Source: NBF, BoC | Note: *Q4 gross issuance estimated based on latest auction sizes*

Chart 4: …flattening curves and helping drive outperformance
Canada 2s-10s curve and Canada-U.S. 10-year differential in 2022



Source: NBF, Bloomberg

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
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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