Vaccination Spreads - Views from the North Transcript

Ben Reitzes:

Welcome to the 10th episode of Views from the North. A Canadian rates and macro podcast. This week, I'm joined by two outstanding gentlemen from the sales desk. First, I'd like to welcome Peter Kleb to his first appearance on the show. Pete heads up our London rate sales effort, and I'd like to welcome back Austin Derris for a second appearance. Austin is one of two Boston-based fixed income salespeople at BMO. This week's episode is titled Vaccination Spreads.

Ben Reitzes:

I'm Ben Reitzes, and welcome to Views from the North. Each episode, I will be joined by members of BMO's FICC sales and trading desk to bring you perspectives on the Canadian rates market and the macro economy. We strive to keep the show as interactive as possible by responding directly to questions submitted by our listeners and clients. We value your feedback. So please don't hesitate to reach out with any topics you'd like to hear about. I can be found on Bloomberg or via email, at Benjamin.reitzes@bmo.com. That's Benjamin.reitzes@bmo.com. Your input is valued and greatly appreciated.

Speaker 3:

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Ben Reitzes:

Both Pete and Austin have expertise in a variety of fixed income products in multiple currencies, but we're going to keep the focus on Canada today. When Austin was last on the show, he strongly advocated for investors to get Long CORRA, which was trading in the mid to low 20s at the time. His call was right on, as the increasing shortage of collateral and persistent excess of cash pulled CORRA sharply lower, earlier this year. He was also a bit early on the microcut speculation, which was a hot topic heading into the January Bank of Canada meeting, but of course, that didn't come to fruition.

Ben Reitzes:

I'm sure both Pete and Austin will be ahead of the curve in this episode as well. Welcome to you both.

Peter Kleb:

Thank you, Ben. Good to be here.

Austin Derris:

Thanks for having me. I'm honored that I was invited back.

Ben Reitzes:

Oh, you got it right. So if you get something wrong, that means that you don't get invited back. That's all. No pressure. So there's a few topics I'd like to cover with you guys this week. They include swap spreads, Canada-US cross-market spreads, and the impact of the pace of vaccinations on the macro outlook. We're going to start with swap spreads. I know both of you like to talk about spreads. So I think that's a great place to start. I think we're all similarly aligned here. We have put out a number of trade recommendations on swap spreads, and I guess I'm kind of ruining the punchline here, but you know whatever. I think I'd like to ask Pete to go first here, and then maybe Austin can play devil's advocate, so we can get both sides of the trade, and maybe where the risks are and where we might be wrong in our thoughts. Pete, why don't you kick us off.

Peter Kleb:

Yeah, absolutely, Ben. Thank you very much. Pleasure to be here. So on the swap spreads, as you said, we've taken a few stabs at this over the last couple of weeks, and I think there's maybe a little bit of consensus on our side, but I'm interested to hear Austin's side of things as well. I come at this one from thinking swap spreads are a bit too high. I'd like to start building a short position in it, and for me, it's really a story of 2020 versus 2021. Like, why we are where we are in swap spreads, kind of for me, informs why I think they can come back down.

Peter Kleb:

So just sort of big picture, keep it simple. There was too much cash in 2020 in the banks. QE, everybody, the central banks were making sure there was an excess amount of liquidity in the markets, as you want to do during a crisis, times of uncertainty. Again, investor appetite gets conservative, that cash gets parked in the front end of the market, and you don't have to look any further than the money markets to understand that, with the desks across the street building barricades to protect themselves from the cash getting thrown at them. So all that cash has to go somewhere, and for the bank Treasuries, that goes to buy assets. And so that's what they did in 2020, they bought a lot of assets, and they asset swapped them, which drove the swap spreads up to what you have to say is crisis levels.

Peter Kleb:

If you go back and look at the five-year swap spreads, I mean, you've got to come to credit crisis, you've got to come to oil crashes, you've got to come to turn events, where CDOR/OIS was blown out to get to the same level on outright spreads, at least in the five-year space.

Peter Kleb:

So we are quite extended from a location point of view, which is one way you want to look at things, I think. From the flow point of view, we can sort of understand why we got here, with the banks having all this excess of cash, and then you think to yourself, "Well, what's going to cause this to turn around?" And as we look forward to 2021, you're going to touch a little bit around the end about the vaccination, I think, in the outlook on the cross border, but you have to think that there's not going to be the same level of QE, and the same level of emergency funds flooding the market in 2021 that we saw in 2020. So the knockdown for that is maybe less cash sitting at the banks, needing to find a home. And so, less buying of assets and asset swapping on the back of that.

Peter Kleb:

And as you look at the CDOR/OIS spread that I mentioned, that was a hot topic a bit ago as well. That's at some pretty low levels historically as well, in the spread between CDOR and OIS, which is another way of saying your carry on an asset swap position, and the assets in the swap spreads themselves. That's at a historic wide. So you basically have eliminated all the carry in a long asset swap position. It's been driven to pretty historical outright levels, and the flows that I think have driven us to these points are likely to be ebbing into 2021, especially if we get that recovery that people are expecting from economies reopening, and cash finds a different place to go. So that's sort of the high level for me, just looking at the basic flows, it seems extended. And I think it's time to start building a short position.

Ben Reitzes:

Good points, Pete. I'm going to add one thing to that. I think that it's important to take into account the likelihood of coming tapering from the Bank of Canada. We are expecting them to taper their QE program starting in April. So I think they take it down from 4 billion in purchases per week to 3 billion in purchases per week, and the cuts are going to come, the tapering is going to come in the two year and five year sectors. I think they probably keep their ten-year and long bond purchases, more or less as is, maybe they shrink those a tad, but the bigger cuts are going to come in twos and fives. And so, again, if they're buying less of those securities, less in those sectors, that provides a little bit less support for the cash market in those two sectors as well, and that contributes to potentially narrowing of swap spreads from, clearly, currently very rich levels.

Peter Kleb:

Yeah. I mean, absolutely Ben. They had a chance in January. So one of the issues that the bank of Canada had at the end of the year is too much liquidity driving the market rates away from target, right? That was where that micro cut you mentioned came from, the proverbial, if the mountain won't come to Muhammad, Muhammad must go to the mountain. So should we lower the target rate because the market's not trading there. They didn't do it because the recognition is that actually we have the opposite problems. There's not enough collateral, there's too much liquidity. So that was a signal for me, from them, a direction of travel, exactly as you say, that they're going to want to start sopping up some of that cash as we start turning the corner, hopefully.

Ben Reitzes:

Okay. Austin, what's the other side, why are we were wrong on this?

Austin Derris:

So just to start, I'm playing a role here, I probably agree more with the short, or being sold on spreads story more than they're being paid in spreads, but the big reason why I'm going to defend, or how I'm going to defend being paid in spreads is that really nothing's changed, and there's no impetus for spreads to crack outside of some earlier or larger taper than expected. The fact is we're going into seasonal widening months for a swap spreads, for what that's worth, March is historically the second best month for spread widening in the year, second only to December, which is usually driven by CDOR widening. And we're doing that with the border like mostly closed. And so, immigrations at lows. If we can get a vaccine rollout earlier, or faster, or anything, and we get a tailwind from even a hotter housing market, which is clearly just being driven by domestic housing right now, then the paying from banks that we're seeing, which is ongoing, should maybe even pick up steam.

Austin Derris:

I think the only thing that probably makes that bid for housing, and that paying slow, is if rates can materially rise, which we really haven't seen yet, but that could be one thing to watch out for. The other thing that's important is that there's a few big negatives that are already baked into spreads, and why they're so wide. CORRA, like we've mentioned, has risen. The bank went from a microcut, which everybody was talking about, to an even more micro hike when CORRA is now fixing at 20, where's CORRA going? When are rate hikes coming? And that's one of the things that could weigh on them.

CDOR/OIS is already super depressed. Our desk would rather pay it than sell that anymore. It's resting up against historical tights. And that's one of the things that could support the carry profile. I agree, Pete, that it does weigh on it in the short term, but if we can stabilize a bit, the CDOR/OIS should support belly spreads. They're rich for sure.

Austin Derris:

They do have scope to go a little bit higher on a constant maturity basis. We can go another three to four basis points to reach even wider levels than we've seen in the past, and the last thing is, is that they've actually, when you look at a little bit further out on the spread curve, because I'm more talking about five-year spreads, but if you look at spreads cross-market, versus the US, US spreads have widened fairly substantially versus Canada spreads. If you look at TY invoice, versus CN invoice, there's almost seven basis points of spread tightening, where TY has actually widened more than CN, which relatively makes them a good bit cheaper if you're a cross-market player. So that's kind of what I'm looking for.

Ben Reitzes:

Good points, Austin. Thanks for that. I mean, you make fair points, and another small strike against getting short spreads is the lack of a near-term catalyst. There just isn't much in February that I can point to, to say, "Yeah, that's what's going to move spreads. That's what's going to move this trade." I think that changes in March and April, when the calendar turns to March 1, the banks right now, the commercial banks in Canada are in blackout mode. So there's no issuance coming. That changes in March. And so, when they issue that, that does tend to weigh on spreads a bit. Also in March, we're going to get, as we've mentioned before, term repos at the Bank of Canada are going to mature to the tune of 120 billion starting in March, through March and April. So that'll mean a little bit less cash in the system. I think on the margin that maybe puts a little bit of downward pressure on spreads, because there's a little bit less support for cash in general, but that's another factor.

Ben Reitzes:

And then again, back to the April QE tapering story. So timing is tough on this one. I think a positive on this is at least a positive carry trade, and we are near the all-time wides on spread. So I guess the question is, can we kind of move from there? We'll see over the next month, but at this point, I think the risks are skewed toward selling spreads. And again, we like that trade at probably around these levels. I'd say I prefer to see it a little bit wider. We have come in a little bit from the wides we've seen over the past few weeks, but definitely our bias here is to sell spreads generally.

Peter Kleb:

Okay. Right. Ben, so yeah, I think I've always liked in Canada averaging into trades, because the weird can get weirder, things can get stretched and stretched just a little bit more. So the arguments that Austin's making, I can't really take exception with them. There are factors in the market. I think it's more of a balance of risk, as you say. It's a timing thing. And the fact that this selling swap spreads is small positive care, you can lock that in over the first three months. It gives you some cover there to sort of let these themes play out, and build a position rather than jumping in right away. So yeah, it is two sides in a market, but I think for me to balance the risks, are to the downside in spreads.

Ben Reitzes:

I like it. Averaging in. The Canadian way. And I'm going to change gears here. A kind of related topic to some extent, but a little bit different though. We can link them if we choose, something that I've been on about for a while now, since really December, when I came out with my 2021 look ahead piece, and that's Canada-US cross-market spreads. And when I wrote that piece in December, pretty much immediately thereafter, Canada went very, very much bid, and outperformed the US pretty, pretty significantly over the following two to three weeks or so. Since kind of mid-January-ish, we've given back most of those gains, and Canada's traded pretty heavy, especially over the past couple of weeks or so. And we've cheapened up pretty, pretty notably against the US, but I still like that theme. I still like that thesis.

Ben Reitzes:

My thinking around being long Canada against the US is really twofold. One, the issuance side of things is pretty drastic. The compare and contrast between the two, between Canada and the US is pretty significant. In Canada, issuance on a net basis, on a notional basis is rising. It's going to go from about net -15 billion or so in the current fiscal year, which ends March 31st, and then next year, assuming my thoughts on QE are right, and the bank tapers a few times through the course of the year, net issuance, net notional issuance will be about +20 billion or so. So a net move of 35 billion or so. A net increase of 35 billion or so in issuance. I would note though that, on a DVO1 basis, that's actually declining probably about 20 million in a one or so, into the 70-75 million in a one range from 90 plus beforehand.

Ben Reitzes:

So that's one aspect, and the Canada side, I mean, issuance is going up, not all that much. In the US issuance is going to skyrocket. Our US strategy team has issuance rising about 1.7 trillion this year, net issuance, and that 1.7 trillion is a big increase over last year's net negative about 400 billion in issuance. So the swing there is over $2 trillion versus the swing in Canada, which is, I mean, 20-30 billion, call it, and not all that big, when all is said and done, especially on a DV01 basis actually going down in Canada.

Ben Reitzes:

So from an issuance perspective, from a supply-demand basics, there's just going to be significantly more supply in the US than in Canada, and that, we'll see how that plays out over the course of the year. But I mean, you got to assume that benefits Canada over time.

Ben Reitzes:

The other side of my being long Canada thesis is just, in a risk on environment, Canada tends to outperform. The US historically has a higher CPI profile, and they have a higher potential growth profile. And so, between those two, that suggests that you get longer-term rates higher in the US than in Canada, that's been the theme for, I mean, really, really forever. And I don't see why that's going to change, and on the inflation side, especially the Fed has said their average inflation targeting, which means, I mean, I don't really know what it means other than they'd like to see inflation above target for an undisclosed amount of time. How high above target? Well, I don't know that either. So all I know is they want higher inflation.

Ben Reitzes:

I don't believe the Bank of Canada is going in the same direction. They are going to stick kind of with what they have, with their flexible inflation targeting. They might loosen that a little bit to emphasize the one to 3% band, that is more to give them more wiggle room, but I don't think they're going to kind of welcome whole-hog above target inflation on any kind of consistent basis. The policy the bank currently has, has worked too well for them to make any massive changes in that. That's pretty much what we heard from one of the Bank of Canada deputy governors last week, and any changes will probably be incremental at most.

Ben Reitzes:

And so, I mean, with central banks still providing all that easy money, and fiscal authorities looking to put in more stimulus wherever they can, especially in the US, I see no reason for risk not to remain bid through the course of the year. There's got to be speed bumps. We might be going through one of them now. I'm not really sure. I mean, the vaccination speed bumps definitely don't help, but I think overall, risk stays bid, at least through the first half. And so, I think that that's why I want to be long Canada against the US at this point. Austin, you have any thoughts on that trade? You like it, you dislike it?

Austin Derris:

I mean, you know I like it. We've worked on it a lot together. Your idea, not taking anything away, but I think it's a smart, specifically adding a credit component to the trade, I think is really sharp. So either being, I mean, for liquidity point if you want, being long Ontario versus US on the other side is something that we've had very nice conversations with clients about. You can turbocharge that trade even a little bit more, if you want to add an energy kicker on, and go straight into Alberta. One of the things that's interesting is that the size of these provincial markets is substantial. So it's easy to get decent clips in secondary trading, or even new issue from the provinces. So it's a flow trade with a credit component, and you're able to get decent size. I think it's a nice trade structure.

Ben Reitzes:

I would agree. I like the Alberta side of thing. I think that that's interesting. I mean, it's a risk on trade in general, and you want to turbocharge the risk, you move from Ontario to Alberta, you get more pickup and spread and carry, and there's more room for that to narrow if you're a believer in oil prices moving up over the past, I don't know, few weeks or so. And they've been kind of relentlessly bullish lately, I think more than anybody thought, definitely adds to that thesis a little bit. Pete, any thoughts on this?

Peter Kleb:

Sure. I like sort of thematically, intellectually speaking, it's always been easier for me to agree with a long Canada short US, than the other way around. Not that they, of course, can't both be the right trade at the right time, but just from a size of the debt market, the demand for duration that is just always there in Canada, there isn't enough of it around, and the sort of competitive advantage when you talk about basis trades and 10-year rates, where should the break even be Canada versus US on a competitive advantage basis, and Canada rates probably need to be lower than the US. So from that side of the market, it makes sense to me. And the locations here are pretty good, if you go back the last five years, so that sort of stacks up. It jives for me.

Ben Reitzes:

We have broad agreement here. Listeners, feel free to email me with your rebuttals. And I know there are some, but I think the risk reward lines up pretty nicely, especially given the under-performance in Canada over the past a couple of weeks or so, as we approach kind of what could be kind of the lows in US tens, maybe toward 1% or so. I think that that's definitely where you really want to be taking a very close look at this, and maybe get very, very much aggressive on that front. One aspect of the trade that I didn't mention, that would also be supportive, at least near term, is the pace of vaccinations and the impact of that on the macro outlook. And so, unfortunately for Canada, and I am a resident of Canada, so unfortunately for me I guess, the pace of vaccination in Canada is inordinately slow, unfortunately slow.

Ben Reitzes:

I mean, call it what you want. You can use more colorful language if you wish, but not on here. And that puts Canada at a serious disadvantage from a macro perspective. The pace, I mean, we only have about a million vaccine doses put in people's arms, that's not people but doses. So we've actually had a little less than a million people, versus significantly more than that in the US and in the UK. And I'll let Pete and Austin talk about those two things. But for Canada, the delay on the vaccine front means that the macro economy is likely going to struggle rebounding from where we are at present. And if anything, it means that restrictions are going to last a little bit longer in Canada. I know that the UK is also locked down right now, and Canada, most of Canada is actually unwinding their lockdowns currently, as cases are falling pretty much anywhere, which shouldn't be a huge shock given our proximity, or now distance from Christmas and new year's.

Ben Reitzes:

But this is a clear downside risk for Canada on a relative basis. And so that should be supportive of Canadian rates, the Canadian rate complex in general, over the coming weeks and months. For those that haven't seen it, most of the Canadian contracts for vaccinations really kick into effect in and on April 1st. The government didn't think we'd approve the vaccines before then. Oops. And so, whatever we're getting now is kind of negotiated after the fact, the bigger contracts are in place for April 1. So things will pick up starting then, but that's still two months away. And in the meantime, the US is going a million per day, and I'm not really sure what the UK is doing, but they're also, well, well ahead of the game.

Peter Kleb:

We're on like 500K a day, sorry to jump in there, but that's like, in a country that's like, you know, what are we, fifth of the size?

Ben Reitzes:

You're double Canada. You're double Canada.

Peter Kleb:

68, or 70-odd million in the UK, versus 307 million in the US.

Ben Reitzes:

Yeah. Versus 38 million in Canada. So I mean, you can't see me on the podcast, but I'm shaking my head when Pete says we're doing half a million per day, and Canada's in like the thousands, or maybe the tens of thousands, but we're nowhere near where we need to be. So Pete, why don't you jump in, where's the UK? I mean, I guess they're doing better.

Peter Kleb:

So we're doing better. But the takeaway for me, we talked about this earlier, is I don't know, maybe it's an emotional hedge, but cautious, because what you see here is, even if you've seen it in Israel, we've seen it here where they're doing pretty good clip at these vaccinations, I think, at time of recording, it must be about 13 million we've vaccinated, and at the current rates, we're going to have all the over 50s vaccinated by May. And yet, we're still in full lockdown because the hospital beds are still being taken up, they always run pretty hot in the winter anyway. These levels, the cases fall, the deaths fall, but the hospital capacity stays high. It lingers, it takes a long time to come down. So even when jabs are going in the arms, just like almost everything else in the pandemic, things take longer now than maybe we hope or want them to.

Peter Kleb:

So this is showing us a way out, and we're seeing the right results, but just the idea that, keep a lid on it a bit more, the governments are going to are being cautious, and it may take just a little bit longer for this rebound to happen than maybe some people would hope, and that's not to say it's not coming and not to say it won't be very, very strong, because I think the other lesson that we've gone through three lockdowns for, I forget, we changed the rules all the time, but we've had periods in the middle where we weren't allowed, and then there is an explosion of life again, and there is a rebound, so it is there, but I take a message of caution, just like knock on wood, maybe it's the emotional hedge, but it might take a bit longer than we hope.

Ben Reitzes:

Austin. How are things developing in the US?

Peter Kleb:

The US has seemingly caught it’s stride. I think, in the last seven days, we're averaging over 1.5 million doses a day, sorry Ben, with 44 million or so doses administered. Those are just single use, not people vaccinated or anything like that, but again, you're spot on Peter, but you know, there's a caveat here. We're still estimating around nine months to get to 75% of people vaccinated with two doses. So we still have a decent runway. We've discussed though that we probably are able to pick up steam a lot faster than that, because as the older generations are vaccinated, hospital usage should decline rapidly, which should get a lot of people out of their house, or their houses. But you know, there's still going to be a nice timeline for that as well.

Ben Reitzes:

So yeah, my view, and then you can write this down, February 10th, late afternoon, when much of the older population is vaccinated, and by older, I really just mean those most at risk. So call it 60 years old and older, and the most vulnerable in society are vaccinated, I think things change pretty materially from pretty much every perspective. So I don't think we should be hanging our hat on 60, or 70, or 80% rates of vaccination. I think it's who's vaccinated, and hopefully, that'll be the focus of government as we move forward here. But that's how I view things.

Ben Reitzes:

Running up on time here. So before we conclude, gentlemen, can you give our listeners your top trade ideas at the moment. Pete, I'm going to ask you to go first. So I think I know what you want to say.

Peter Kleb:

Well, I don't know. I get to try this a couple of times, right?

Ben Reitzes:

Try as many times as you want. You can just say five-year spreads, and that's why I want you first, because Austin's got something different. So [crosstalk 00:24:27].

Peter Kleb:

I do think five-year spreads. I think, obviously, that's what we led off with, and I didn't just take that side of the trade on the flip of a coin. I do like that side of the trade, so clearly on there, and I think the other one that would come to mind is CANHOU versus provies, just some just at the right locations as those CANHOUs keep getting beat up. They're not issuing more in 2021, they're issuing less, and the provincials have got to issue more. They've got budget deficits to fund, and there's still the fallout of all of the spending that we've done to keep everything afloat. So just looking for opportunities where you can switch in and out of those credit ladders for me, when CANHOUs cheapen up getting along there, and coming back, because as I mentioned before to you, CANHOU versus govies for me, it's the same issue or you just get some spreads. So I like that trade from a couple different angles.

Ben Reitzes:

All right, cool. Austin, how about you?

Austin Derris:

Yeah. You know me, Ben. I like the front end. I like the widgets, and we actually have a new widget in Canada. We have a new two-year contract, a futures contract, the CV, currently, it's the CVH1. And it's benchmarked off for the cheapest to deliver, I should say, is the NOV22 Canada, and what I like about this contract is that it really highlights what's wrong with what the bank has done to the front end and entire market in Canada by buying too much cash. It really highlights just how rich cash is, and just how cheap OIS is, and I think that that's what's defining the Canada market right now. When you look at CV versus OIS, it trades at plus eight, which is to your cash eight rich to OIS, whereas T-OIS, which is very liquid, or much more liquid, I should say, trades at 1.4 through, which is to your cash cheap to OAS.

Austin Derris:

So you have about a 10 basis point swing on that. And so there's a few ways, I mean, the best thing you could probably do is just sell this where you're selling cash and receiving OIS. If you don't want to do that, it's easy to dissect it. It really highlights that OIS is probably the cheapest and best thing to be received in Canada right now, and cash is probably the best thing to be sold or short. So that's something that I like.

Ben Reitzes:

All right. Thank you. Gentlemen, thank you for joining me this week. Pete, thanks. I hope your first experience me was tolerable. Austin, thanks for coming back. I hope to have you both again.

Austin Derris:

Thanks for having me.

Peter Kleb:

Cheers, Ben. Thanks for having me.

Ben Reitzes:

Thanks for listening to Views from the North, a Canadian rates and macro podcast. I hope you'll join me again for another episode.

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