The End is Near - Views from the North Transcript

Ben Reitzes:

Welcome to the 11th episode of Views from the North, a Canadian rates and macro podcast. This week, I'm joined by Adam Whitlam, part of the Toronto based fixed income sales team and Jordan Sugar, one of our provincial bond traders. This week's episode is titled, The End is Near.

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 this 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.

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Speaker 2:

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Ben Reitzes:

I'd like to welcome Adam and Jordan back to the show. Their appearance is well-timed with provincial markets front and center once again. There are plenty of topics to cover here, but we should start with the Bank of Canada's PBPP or Provincial Bond Purchase Program.

Ben Reitzes:

Earlier this week or late last week, depending on when you would randomly check the Bank of Canada's website, the Bank of Canada announced that they are cutting back to one tender per week from two for the PBPP. Risk was already under pressure ahead of that announcement and that added to the widening in provincial spreads. The Bank of Canada said that the move was because the market is functioning well and it's consistent with their other moves to back away from supporting the market.

Ben Reitzes:

Adam and Jordan, welcome back to the show. Glad to have you.

Jordan Sugar:

Good to be back, Ben.

Adam Whitlam:

Thank you very much for having us again. I'm surprised you let us back after the last time.

Ben Reitzes:

You're very entertaining, how could I not? So let's start with you, Jordan. And how do you view the latest changes to the Provincial Bond Purchase Program?

Jordan Sugar:

Yeah, so we found out via the Bank of Canada website early Monday morning that there's going to be, as you mentioned, just one tender per week, and it's definitely a sign of the program starting to taper off. And I think that it would be tough to dissect the market reaction from the global risk off tone when the clients and the dealer community seem to take notice that it switched to one tender.

Jordan Sugar:

So I think any backup in spreads was a little bit of a knee-jerk reaction. The credit boxes are what I think is the most important to be focused on. And I think you see them move in the direction that they moved once it became clear that the PBPP is coming to an end in May. The spirit of the program is that they will respond to the market as needed. And I guess this is a sign that the market is in better shape and should come to an end in the next couple of months.

Ben Reitzes:

Thanks for that, Jordan. I think you have to question the timing a little bit though. I mean, I'm not sure what the rush was here to do this on this week when markets were already under pressure. I guess they could have done it a few weeks ago or a couple of weeks from now, or next week, if things are a little more stable, but I think we should question the timing always a little bit and just maybe not understanding that the market is still digesting a fair amount of provincial issuance that we've seen from mid January through to mid Feb.

Jordan Sugar:

Yeah, I completely agree with that. It did seem odd. Definitely not the best timing and I would have waited for me, like you said, some supply to be out of the way and just the global backdrop on firmer footing, for sure.

Ben Reitzes:

They've tapered this program like we can call it that. It's still in place until May 6th, as you mentioned, and so we've got kind of the initial reaction to the taper. Do you expect further impact when they actually wind the program down altogether and when this thing ends on May 6, is there going to be another widening in spreads or maybe we're kind of through the worst of it here and now the market's effectively on its own and Bank of Canada really isn't the same support that it has been over the past number of months?

Jordan Sugar:

I think the credit boxes will continue to do what they've done over the past couple of days and that is definitely in 10s, 30s, the Ontario 50/30 box continuing to flatten. One week ago, it was a trading in the context of 20 basis points and it was last trading at 16 basis points. So that's a big flattening move. That's four basis points. We would've been talking about that at the bar very excitedly over the past couple of days.

Jordan Sugar:

So that is a big move and not to be dismissed, but I don't think there's much more the Bank of Canada can do to show any more signs of tapering. So you have one tender per week. You have a $350 million target. The past two months has been typically around a $750 million target, but the fills have been in the context of about 50% or so. So I don't think you're going to see a tender where it's $100 million target. I don't see the point of that.

Jordan Sugar:

And if clients and other dealers were paying close attention to what they're posting on the website, they had been dialing back the target amounts over the past two months. And on certain weeks when maybe 250 million was purchased instead of their target amount, it's not like we saw spreads move materially wider or tighter on the back of that. And so this announcement comes out, you get your knee-jerk reaction, the credit box has moved because that's where they're going with this program about to be done but I don't think the spread movement wider is warranted right now.

Ben Reitzes:

Okay. One more question for you Jordan before we move on to Adam. How does the PBPP play into your thinking when you're pricing trades? Before you know whether the bond's eligible or not, in general, does that drive your pricing in any way? Are you more willing to take risks knowing that the Bank of Canada could take you out of that at a future date? How has your thinking evolved there over the past number of months and now that the program's shrunk, has anything changed?

Jordan Sugar:

In general, I don't let that influence how I'm pricing any risk. I think that, on some of the smaller, shorter, dated high coupon lines, in the back of my mind, I might remember in that moment, if I'm bidding on, let's say the Saskie high coupon 22s, it's good to know that that is in the tender the next day, but any real material risk, we try to put the best price on it for the client and move whatever risk we have to afterwards, because it's too much time in between pricing risk and then the tender that would be a later in the week, whether it's a day later or two days from the time you add that risk.

Jordan Sugar:

So I don't think in short, it doesn't influence my decision. I do think that having the general backstop there, knowing that you would be able to sell some risk in the tender the next day, that does help in general for credit. So it would be misleading to say that you don't take it into account at all, but line by line, I would say, no, don't focus on that.

Ben Reitzes:

Okay. Fair enough, Adam, let's move to you. Are your clients concerned about the program ending? What are they telling you?

Adam Whitlam:

Well, so the interesting part is none of my clients are surprised by the fact that the program is tapering. I think most of them are surprised that it wasn't tapered earlier on. The biggest surprise is on the reaction, the reaction on the curve and the knee-jerk reaction to spreads and why things widened so aggressively.

Adam Whitlam:

Now, the backdrop, when that happened was also pretty negative. Stocks were down pretty heavily at that time, too. So I'm sure that had a bit of an influence, but the consensus was, and it had been for some time that, the provincial market was functioning very well, they were doing a ton of issuance and that, maybe this program wasn't really needed at this moment.

Adam Whitlam:

So, there really wasn't a lot of shock there. And it was just more a reaction function of spreads, where especially, as Jordan was talking about in terms of the boxes, some of the steepening that we saw in 5s, 10s after we saw massive flattening in it, some of the flattening we saw in 10s, 30s, some of those box moves were really dramatic. So I that's where I think the real surprise was not in the program slowing down.

Ben Reitzes:

So it's fair to say that your clients don't expect any more reaction when the PBPP actually does wind down eventually?

Adam Whitlam:

Yeah, I think at this point it's more of a supply side story than it is the PBPP winding down. I mean, the expectation as we go through budgets is that borrowing programs are going to still remain pretty robust. So, I think if spreads were to widen out here, they wouldn't be shocked, but they're not expecting the drastic moves like we saw earlier this week, where things are widening out three basis points in a day or four basis points in a day as maybe the take up on this PBPP lightens up.

Adam Whitlam:

My client base generally has thought that the provi market has been functioning fairly well. Maybe we do get some widening, but that's more in relation to additional supply and it shouldn't be as fast or as violent.

Ben Reitzes:

And how do you think the shape of the credit curve revolves here as the PBPP winds down?

Adam Whitlam:

Yeah, to me and to a lot of the clients I talked to was a little bit telling this week. Like I think, it looks like 10s definitely are the most vulnerable, and you could see more steepening in that 5s, 10s box. And that's really because, the provinces are going to continue to tap the 10 year sector and you're going to lose what's been a natural buyer.

Adam Whitlam:

Now you have a situation where the 10 years that they're tapping, are now getting longer than what the PBPP program was willing to accept, but it's still just, more net supply in that 10 year part of the curve. Whereas, in the shorter end of the curve, you don't have the same supply problems. So, it looks like 10s will probably take the brunt of it. That probably means we get 10s bonds flattening back, maybe even as far as some of the old ranges where, maybe we even go back into single digits. So 10s look the most vulnerable from here, I think.

Ben Reitzes:

How about you, Jordan? You are in agreement with Adam that 10s are the most vulnerable part of the credit curve here?

Jordan Sugar:

Yes, absolutely. Definitely 10s are going to take the brunt of this move and they have, but the main move that we've seen in the credit boxes, as I mentioned before is in the long end with longs just really flattening in and gaining ground versus 10s. 5s have done okay but really it's the stories in the long end here.

Jordan Sugar:

The Bank of Canada had not been buying longs and had been focused on 10s. And we discussed this last time that Adam and I were here, that when this program does start to wind down and it becomes clear that it's coming to an end and not extending that we do expect those boxes to flatten, and so we've seen that, but all that to say that I still don't think that it is much of a credit winding move overall.

Ben Reitzes:

Okay. I think provincial bond holders will be happy to hear that. I'm going to throw out a bit of a curve ball here. I didn't discuss this with you guys earlier, but oil prices are up another 2% today, WTI is at $63, WCS is also climbing nicely and that's moved all the way up to about 50 bucks, now it's at $52 today, on Wednesday afternoon.

Ben Reitzes:

Adam mentioned that provincial budgets, provinces are going to have to keep borrowing pretty notably. I mean, is there a chance that as we get this better economic rebound, I think that most people have expected, maybe the expectations about provincial issuance are too high and they won't need to borrow quite as much? And maybe the peripherals and I would point to Alberta in particular, maybe have a good amount of room to richen here if oil prices can stay at these levels and maybe they even move higher?

Jordan Sugar:

Yeah so I'll jump in here. I think, you're stealing my thunder when I was anticipating a trade idea. I think it makes sense to look at the relationships among all the different provinces, specifically the peripheral provinces to each other pre pandemic and where we are now. And a lot of those relationships have gone back to a pre pandemic levels and Alberta longs in the long end specifically have lagged that move.

Jordan Sugar:

And I do think given the oil story, given the better fiscal backdrop for the province of Alberta, that they are lagging, and I would keep an eye on Alberta longs versus the others. I'm not saying to necessarily to sell any other province versus Alberta, but those relationships, I think, need to come back to a pre pandemic levels of specifically for long Alberta.

Ben Reitzes:

Adam, any thoughts there?

Adam Whitlam:

Yeah, I agree with Sugar. I think Alberta looks attractive and they have still a fairly large borrowing program, but I think, when that budget comes out tomorrow or on Thursday, that you're going to see a pretty nice uptick in forecast for oil prices, given that, it's been on the rise, but we've also seen a little bit of stability here. Like we've had oil prices kind of north of 50 bucks for quite some time, not WCS, and so I think that will help in terms of some of the deficit and some of the financing needs that you're going to see from Alberta so I think they will benefit.

Adam Whitlam:

I've seen clients coming into Alberta ahead of them releasing their budget because I think that expectation is out there kind of on the street and with all-in yields where they are now, Alberta, that's a lot of pick against some of the other provinces, so your all-in just looks great. So I do think, that's probably a decent province to be in and I don't mind...

Adam Whitlam:

Actually BC is another one. I think BC longs, that's been fairly steady. That's a province where, if you read any of our economic forecast or the pieces that like Robert Kavcic is putting out we've got a pretty positive GDP growth outlook for BC. They didn't have anywhere near the same level of lockdowns that provinces like Ontario had. So I think they fiscally are in a pretty good spot. Nobody likes to pay away spread when they're investing in provies.

Adam Whitlam:

But when you're talking about BC 50s at, maybe minus four and a half or minus four relative to Ontario 50s, and then you factor in the 50s, 51s is inverted in Ontario, you're really only giving up two and a half to three bps to own a long BC. And I think that their fiscal picture looks a lot better. So I think BC is another one where you could see some performance or there's a province that looks maybe a little bit cheap, but I think Alberta's probably got the most room to run.

Ben Reitzes:

Okay, cool. So I guess broad agreement there that the peripherals and Alberta in particular maybe have some room here to improve generally. I'm going to move on to our next topic. This is, I guess, something that I've been talking about a lot and something I've been dead wrong about. So Canada's traded incredibly poorly across market for a number of weeks now, and especially over the past couple of weeks or so.

Ben Reitzes:

My bullish Canada-US thesis has been dead wrong. I mean, I still like the fundamentals of the argument. They still make sense, but that's just not the way things have gone for a little while. The way I see this, I really think it is an issuance driven move here. You've had the biggest flow of provincial new issues from kind of mid January to mid February that we've seen since April. So kind of the moving average, the rolling total of that amount has been pretty sizeable and that's a tough for the market to digest.

Ben Reitzes:

I think that's probably part of what's going on here and assuming the province is back off a little bit and they should given that budget season is approaching, and that means blackouts for many of them, that should help things as time helps digest those new issues. But another aspect is the commodity price thing and the fact that commodity prices have moved up so sharply. And while that's a benefit for Alberta and Alberta credit, it's also a bullish for the macro backdrop and lends to the theme that the Bank of Canada is going to be earlier to pull back on stimulus and the federal reserve.

Ben Reitzes:

I think that's something that a lot of people have probably latched onto, the fact that the bank is going to be tapering before the fed, even if the tapering is almost entirely due to the fact that government of Canada issuance is going to be down, we'll get the budget. Maybe at some point next month, it could be, some rumors it might get delayed into April, the federal budget, but issuance is going to be down notably in the next fiscal year. And so the bank Canada just can't keep buying at the pace they are without becoming too dominant a part of the market.

Ben Reitzes:

Despite that fact, I mean, at this point, Canada's just traded so poorly. Maybe we're nearing the end of that and maybe if the provinces is back off, the issuance will get digested a bit better. Let's start with Adam on this one. Adam, do you think there's much further for Canada underperform, or we may be nearing the end of that given kind of stretch levels and 5, for sure, 5s and 10s, I mean, under performing significantly in the past couple of weeks?

Adam Whitlam:

Yeah, I think you nailed it in terms of like, why it's happening in Canada. I mean, we definitely, there's been a couple of bulge brackets calling for tapering. I even heard someone say it was an imminent tapering for Bank of Canada purchases, and that has really had a big impact on our market and a big impact on the steepening and a big reason that we've been kind of underperforming.

Adam Whitlam:

You look at some of the cross-market levels. Like 30 years is one where I've been kind of keeping my eye on that. 10s we've kind of blown through resistance. I think 10s, we could continue to underperform here. I wouldn't be shocked because, looking at the chart, we could still cheapen up another 15 bps versus the US before we see, the next really definitive level where Canada should find a bit of a footing.

Adam Whitlam:

Longs is a little different. We've definitely kind of tested where we are right now in longs a few times, you go back to kind of throughout 2020. In the long end we're not that dissimilar from where we got. Minus 32 level in longs, minus 33 level in longs. If you look at going through say November, you'll look at the end of January, you look October, in these kind of low minus 30s, 32, minus 33, we've kind of found support a number of times. So maybe in the long end it's time that we actually do see some support in Canada stopped selling off, but I don't have the same conviction in 10s.

Adam Whitlam:

5s, we have seen a couple of players come into buy 5s on our curve. They've looked cheap 2s, 5s, they've looked cheap cross market, but if you look at some of the forwards, say, you look at like a one-year, one-year, three-year, one year, for instance, that curve in swap land has steepened very dramatically since the start of the year. And if you look at, say the slope of the 2s, 5s curve relative to one year, one year, three year, one year, the one year, one year, three one year suggests that 5s should have been a lot cheaper.

Adam Whitlam:

So that curve has gone straight up and had cheapened up from kind of about the middle of January or beginning of January. And 5s now seem like they're catching up to that move, but that steepening in the forwards curve hasn't stopped yet. So I think 5s have more room to go. I think that they look cheap here on a cross-market basis, but I don't see a reason why that can't continue and we can get some to some pretty hefty extremes going back, many, many, many years.

Adam Whitlam:

I mean, even if you look at say some of the curves, you have these instances where 2s, 10s, for instance, can steepen very dramatically when you get into the end of rate cutting cycles. And if that's kind of where we are, then I think you could keep seeing the curve steepen and you could see more pressure in 5s, more pressure in 10s.

Ben Reitzes:

That's fair. Well, looking at the forward curve, looking at the forward space, we right now, I see the first full Bank of Canada rate hike priced by December 2022. And there's another 50 basis points plus, 60 basis points really in 2023. That's definitely on the aggressive side. I mean, I'm easily the most macro bullish guy that I know and I think that's kind of the most optimistic case would be the bank hiking kind of late 2022 and maybe a couple more times in 2023, every six months or so.

Ben Reitzes:

That's almost the most optimistic case, and that's what we currently have priced in. And it doesn't seem like we're going to end there. Further sell-off in 5 would suggest that you're going to see an even more aggressive bank pricing and relative to what's being priced for the fed, like the bank is being priced 50 basis points more aggressive than the fed at this point. Which again, that for me is the extreme, you can't go further than that without the Canadian dollar really getting out of hand.

Ben Reitzes:

From my perspective, it looks like we should be closer to the extremes in the five-year point, just from looking at it from a policy perspective. Doesn't mean we can't go further, it doesn't mean extremes can't get pushed there even further. That's one thing. The other I'd note is on March 1st, there is a decent Canada index extension because we have kind of sizable issues in March and September now that there is a pretty good extension in the short and mid indices that should help the sectors. It's not going to do anything for 10s or longs, but it should provide at least a little bit of support to the five-year sector as we go through month end.

Ben Reitzes:

Before we conclude I'd like each of your top trade ideas at the moment, try to stick to the provi theme if you can, anything you have high conviction on. Adam, if you got another product you want to talk about, that's totally cool as well. Why don't we start with Jordan? I kind of took your idea or brought your idea out to the fore a little earlier, reiterate that, tell us what you like best in provi land at the moment?

Jordan Sugar:

So now that you've already stole my thunder and my trade idea, I would quickly reiterate just to go back and look at charts on where stuff was trading pre pandemic and what those relationships were because I do think they do have to come back to where they once were. But I think on the last podcast, I talked about the 20 year sector and how that looked versus longs and versus 10s, while I still think that that 20 year sector looks good and you have the Bank of Canada buying the long bonds to thank for that.

Jordan Sugar:

But I would say that now might be some time to take a little bit of money off the table there. If you've owned anything in the, let's say 2035 to 2040 sector so, Ontario 35s, Ontario 41s, those have all rolled down quite nicely. When we last did this podcast, the credit pick out of longs was north of 10 basis points. I think it was even closer to almost 12. Now that's about 8 basis points. So I think it makes more sense to sell some of the stuff that's rolled down the curve nicely and not necessarily outright, but either versus longs or reload versus stuff in that 25 year sector, the Ontario 45s, the Ontario 46s being the two highest yielding Ontario bonds out there.

Jordan Sugar:

And of course you can do that in any of the peripherals in Alberta or BC or Mani, but obviously Ontario will provide and Quebec, the best liquidity. So I think that makes the most sense right now and I'll leave it at that.

Ben Reitzes:

Thank you, Jordan. Adam, what are your top ideas at the moment?

Adam Whitlam:

Yeah, so I'll kind of go two. So one is a trade that we've actually done a bunch of already this week. And I think a number of accounts like the accounts that look at, or are looking at say the provincial market relative to the corporate market. We've done a bunch of this already, but I think provi spreads the give out of some of these utility credits or like high quality say bank spreads, that type of credit, for instance, the give is so scant that it really wouldn't take much of a risk backup to pay off.

Adam Whitlam:

One trade that we'd been flogging was Alberta 27s relative to utilities. The give there look to be about eight basis points of carry over the course of a year that you'd be giving up. That's the type of thing that you could make over the course of two trading days, let alone over the course of a year. So I think provi spreads are very tight to high quality corporate spreads. I think that trade should continue to be explored.

Adam Whitlam:

We're right in the middle of bank reporting season, there will be bank funding coming through the market. The arbs are onside for them to do their funding in the domestic market. And, while the first couple of deals might go well, eventually you get to a point where, the bonds are in weak hands and they start to underperform. And just to position yourself for, if we do get a risk wobble, you can protect yourself by being long, the provincial sector.

Adam Whitlam:

Meanwhile, I don't think you're going to have a situation where provies are going to trade cheaper than bank spreads. So I think your downside is pretty limited. It's really just the carry and then it doesn't take much to give up on that. The second one I wanted to kind of note was CMBs. So one of the most interesting things about the sell-off in the provi market when they announced this PBPP thing was that CMBs got hit bp for bp, along with provies, even though they'd ended the CMB program months prior and had nothing to do with the PBPP program, CMBs underperformed tick for tick, which I think is really interesting.

Adam Whitlam:

To me, it makes CMBS look very, very cheap. I think it's worth noting, the CMB funding program, it was bare last year, went from 40 billion to 60 billion. This year it's right back to 40 billion. So it's not like provinces where you're seeing a ton more issuance come in and the issuance profile keeps growing. It's gone right back to where it was at only 40 billion.

Adam Whitlam:

And the other thing I'd like to point out is, if you look at the CMB asset swap curve, so this is like a, bank treasuries are often, this is kind of exclusively how they're looking at their CMB positioning, the CMB Dec 24s and the June 25s stand out as cheap. And they stand out as cheap because say you look at like a Dec 24 CMB or a March 25 CMB, the asset swaps are around minus 17 and a half and minus 16 and a half respectively.

Adam Whitlam:

If you go further out the curve, say, you look at like a Sep 26 CMB. So, you're going out almost two years from those Dec 24s. And the asset swap is about minus 17 at the moment. So it's just completely flat. There is no role owning a CMB Sep 26 and rolling it back down to a CMB Dec 24.

Adam Whitlam:

Whereas if you look at that same trade say in provi land, an Ontario, June 26, for instance, is around a minus two and an Ontario Sep 24 is around a minus eight. So there is a curve in provi land. So, that suggests that CMBs are too flat, the CMB Dec 24s and like the March 25 standout as cheap on the curve versus provies and cheap on asset swap. So I think that's something kind of worth having a look at. It also says that stuff further out the CMB curve looks fairly rich. If there's no asset swap carry, then it's not worth owning. So it makes sense I think to maybe sell CMBs further out in 2026s, 2027s, maybe roll that stuff into provies. And then in the four year part of the curve, 2024, 2025 to own CMBs.

Ben Reitzes:

All right, thanks, Adam. I'm going to chime in here just a very briefly. Last episode, I talked about swap spreads throughout most of the episode. They finally started to move here and we still like the short spreads here. Again, Adam mentioned bank funding coming. We are expecting some issues from the bank that should push spreads lower still from here. So still a trade that we like at this moment.

Ben Reitzes:

I'd like to thank both of you gentlemen for joining me this week and hope to see you again soon.

Jordan Sugar:

Thanks for having us.

Adam Whitlam:

Thanks a lot, Ben, always a pleasure.

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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