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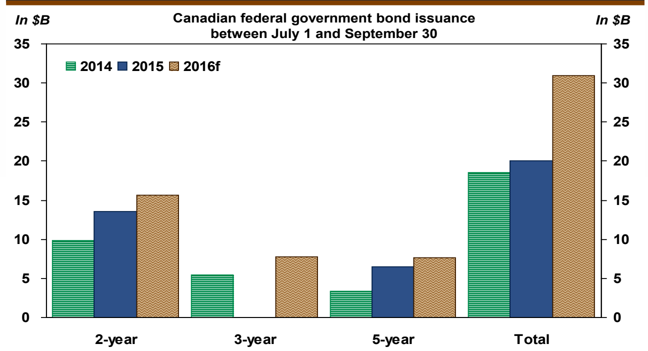
CANADA

Canada bond supply: a busy summer!

Today, the Bank of Canada (BoC) will, on behalf of the federal government, auction $3.9B of a bond maturing in August 2018, about two years from now. This will be the fourth time that this bond is issued, the authorities having already issued $11.7B since its first auction held May 4. The bond carries the benchmark status for 2-year bonds ever since June. The next 2-year bond auction, scheduled for August 10, will likely be a new issue of bonds maturing November 2018. This bond will in turn become benchmark by late September. It is as such that the government, via the BoC, routinely manages its new bond issuance, the amounts collected being used to finance the deficit and repay maturing debt.

What stands out this year is the significant increase in the budget deficit. From a deficit estimated at $2B for the 2015–2016 fiscal year, the balance should be around -$30B in 2016–2017. In addition, the federal budget tabled in April foresaw $92B in refinancing needs, to address bonds maturing during the year. By comparison, in 2015–2016, the government had to redeem only $76B. In total, $132B in bond issuance has been planned for the current fiscal year. In its debt management strategy, the government indicated that it would be targeting increases in the issuance of 2- and 5-year bonds. In addition, the 3-year bond issue, which was discontinued in early 2015, was re-introduced: a first auction took place on July 13. What this entails is that the supply of Canadian bonds with maturities up to five years is particularly important this year, including in this summer period where markets are typically less liquid. All else equal, an increase in supply without a corresponding increase in demand should result in some upward pressure on bond yields. So far, however, there have been few signs pointing in this direction. Canada's 2-year yield has remained below its U.S. counterpart for over a year, and the prospect of higher supply has done little to change this state of affairs.

The Canadian front end sees heavy supply this summer



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Sources: Bank of Canada and Desjardins, Economic Studies

Implications: Markets seem oblivious to the substantial increase in Canadian federal government bond supply. This reflects demand that is still strong. Reinforcing this notion, Statistics Canada released data on Monday showing positive net acquisitions of Canadian federal bonds by foreign investors in four of the first five months of 2016. With about a quarter of global sovereign bonds outstanding offering negative yields, it is not surprising that global investors are attracted to high-quality, yet positive-yielding issues. However, this exacerbates the state of overvaluation in bond markets. If for any reason an upward movement in yields were to be orchestrated, realigning bond market valuations to some concept of equilibrium, Canadian debt securities might be vulnerable, especially given their abundant supply. The question is of course: what will be the catalyst to an escalation in yields. There have been precious little of these lately!

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