ECONOMIC VIEWPOINT

BoC Balance Sheet: A Strict Diet of No Bonds

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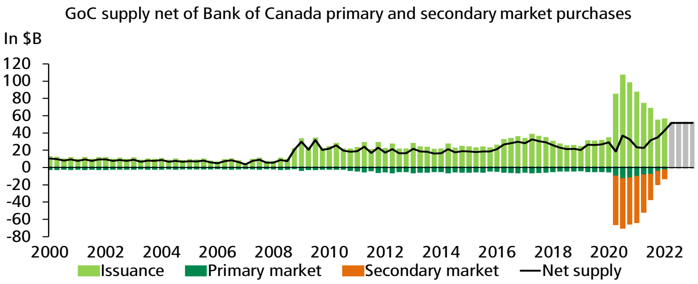
After feasting on Canadian fixed income, the Bank of Canada's balance sheet is now officially on a strict diet of no bonds. With a goal of slimming down its holdings as assets mature and roll off, the central bank ceased purchasing Government of Canada (GoC) bonds in both primary and secondary markets.

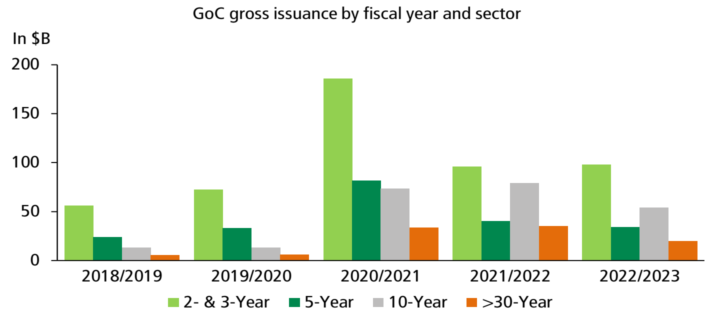
That is in stark contrast to the past couple of years when the central bank ate up a significant portion of bonds via both primary and secondary market purchases. During the pandemic, the Bank of Canada's first foray into quantitative easing saw its GoC bond holdings swell from $90B to $430B. With the central bank pulling away from these purchases as a part of its quantitative tightening program, net bond issuance hitting the market will be equal to gross issuance. That means net GoC supply is set to sharply increase this fiscal year (chart 1).

GRAPH 1
Net Supply will equal gross supply in FY22/23



Net supply is net of Bank of Canada primary and secondary market purchases. Grey bars represent projected issuance based on the Debt Management Strategy. We assume that issuance is equally spread across the 4 quarters of the fiscal year.
Sources: Bank of Canada, Government of Canada and Desjardins, Economic Studies

GRAPH 2
Gross supply of GoCs will be less than in previous years



Sources: Bank of Canada, Government of Canada and Desjardins, Economic Studies

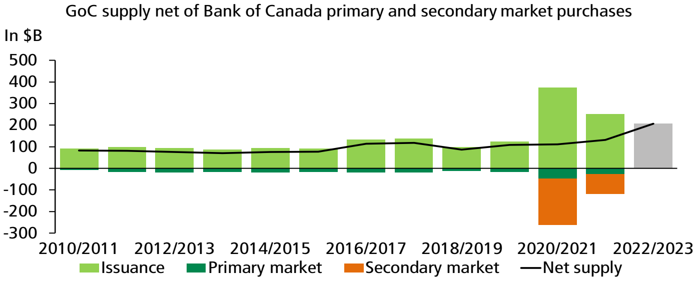
Gross Issuance Also Slimming Down

Gross issuance is expected to shrink this year, reflecting the lower federal deficit, which will partially offset the impact of quantitative tightening on net supply. Projected FY22/23 GoC gross bond supply stands at $212B, a reduction of $43B compared to last fiscal year. The pullback in gross bond issuance will be most pronounced at the long end of the curve (chart 2), although even there supply will be heavy relative to pre-pandemic levels.

So, despite the reduction in gross GoC bond issuance, net supply will reach its highest level on record this fiscal year (chart 3 on page 2). That's not a difficult milestone to reach. Bank of Canada buying was so rampant that the significant increase in gross debt issuance over the past two years barely caused a ripple in net supply for the market to digest.

Most of the increase in net supply will come in the short end and belly (chart 4 on page 2). Even though net supply is also expected to fall in the 30-year-and-above sector, the decline will only be marginal.

GRAPH 3
Net supply of Government of Canada bonds reaches the highest level on record



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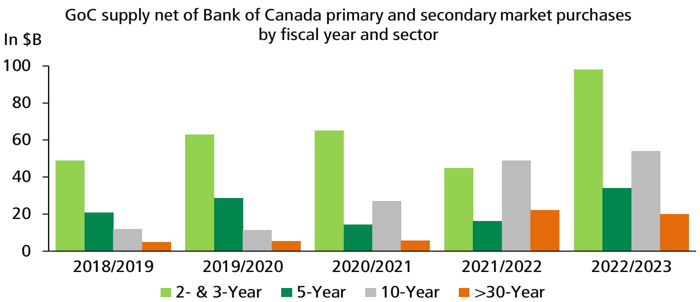
Sources: Bank of Canada, Government of Canada and Desjardins, Economic Studies

GRAPH 4
Net supply of Government of Canada bonds will be the largest in the 2- and 10-year sectors



Net supply is calculated net of Bank of Canada primary and secondary market purchases. The dotted bars represent the projected issuance based on the Debt Management Strategy.
Sources: Bank of Canada, Government of Canada and Desjardins, Economic Studies

Given the skew towards shorter-dated issuance, the increase in net DV01[1] relative to last fiscal year will not look as pronounced as the increase in net supply in dollar terms (chart 5). But because there was a sharp increase last year as debt issuance was termed out, net DV01[1] hitting the market will also reach its highest level on record.

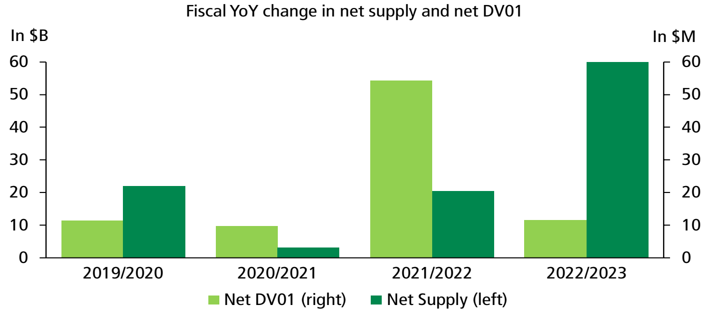
As a result of the continued heavy long-end issuance relative to pre-pandemic, the weighted-average maturity of bonds outstanding will increase to roughly 7 years from under 6 years pre-pandemic. But the shift toward short-end issuance means the weighted-average maturity of bonds outstanding will still be a year shorter than was expected in last year's Debt Management Strategy.

Lingering Indigestion?

The end of primary market purchases by the Bank of Canada will also leave the central bank with fewer benchmark bonds to lend out. As a result, there will likely be more demand from market participants at auctions to proactively shield themselves from market dislocations.

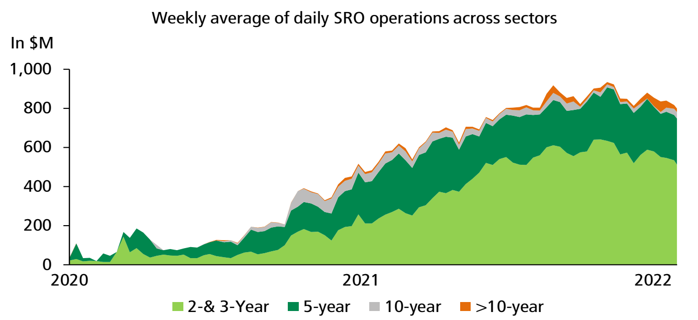
Some benchmark bonds have traded with negative rates in repo over the past year, and the central bank's Securities Repo Operations (SRO) program continues to see strong demand for bonds in short-term tenors (chart 6). The increase in net supply at the short end may ease some of those strains. However, the Bank of Canada has kept the door wide open to buying bonds at auction again if market functioning remains challenged.

GRAPH 5
The change in net supply is larger relative to the change in net DV01



Sources: Bank of Canada, Government of Canada and Desjardins, Economic Studies

GRAPH 6
The Bank of Canada's SRO program continues to see strong demand for the under-5-year sector



Sources: Bank of Canada, Government of Canada and Desjardins, Economic Studies

Re-balancing Act

The Bank of Canada's quantitative easing wasn't a game changer for bond yields. Most estimates suggest that the QE program depressed the 10-year benchmark yield by roughly 10—20bps, with the rest coming from either global factors such as the Fed's QE program or depressed expectations for the future path of the policy rate.

So, the Bank of Canada's quantitative tightening policies might not do all that much to raise risk-free rates, particularly since GoC bond issuance will be focused at the short end. Global factors and increasing expectations for the domestic policy rate have

[1] DV01 is a measure of how sensitive a bond's price is to small changes in interest rates and is an indicator that many market participants use to manage risk.

likely done more to raise rates in Canada and could continue to do so in the months to come.

That said, the Bank of Canada's QT program might have more meaningful effects on other assets via the portfolio rebalancing channel. The private sector will need to hold more GoC bonds. In turn, investors might need to reduce exposure to other assets. Given that the Bank of Canada has no experience with quantitative tightening, there are sure to be at least some unintended consequences. But whether that will push the central bank off its strict diet of no bonds remains to be seen.