ECONOMIC VIEWPOINT

Quantitative Tightening: Diet to End Next Year, but Bonds Not on the Menu until 2026

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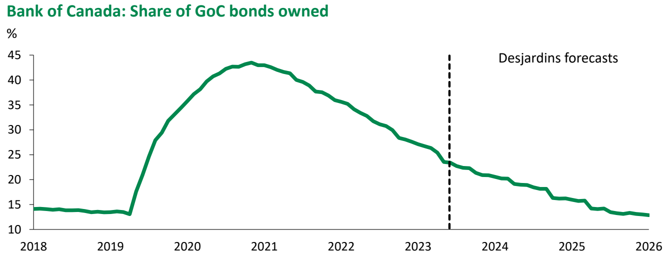
The Bank of Canada has been on a strict diet—and it's been working. Since the beginning of its quantitative tightening program (QT) over two years ago, the Canadian central bank has cut its balance sheet in half, rapidly reducing settlement balances from their previously bloated levels. Still, the Bank is looking to shed more weight, and QT will likely continue until at least April of next year. By then, the Bank of Canada will have shaved off an additional C$26B in bond holdings and is projected to own just 18% of outstanding Government of Canada (GoC) bonds, down from a peak of almost 45% (graph 1). However, even when QT ends, it could take time for the Bank to begin buying bonds again. That will put more pressure on the private sector to absorb the expected record level of incoming bond supply.

Graph 1
Bank of Canada Ownership of GoCs Expected to Decline



GoC: Government of Canada
Bank of Canada, Department of Finance and Desjardins Economic Studies

So, What's Changed?

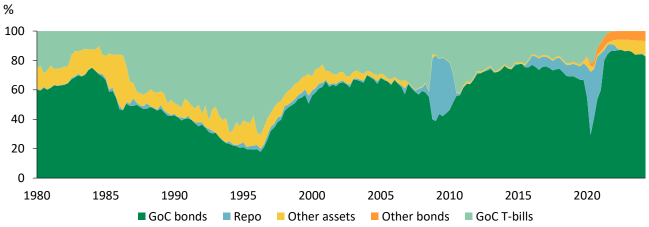
The successful use of operational tools has made it more likely that policymakers get at least close to their target level for settlement balances. Funding pressures rose earlier in the year, causing some economists to call for an early end to QT. However, with the use of overnight repos and the reintroduction of the Receiver General auction, concerns about short-term funding pressures have abated. As a result, the Bank of Canada can continue removing liquidity from the financial system via its QT program, with the goal of pulling settlement balances down to a range of C$20-$60B.

While US central bankers are tapering asset runoff slowly to reduce the stress on funding markets, the Bank of Canada's bond maturities are lumpier, which makes tapering balance sheet runoff more challenging. As a result, Canadian QT will operate more like an on/off switch, with the program working at full tilt until officials put an end to it. Policymakers will therefore lean on operational tools to counter any unwanted funding pressures and reach the desired level of settlement balances. Our revised forecast sees the Bank of Canada ending its QT program in April 2025, just as the mortgage renewal wall hits. That would leave settlement balances just slightly above the top end of the central bank's target range.

The Bank of Canada wants not only a smaller balance sheet, but also to hold a more diverse set of assets. Today, almost the entirety of the central bank's assets are held in GoC bonds, a legacy of the quantitative easing (QE) program used during the pandemic. That's in stark contrast to the Bank of Canada's pre-crisis balance sheet, which held a mix of GoC bonds, GoC treasury bills (CTB), and term repos (graph 2 on page 2). Earlier this year, Deputy Governor Toni Gravelle outlined a path towards a more normal balance sheet. He noted that the central bank would first auction term repo. After rebuilding a sufficient position in term repo, Bank of Canada staff will then work towards adding CTBs. The final step will be to begin buying GoC bonds again. We assume that central bankers are aiming for a mix of assets similar to what was seen pre-pandemic.

Graph 2
Bank of Canada Needs to Reduce Bond Holdings and Add Repo and T-bills

Bank of Canada balance sheet: Composition of asset holdings



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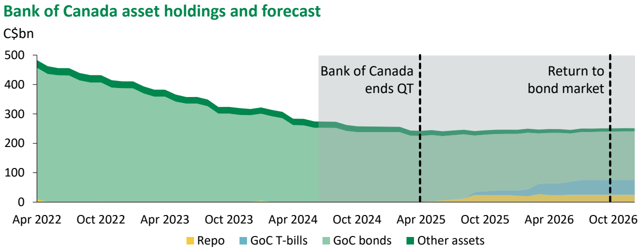
Achieving that composition would mean that the Bank of Canada will only resume its GoC bonds purchases towards the end of 2026 (graph 3). By that time, its ownership share of GoC bonds should have fallen closer to 13%, where it was before the pandemic. That said, the DV01 of GoC bonds held by the Bank as a share of outstanding is likely to remain elevated, reflecting the longer weighted average maturity of its bond portfolio, a result of the long-dated bonds purchased via its QE program.

Graph 3
The Bank of Canada Should Only Begin Buying Bonds towards the End of 2026

Bank of Canada asset holdings and forecast



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When the central bank does begin buying bonds again, purchases will be guided by three key principles: prudence, transparency, and neutrality. To satisfy these principles, the central bank will likely stick to what has worked in the past and buy a fixed share of bonds issued at primary auctions. Our calculations suggest that purchasing roughly 5-7% percent of auctions would be enough to keep pace with the natural growth in its liabilities, which is driven by increasing currency in circulation.

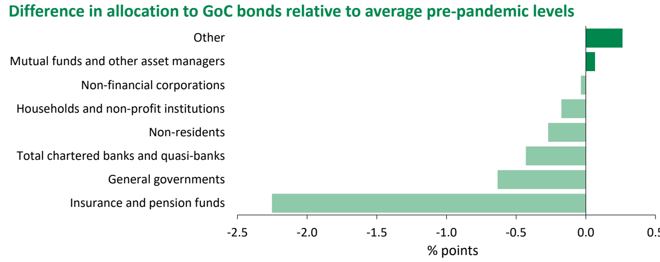
The End of QT Is Likely to Steepen the Yield Curve

CTB purchases should put downward pressure on bill yields. The Bank of Canada will need to buy around C$60B of CTBs (roughly 22% of outstanding) to hit its pre-pandemic balance sheet share. That's a large amount. For context, the main holders of CTBs are domestic pension funds and non-residents, which hold about C$100B of the roughly $280B outstanding.

Between now and the fourth quarter of 2026, the Bank will shed C$84B worth of GoC bonds from its balance sheet. Since the start of QT, domestic pension funds and non-residents, have been the main buyers of the additional supply, taking down nearly C$100B since Q2 2022. But both are still underweight GoC bonds relative to their pre-pandemic asset allocations (graph 4). So, while the combination of bonds rolling off of the Bank's balance sheet and record expected bond issuance will probably require some additional yield to be fully absorbed by the private sector, the increase in term premium from these sources is likely to be relatively contained by still strong demand. In the coming weeks, we'll be publishing an analysis on other factors that will limit the extent of the curve steepening relative to past cutting cycles.

Graph 4
Insurance and Pension Funds Remain Underinvested in GoC Bonds

Difference in allocation to GoC bonds relative to average pre-pandemic levels



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Statistics Canada, Desjardins Capital Markets and Desjardins Economic Studies