INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

Functioning and Liquidity of the Canadian Debt Markets to Date During the COVID-19 Crisis

April 2020

While there are several widely accepted definitions of liquidity, traditionally liquidity is most commonly referred to as the ability of market participants to buy and sell quickly and efficiently without causing a material change in the price of the fixed income instrument in question. In the recent market turmoil as a result of COVID-19 crisis, at times liquidity would more accurately be described as the ability to transact at a price that is an acceptable spread to an indicative market price.

Most market participants will agree that ready and reasonable liquidity is necessary for a well-functioning market. Recently, there have been significant stresses to the financial system and the degree of fixed income market liquidity as a result of the COVID-19 global pandemic. There have been changes in volume of trading activity across all fixed income products (see Chart 1), but decisive actions by the Bank of Canada, federal and provincial governments and regulatory bodies have softened the blow and helped the functioning of many product lines. Impressively, IIROC's Canadian monthly trading volume data for March shows that Canada's money market and bond trading volumes have actually gone up. That is not to say that certain less liquid products such as high yield debt are actively trading.

To be sure, Government spending and other programs that have been announced to offset the economic effects of Covid-19 have dramatically increased during the month of March and into early April resulting in a large increase in government debt issuance. This will require record issuance of T-Bills and bonds in the coming months that dealers and their customers will have to contend with.

In early March, there was extremely high volatility in both equity and fixed income markets resulting in sharp and unusual price movements and the flow of funds into safe haven government fixed income products and gold. Credit and bid offer spread spreads on provincial and corporate bonds moved wider, but these markets did continue to trade. Corporate spreads in particular widened dramatically as one might expect, but investment grade issues have since tightened back in to a degree.

The Bank of Canada has announced a number of actions that will help support a well functioning Canadian capital markets. These include monetary policy through lowering interest rates that help to sustain economic activity while maintaining low and stable inflation. Other actions by the Bank of Canada that will help support and provide liquidity to the financial markets will result in a substantial increase in their balance sheet include the following:[1]

Government of Canada Bond Purchase Program (GBPP)

- The purchase of Government of Canada securities in the secondary market.

Canada Mortgage Bond Purchase Program (CMBP)

- The purchasing of CMBs that aids financial institutions to renew mortgages during this time of financial stress.

Bankers' Acceptance Purchase Facility (BAPF)

- The purchase of bankers' acceptances (Bas) that are an important source of funding for small and medium-sized corporate borrowers.

Provincial Money Market Purchase Program (PMMP)

- The purchase of short-term provincial borrowing.

Commercial Paper Purchase Program (CPPP)

- The purchase of commercial paper markets that have shown strains and are issued by a diverse group of public and private institutions.

Contingent Term Repo Facility (CTRF)

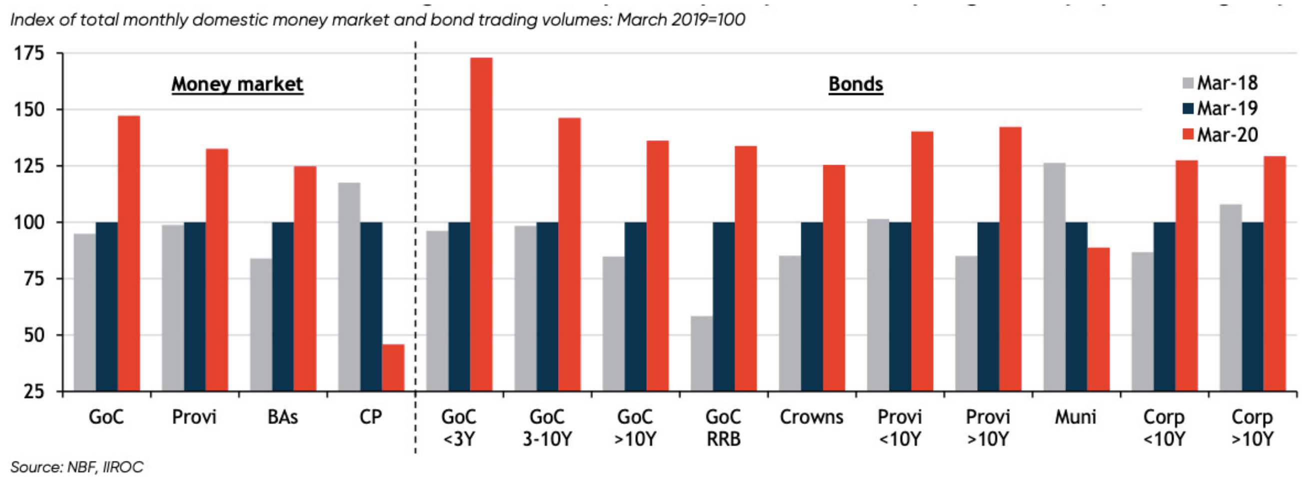
- This bilateral liquidity facility provides funding secured by securities issued or guaranteed by the Government of Canada or a provincial government.

Liquidity for individual financial institutions

- Provides liquidity to certain individual financial institutions that may have their own unique funding issues.

[1] https://www.bankofcanada.ca/markets/market-operations-liquidity-provision/covid-19-actions-support-economy-financial-system/

Chart 1



Enhanced term repo operations and Standing Liquidity Facility (SLF)

- Provides access to funding for an expanded list of eligible institutions with access to a longer term and broader range of collateral that is accepted.

Standing Term Liquidity Facility (STLF)

- Financial institutions can use broader set of collateral that includes mortgages to help provide business and personal loans.

The Canadian and U.S bond markets have resisted the movement towards negative interest rates that is found in a number of European and some Asian markets. At present it would seem that this is not a likely scenario for the Canadian market, but to be sure Canadian rates are close to zero and there exists a small possibility for a move to negative rates. The recent increase in government debt issuance would tend to make this move to negative rate all the more unlikely. On a related note the COVID-19 crisis resulted in the Bank of Canada postponing a GoC market functioning (GMF) steering group that was considering a fail charge regime to help proper repo and settlement functioning in an ultra low rate environment.

With the Bank of Canada overnight target at 0.25% the yield curve is currently normal albeit at historically low rates (3 mos 0.325%, 2 yr 0.374%, 5yr 0.554%, 10yr 0.752%, 30yr 1.416% as of 04/14/20). Rates are likely to remain low and the curve normal until there is more clarity on COVID-19 outcomes and the resumption of most economic activities and ultimately economic growth. During crisis periods experienced in the last 35 years rates generally risen quite slowly as market conditions improved.

There have been temporary dislocations in fixed income and safe haven markets: bonds, cryptocurrencies, and gold selling off at the same time as equities for short periods of time because there was liquidity in those products when cash had to be raised. It should be noted however, that these forced liquidations were thankfully short lived.

Fixed income ETFs also experienced short lived disconnects where bid-offer spreads on actively trading bonds widened dramatically and market participants were unable to get satisfactory fills on their orders or were compelled to buy at wide spreads to meet mandates. This temporary situation resulted in a mismatch between certain fund's net asset value (NAV) and the fair market value of the underlying instruments, resulting in erratic price movements. A positive spin on the disconnect that can and has occurred in related markets is summarized by Rich Powers, head of ETF product management at Vanguard, the world's second-largest asset manager "Market prices for ETFs can move more rapidly than the net asset value. That is part of the price discovery process." It is a positive outcome that pockets of illiquidity and disconnect, with a few exceptions, to date, have been short lived.

In the current environment of economic uncertainty and the ultimate COVID-19 related effects on people and financial markets in addition to vulnerable groups and businesses large and small, the federal and provincial governments, the Bank of Canada and regulators have risen to the challenge. Going forward there will no doubt need to be additional support to encourage capital formation and investor confidence, but these groups have shown that they have the know how and tools that they have used, and additional measures and tools, if need be, to promote economic growth and stability of the Canadian financial markets.

Appendix – Recently Announced Future Programs

PROVINCIAL BOND PURCHASE PROGRAM (PBPP) (MONETARY - UNCONVENTIONAL)

On April 15, 2020 the Bank of Canada announced a Provincial Bond Purchase Program (PBPP) augmenting the PMMP to support provincial government funding. The PBPP will buy up to $50Bn bonds to a maturity of up to 10 years. The program will purchase up to $50 billion. The program will start in early May.

CORPORATE BOND PURCHASE PROGRAM (CBPP)

On April 15 the Bank of Canada announced a Corporate Bond Purchase Program (CBPP) to support corporate bond issuers in Canada. The CBPP will buy up to $10 billion senior secured and unsecured bonds with remaining maturity of up to 5 years originated by Canadian incorporated companies with a minimum credit rating of BBB. The program will start in early May and does not include bank issues.