Investment Industry Association of Canada

LIQUIDITY IN CANADIAN FIXED INCOME MARKETS

August 2022

INTRODUCTION

Debt markets play an important role in the functioning of the Canadian economy and financial system. Government bonds in particular are very important as they set the benchmark spread for other non-government products. Fixed income market liquidity—the ease of buying and selling desired quantities of a fixed income asset—is an important indicator of how well these markets are functioning. According to some measures, market liquidity has declined since late 2021 for recently issued Canadian government bonds, provincial bonds, and corporate debt instruments as well as in futures markets.

Lower liquidity in these important markets can amplify price volatility and result in unexpected tightening in overall financial conditions. In extreme cases, such as the market turmoil at the onset of the pandemic in March 2020, liquidity issues threatened to impair the core financial system and investor's ability to adjust their holdings of assets to raise cash or hedge risks, or if they were able to, they were only able to do so only at a substantial cost. While the recent deterioration in liquidity over the last 12 months has not been as extreme as some past episodes, the risk of a sudden significant deterioration may be higher than normal.

Several actions by our central bank have contributed to this current state. Notably, The Bank of Canada (BOC) ended and adjusted operational parameters of emergency liquidity measures, they began quantitative tightening (QT) and increased bond issuance. In addition, increased capital constraints on banks and dealers and persistently high inflation may also have a meaningful combined effect on bond market liquidity and fixed income market sentiment going forward.

Evidence of lower liquidity is demonstrated by liquidity providers reducing risk at times by quoting in lower trade size quantities and possibly even widening bid-ask spreads. In extreme situations, there is concern that some liquidity providers may pull back from the market altogether in certain instances.

BANK OF CANADA PROGRAMS

When key financial markets became strained in March 2020, the BOC promptly responded by introducing several programs to provide liquidity and maintain market functioning. As market functioning gradually recovered, some of these facilities and operations have either been suspended, discontinued, or scaled back.

The following programs which have been suspended include:

- **Securities-lending program**
- **Term Repos**
- **Contingent Term Repo Facility**

The following programs which have been discontinued are largely asset purchase programs which include:

- **Bankers Acceptance Purchase Facility**
- **CMB Purchase Program**
- **Commercial Paper Purchase Program**
- **Corporate Bond Purchase Program**
- **Government of Canada Bond Purchase Program**
- **Provincial bond purchase program**
- **Provincial Money Market Purchase Program**

The programs which are still in operation include:

- **Overnight Standing Repo Facility** - The BOC makes its Overnight Standing Repo Facility available to primary dealers in order to help reinforce the upper limit (Bank rate) of the operating band for overnight interest rates.
- **Standing Liquidity Facility -** The BOC's Standing Liquidity Facility (SLF) provides access to liquidity, in the form of secured overnight advances, to direct participants in Lynx, to support orderly settlement in the payments system

QUANTITATIVE TIGHTENING AND IT'S IMPACT ON FIXED INCOME MARKETS

As announced on April 13, 2022, the BOC ended the reinvestment phase of its asset purchase program and the beginning of QT. With QT, maturing Government of Canada bonds will no longer be purchased by the BOC and the size of its balance sheet will decline over time. Effective April 25, 2022, the BOC stopped purchasing Government of Canada bonds in the primary and secondary markets. Accordingly, the final Government of Canada Bond Purchase Program operation was held on April 21, 2022, in the 10-year sector. At this point in time, the BOC is not considering selling bonds that it currently holds.

While central bank asset purchases were instrumental in calming financial markets during the period of extreme volatility in March and April 2020, as the pandemic wore on QE appears to have had a more muted impact in reducing yields and less of a need to soothe strained market functioning.

With ongoing economic recovery and continued upside inflation surprises, central banks reversed course, but not as quickly as some called for. The process of raising policy rates and normalizing swollen balance sheets once begun, however now has a sense of urgency. QT will, by increasing the supply of bonds available to the market reinforce central banks policy hikes and, by increasing the supply of bonds available to the public, put downward pressure on bond prices and upward pressure on yields. As central banks allow assets to roll off their balance sheets, reserve balances will decline, putting downward pressure on commercial bank deposits. As long as the process is gradual enough and lending growth remains positive, deposits will decelerate but not shrink outright. As the QT process takes money out of the financial system, some borrowing costs are bound to rise. Just as QE drove interest rates down, QT can be expected to put pressure on them to rise.

As the economy recovers from the pandemic shock, central banks will continue the process of balance sheet normalization. In a reverse fashion of the effect of QE, QT influences longer-term yields mainly by signalling higher short-term rates. In contrast to its impact on yields, the mechanics of QT on the quantity of reserves is relatively clearer. As a central bank removes assets from its balance sheet, its reserves will also decline. Due to its interaction with liquidity requirements, the downward pressure on deposits may increase funding costs for financial institutions.

With the combined effect of a currently slowing economy, central banks need to continually reassess QT and not act too abruptly but will eventually likely ramp up the runoff. The BOC has stated that active sales of assets are not anticipated at this time.

EVIDENCE OF LIQUIDITY STRAINS IN CANADIAN FIXED INCOME MARKETS

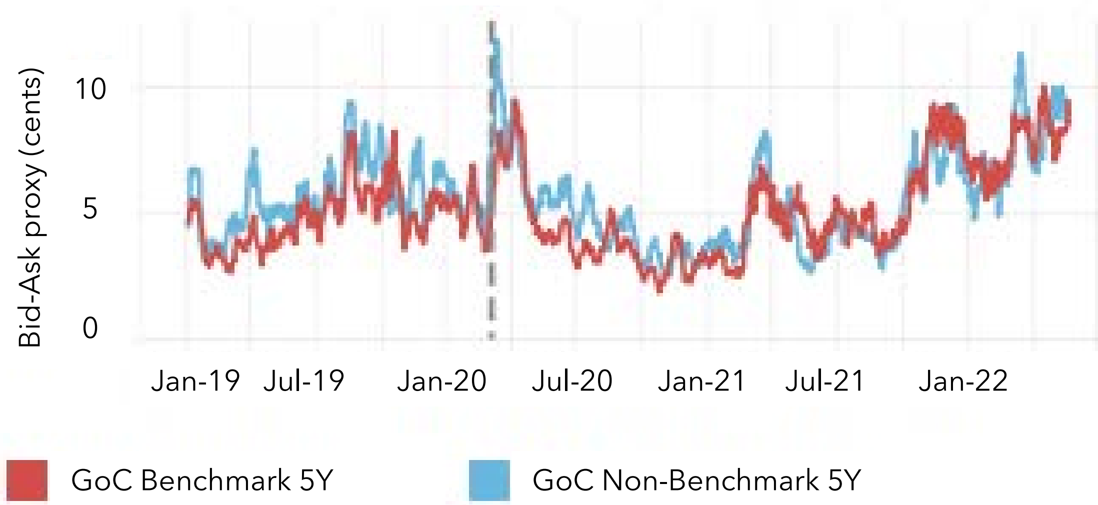
A worrisome development for markets this year has been the deterioration of liquidity in fixed income markets. It can be convincingly argued that liquidity has fallen since late 2021 in Government of Canada bonds, provincial bonds, corporate bonds, and futures markets. These markets have been supported since the start of the pandemic but underlying structural weaknesses have become evident.

The wholesale funding markets where historically banks, acting as dealers, have played a key role in providing liquidity have been impacted by more restrictive regulatory capital requirements put in place as a response to the financial crisis which arguably makes participating in fixed-income markets more costly.

In Figure 1, which displays a bid-ask proxy for 5yr Government of Canada benchmark and non-benchmark bonds it is evident that there has been a general widening of these spreads since the fall of 2021. Supporting this view is Figure 2 which displays the price impact proxy for 5yr Government of Canada benchmark and non-benchmark bonds which have also appreciably widened since the fall of 2021.

Figure 1: CFIF Liquidity Dashboard (June 21, 2022)

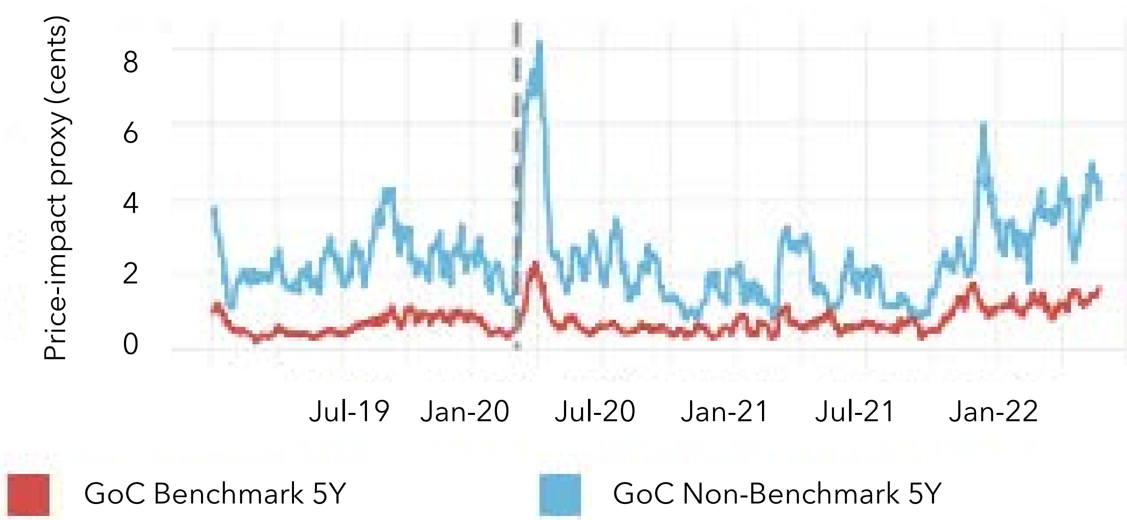
Bid-ask Proxy, Government Bonds
10-day moving average, daily data



Source: Canadian Depository for Securities and Bank of Canada calculations

Figure 2: CFIF Liquidity Dashboard (June 21, 2022)

Price-impact Proxy, Government Bonds
10-day moving average, daily data



Source: Canadian Depository for Securities and Bank of Canada calculations

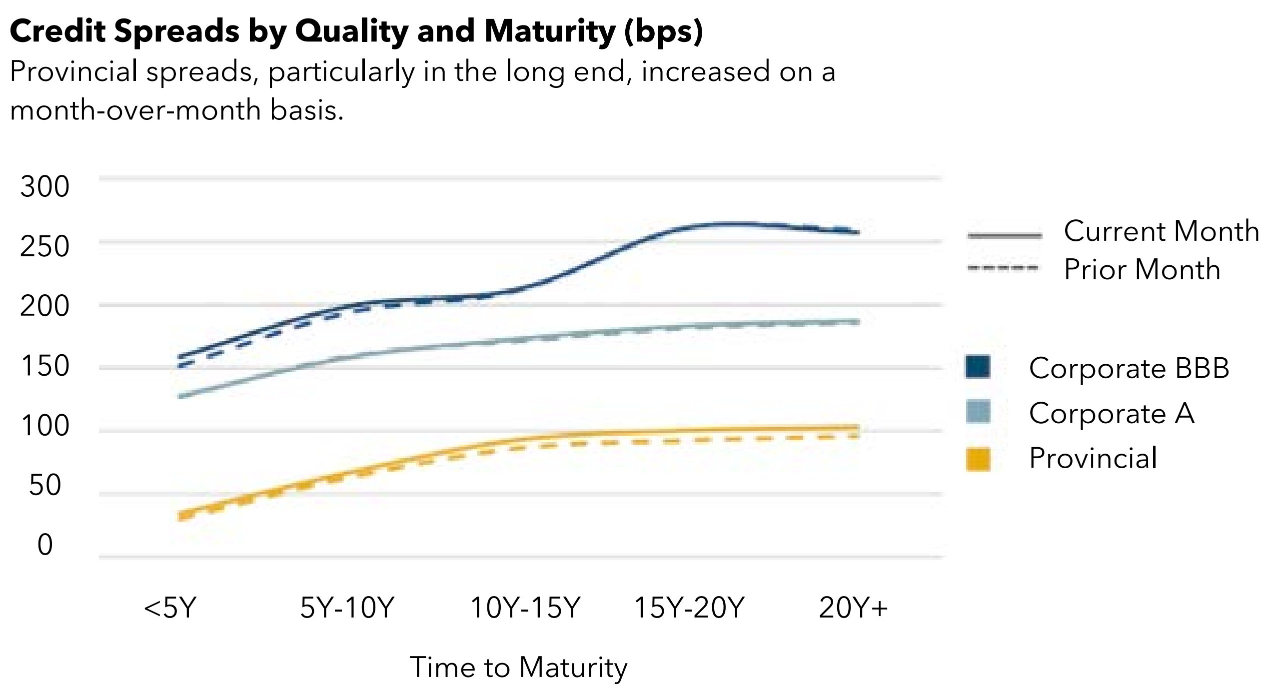
Reasons for lessened liquidity in fixed income markets include a rollback of liquidity supports and increased supply, but it also appears that capital markets firms are committing less of their balance sheet to market-making activities. To their credit, central banks and policymakers have identified that there may be some fundamental structural impediments and have made it clear that market liquidity support can be re-instated at any time if needed.

The lesson from the events of March 2020 is that secondary markets need to be in a position to supply adequate liquidity to all market participants when it is needed most and there needs to be an evaluation of the impact of regulations and capital requirements on market participants that provide liquidity and act as dealers in these markets.

CORPORATE AND PROVINCIAL CREDIT SPREADS MOVED WIDER IN RECENT MONTHS

On aggregate, corporate bond liquidity has deteriorated in the last several quarters and credit spreads have continued to increase across the maturity spectrum. In a continued "risk-off" environment for higher beta, BBB-rated, as well as financials (often deemed the most liquid corporate bonds) credit, has underperformed. With market volatility still elevated, new issuance was slow in the 2nd quarter of 2022 with very muted volume and antidotal evidence that many corporate entities have in fact recently relied on utilizing bank lines instead of new bond issuance. The increase in provincial spreads was largely due to abundant supply.

Figure 3: (April 2022 May 2022 Spread movement)



Source: SLC Management - June 2022: Canadian Corporate Monthly Bond Watch

Government policies centred on quantitative tightening and aggressively hiking overnight administered interest rates have led to increased volatility largely for the following reasons:

- It has been a while since most central banks last tightened – so this all feels unfamiliar. Markets typically react negatively to uncertainty and rate increases in general.
- Aggressive tightening is viewed less favourably than gradual tightening cycle.
- Markets might be more forgiving if the rate hiking was to deal with excessive economic growth, but in the current instance, it is mainly to deal with surging broad-based inflation.

CONCLUSION

Many market participants are assuming that central banks will quickly succeed in fighting inflation through raising interest rates and that government finances and corporate profitability will remain buoyant, downplaying excessive central bank tightening that would result in significantly lower demand and economic growth.

- Some disagree with these views. They believe investors are too focused on a rapid but muted rate hike cycle and overlooking the impact of a withdrawal of liquidity.
- In the next 12 months, central banks are expected to drain up to $2 trillion of global liquidity. The U.S. Fed will account for about half of this as it reduces the size of its balance sheet, but the BOC will also make a sizable drawdown. Removing excess liquidity, and significant capital requirements alongside ongoing interest rate hikes poses undeniable headwinds for fixed income market liquidity as well as on rich stock valuations, but it also creates room for central banks to react and smooth future market disruptions.

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