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June 2020

COVID-19 Recovery: Canada versus the USA

Summary

Portfolio Managers tasked with a relative value mandate may agree that Canada's economy can suffer more than that of the US given earlier and more complete stay-at-home orders, slower opening of the economy in May/June, and less aggressive fiscal policy. Although economic statistics have been slow to reflect some of the unusual slowing of the economy due to the pandemic, some evidence already shows this such as the Q1 GDP decline released in late May and the reversal in the US unemployment rate (but not Canada's) on June 5th.

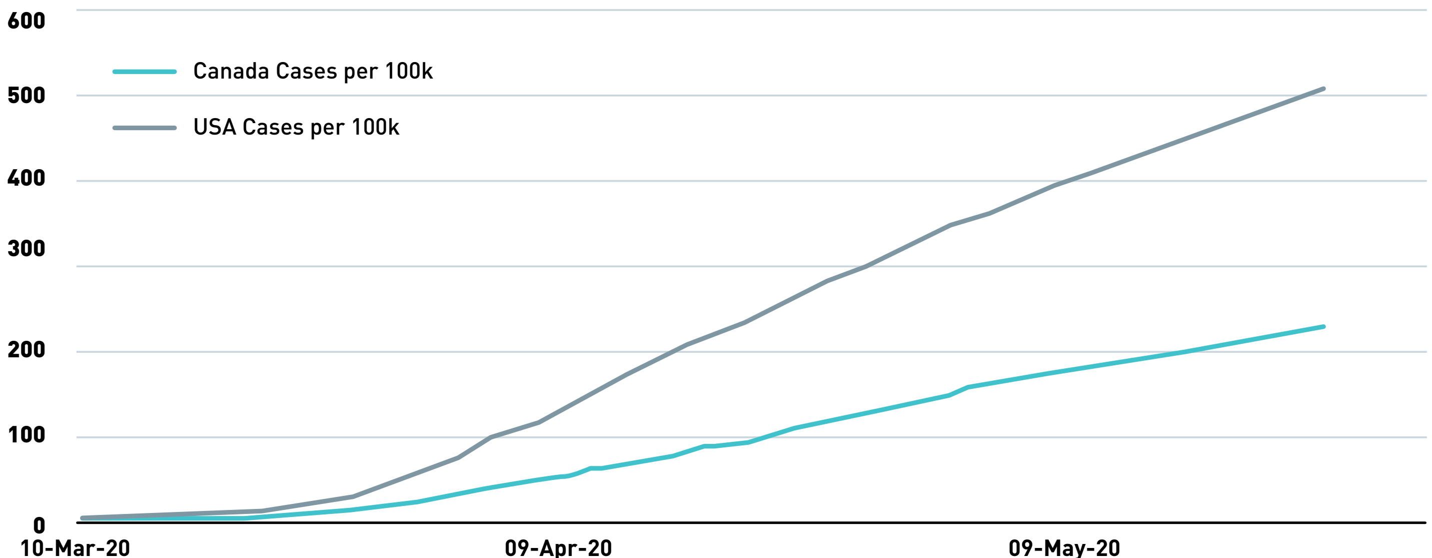
Impossible Policy Choices

As we have all read in recent days, policy makers in all countries must make an impossible choice between lives lost to COVID-19 and livelihoods lost to the stay-at-home orders and their effect on the economy. It appears that the USA is pursuing a more rapid opening of the economy currently than Canada's go-slow approach and, while we refrain from judging any policy decision, the speed of re-opening may provide cross-currency relative value opportunities in the future.

Severity & Response

The severity of the COVID-19 crisis, while by no means inconsequential in Canada, has paled in comparison to the experience south of the border. In early March, Canada had a growth rate of COVID-19 cases rivaling that of the USA[1] but the rate of infection in the population has tracked at less than half that of the USA for months now, as shown in Figure 1. The number of deaths has tracked with roughly the same ratio during the same period, as shown in Figure 2.

FIGURE 1
Cases per 100k Population

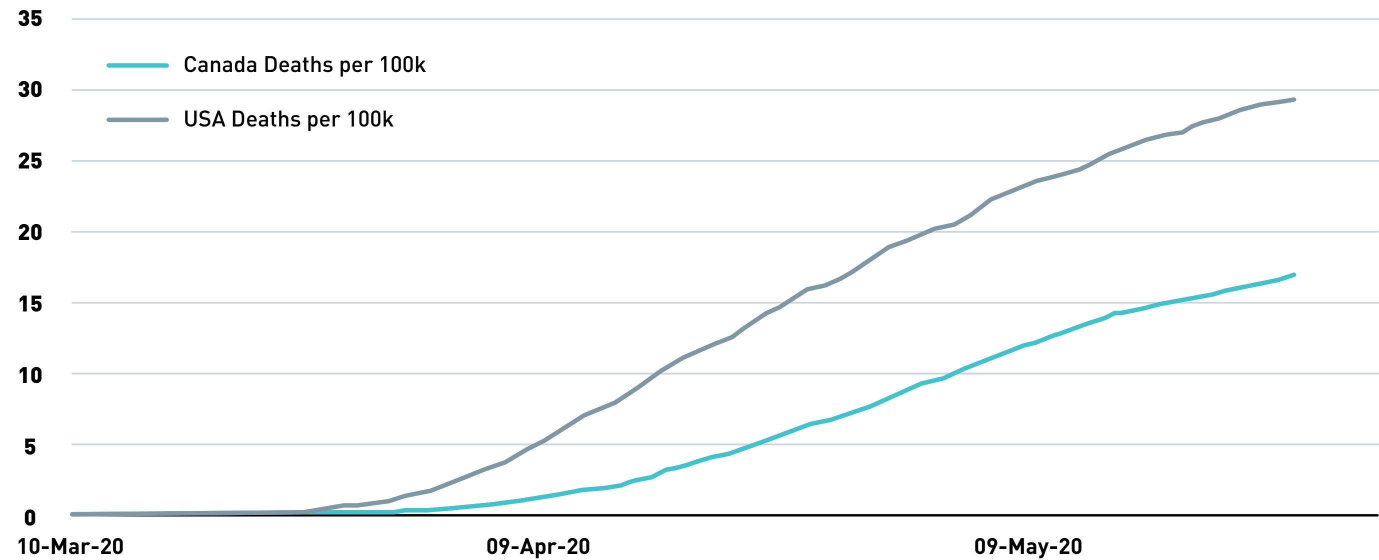


Source: New York Times, Statistics Canada

1. Both nations had doubling rates approaching 2 days in mid to late March.

FIGURE 2

Cases per 100k Population



Source: New York Times, Statistics Canada

One reason for this lessened impact was almost certainly the decision to implement stay-at-home orders in most of Canada on or before March 23rd while the USA[2] did not shut down until March 27th. While the severity of cases and deaths has been lesser in Canada, the tradeoff of interest for portfolio managers is the potential greater effect on economic activity in Canada.

Fiscal Response

The fiscal response to severely reduced aggregate demand due to stay-at-home orders and a general fear of social interaction has been similar in each country.

Largely by March 18th, Canada's federal government had announced a multitude of new measures designed to fight the virus spread, prop up consumer demand, and support businesses during the pandemic. The myriad of measures undertaken include mortgage payment deferrals, payments to workers who have lost their jobs, payments to low/modest income families, payments to those caring for children, payments to seniors and students as well as access to credit for businesses, interest free and guaranteed loans. The measures, in terms of Federal spending, amount to 11.5% of GDP[3] , including amounts implemented in close coordination with the Provinces.

The US CARES act was signed into law on March 27th, after a shortened political process that began around March 23rd. Like Canada, there are a myriad of measures which include direct payments to individuals and those caring for children, loan advances, and loans to struggling businesses. The measures amount to $3 trillion or 15% of GDP, exceeding the measures enacted by Canada after adjusting for the relative size of the two economies. Additional stimulus packages have thus far failed to pass the Senate. States, unable to borrow, have enacted small responses, mostly to direct emergency funding directly to hospitals to fight the pandemic.

Monetary Response

By and large, the monetary response in each country was swift and almost immediate. Intra-meeting rate cuts by 150 basis points in each currency, mortgage forbearance programs, quantitative easing in the form of government bond purchases, money market liquidity facilities, protecting banks and other primary dealers from pulling back liquidity, corporate bond purchases, commercial paper purchases, municipal bond liquidity programs in the US and short-term provincial bond and mortgage purchases in Canada. The programs run the gamut and are, doubtless, familiar to all readers at this point.

The net result of the above programs has been to increase the assets on the balance sheet of the Bank of Canada from $120 billion pre-COVID to $442 billion in late May 2020, an increase of 268%. At the Federal Reserve, assets have increased from $4.15 trillion to $7.04 trillion during the same period for an increase of just 70%. Although the Federal Reserve had a "head start" on all types of quantitative easing from the 2008 financial crisis and has a higher quantity of assets[4] on its balance sheet, it is relatively clear that more monetary easing has been necessary in the Canadian economy than in the US economy as a direct response to the pandemic.

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2. Population weighted for each state. Municipal orders are ignored here. Some states that never imposed stay-at-home orders are also ignored.
3. International Monetary Fund Policy Tracker.
4. After scaling for the size difference between the two economies, of course.

Economic Impact & Reopening

Given the smaller sized fiscal stimulus, greater unusual monetary stimulus drawn upon in secondary markets, and quicker response to shut down, one would expect the total economic harm to the Canadian economy would be greater than that to the US economy. Although data is limited still at this point, this appears to be the case. Real GDP decreased in Q1 in Canada by 8.2% versus just a 5% reduction in the US. The difference was largely attributable to two factors.

First, Canadians purchased less goods than US consumers during the lockdown, particularly durable and semi-durable goods. Recall that Canada shut down more quickly than much of the US did when the pandemic hit and, to our knowledge, few areas of Canada have been involved in attempting to openly defy the stay-at-home orders.

Second, the US benefited from an increase in Net Exports when imports fell more than exports which seems to indicate that the domestic economy was suffering harm while other economies which receive US exports were not. This was not the case in Canada as the rapidly dropping oil price hurt exports significantly.

In non-GDP indicators, Canada's unemployment rate rose 7.3% to the end of April from April 2019. In the US, that measure is an increase of 11.4%, but Canada's participation rate fell drastically more than that of the US – it seems the population simply gave up looking for work during the lockdown in Canada while the search continued in the USA[5]. Canada lost 3 million jobs (10% of the population 15+) while the US lost 25.4 million jobs (also 10% of the population 15+) but both economies bounced back a little in the surprising May labour market data released on June 5th.

In terms of reopening, Canada appears to be following a "go slow" strategy despite having a growth rate of virus cases lower than that of the US and far fewer cases and deaths per capita. In contrast, US officials have committed to reopening and staying open regardless of future developments. With a longer social distancing period, greater reduction in GDP per capita (so far) and less fiscal stimulus by Federal and Provincial governments, we believe Canada is more likely to suffer greater economic damage from the virus than the US.

Trade Potential

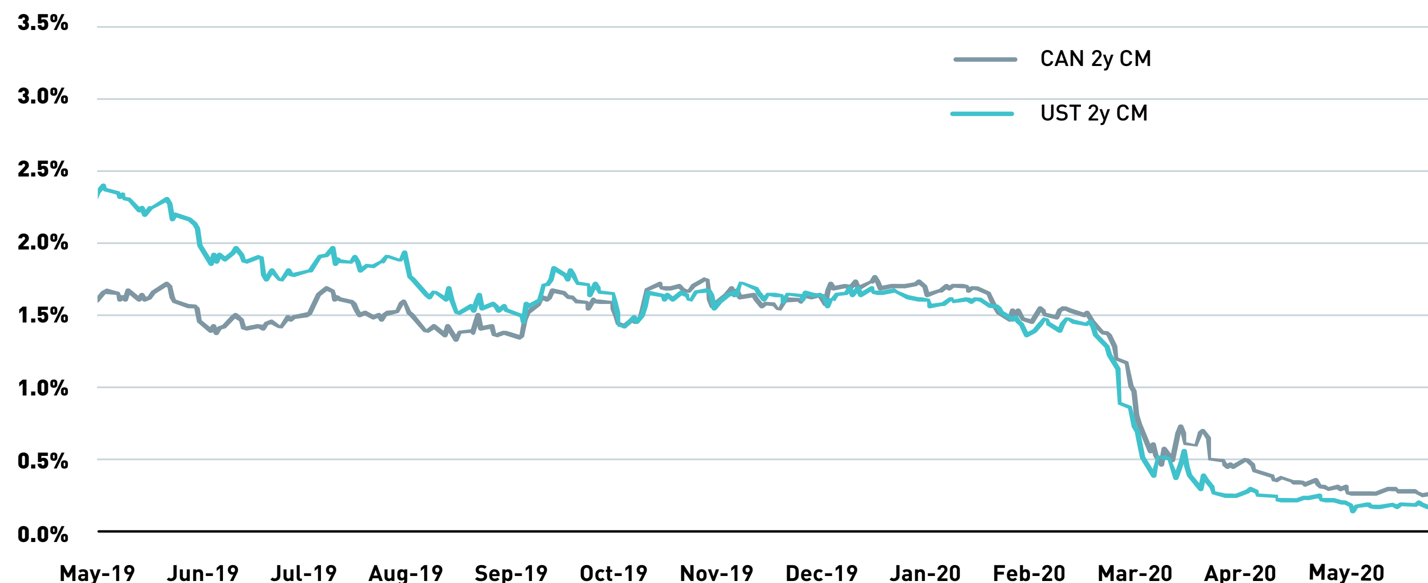
While the timing is subject to much debate, at some point interest rates must revert to a more normal level. Given the arguments above, one could fashion a long position in Canada versus a short position in US bonds, or, alternatively, by trading futures contracts as described below.

Current Market Conditions

Yields have fallen in both markets, to make an understatement, but they have fallen farther and lower in US markets than in Canadian markets. Figure 3 shows the rapid fall in 2-year bond yields in each country from around 1.5% to the current 0.25% and 0.15% in Canada and the USA, respectively. Similar moves occurred in the 5-year rate (not shown).

FIGURE 3

CAN, UST 2y CM Bond Yields



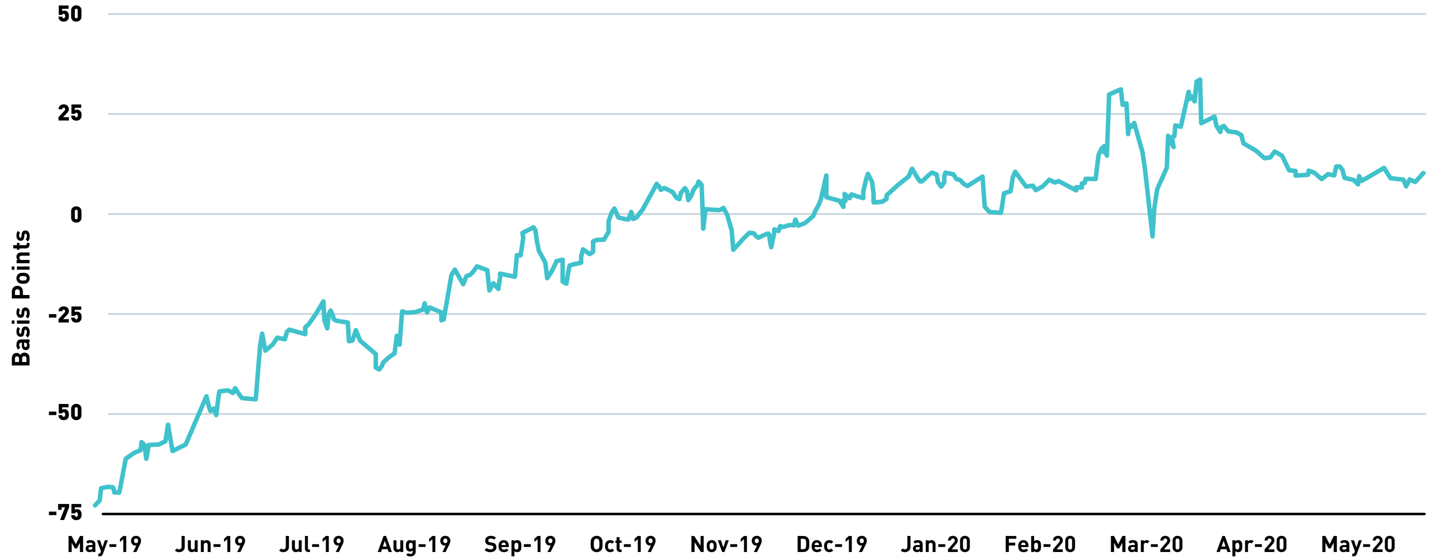
Source: Federal Reserve H.15, BMO Capital Markets Fixed Income Sapphire database

5. Canada's benefits to the temporary unemployed appear more generous as those out of work due to the pandemic can collect $2k every four weeks for up to 4 months plus some generous wage subsidies that are missing in the US. In contrast, US CARES cheques have suffered delays given the large volume.

Turning to spreads instead of yields, Figure 4 and Figure 5 show the change in the Canada versus US yield spread over the past year for 2-year bonds and 5-year bonds. For our COVID-19 recovery hypothesis, we should only be concerned with the spread movements since the beginning of the year. We suggest here that, if the US is to recover sooner than Canada due to aggressive reopening, the spread should revert toward levels more akin to the pre-virus era.

FIGURE 4

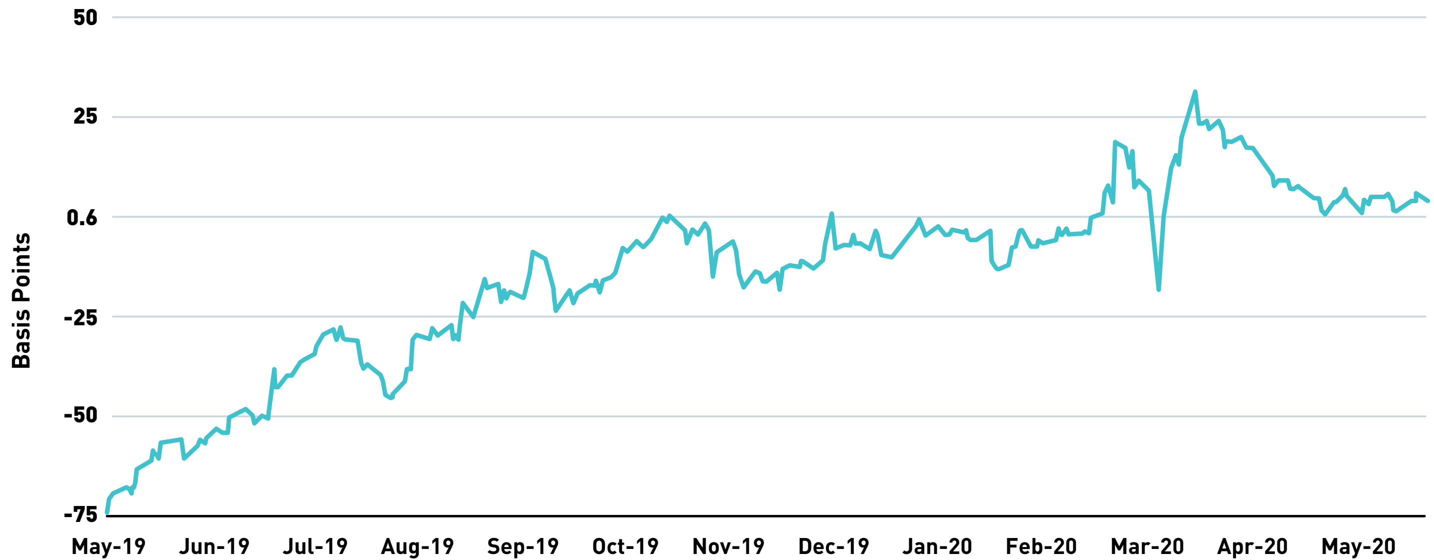
CAN 2y Yield less UST 2y Yield



Source: : Federal Reserve H.15, BMO Capital Markets[i] Fixed Income Sapphire database

FIGURE 5

CAN 5y Yield less UST 5y Yield



Source: : Federal Reserve H.15, BMO Capital Markets[i] Fixed Income Sapphire database

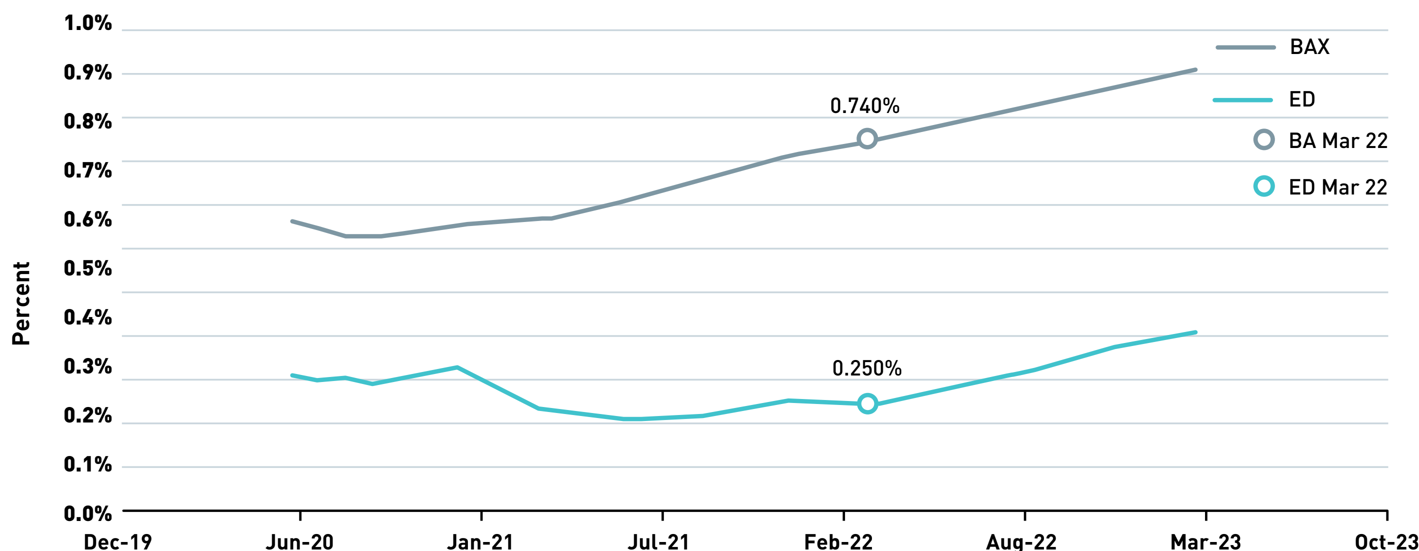
BAX/CORRA

The spread widening in Figure 4 from the beginning of the year is not extreme but for those that believe in a rapid recovery occurring first in the USA (or a lagging Bank of Canada for any other reason), trading the very front end of the curve may make sense.

As of early June, a Portfolio Manager could buy the March 2022 three-month Canadian bankers' acceptance futures (BAX) contract and sell the March 2022 Eurodollar contract at a spread of about 50 basis points, as shown in Figure 6, which plots the short-term interest rate futures curve in each currency. The position would roll positively by just over 15 basis points in the first year.

FIGURE 6

BA-ED Term Structures, June 3rd, 2020



Source: CME Group, Montréal Exchange

An alternative trade, after the launch of a new product on Montréal Exchange on June 12th, would be to do the same trade using CORRA futures (CRA). Although one would forego the positive rolldown arising from the credit spread term structure embedded in bankers' acceptance rates (small, but positive) it would be a direct play[6] on the relative actions of the Central Bank which could be spread against either Federal Funds or Secured Overnight Financing Rate (SOFR) futures in the USA[7].

CGF/FV

Although not as pure, a more conservative trade would be to express a potential COVID-19 recovery trade in 5-year yields. As shown above in Figure 5, the spread of 5-year yields moved drastically in the latter half of 2019 and has widened from -5 to +4 since the beginning of the year. Although the 5-year spread was very wide at +28 at one point during the preliminary stages of the pandemic in mid-March, that was probably associated with extreme market reactions to buy safe haven assets such as short-term treasury bonds that Canadian bonds didn't immediately benefit from.

On June 5th, a Portfolio Manager could buy Canadian 5-year Government of Canada bond futures CGFU20 at 126.55 (futures yield of 0.573%) and sell the 5-year US Treasury note futures FVU0 at 124.804 (futures yield of 0.525%) or a yield spread of around 5 basis points. The trade would carry slightly positively and the position would benefit if Canadian yields fail to rise as quickly as US yields during a COVID-19 recovery scenario. Figure 7 shows that a position of 172 contracts of CGF versus a short position of 137 contracts of FV would be DV01 and currency neutral for a spread position of $10,000 CAD in total, which can be scaled to the appropriate size for most portfolios.

6. For more information on the Montréal Exchange's CORRA Futures, visit m-x.ca/corra and the product specifications page.
7. Portfolio Managers who think Canada will recover much faster than the USA might prefer the CORRA/SOFR version in the opposite direction as they would save the negative rolldown costs.

FIGURE 7

	CGFU20	FVU0
Contract Price	126.55	124.80
Cheapest-to-Deliver Bond (CTD)	1.25% Mar 01/25	1.5% Nov 30/26
CTD Years to Maturity	4.73	4.48
Conversion Factor	0.8151	0.8362
CTD DV01	4.7	4.5
Contract DV01	5.8	5.4
Contracts for 10k/bp in Local Currency	172.0	184.6
FX to CAD	1.0000	1.3499
Contracts for 10k/bp CAD	172.0	136.8

Source: CME Group, Montréal Exchange

Risks

The pandemic in 2020 has unfolded in unforeseen ways, obviously, and will probably continue to do so. Among other possibilities, the following risks exist for anyone playing the Canada/US spread:

1. This is an election year in the USA and the Federal Reserve is, in many ways, less independent than in the past. A normal course of action in the past would be avoid meddling, or even the appearance of meddling, in the political process during the political campaigns. That may or may not have changed given the recent attempts to politicize the Federal Reserve but, in any case, the Fed may be reluctant to even speak about reducing the monetary stimulus in place before the vote in November, regardless of the state of the economy.

2. Canada has more borrowing capacity than the US in terms of total government debt[8] to GDP and typically responds more quickly with fiscal policy. Even with a minority government, Canada can apply more stimulus while the US seems to be struggling to do so as summer begins.

3. Volatile markets can lead to a rush to US Treasuries that is typically not reflected right away in Canadian bonds. This can lead to temporary spikes in the cross-currency spread which would harm the mark-to-market value of this trade.

4. Although both central banks are already taking aggressive quantitative easing measures by buying government bonds, if the Federal Reserve became more aggressive than Canada (i.e. more monetary easing), or began targeting negative yields with their bond purchases, Canada may not follow and long Canada versus short US Treasury trades would suffer.

8. Including all levels of government

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