Futures Flash Series ARTICLE 24

MONTRÉAL EXCHANGE

July 2024

Summer: Season of Opportunities?

The summer months have a reputation for calmer markets, lack of liquidity, and generally slower working days for fixed-income managers. Rather than use the slow days for completing bureaucratic tasks and shelving the summer months as non-productive trading days, let's take a moment to examine some opportunities that are often unique to the summer.

Liquidity Doldrums

Although the pandemic and work-from-the-cottage may have changed the dynamic somewhat, the summer months of July and August, when kids are out of school and cottage life beckons for many city residents, have typically been associated with periods when trading floors on both the buy and sell side of the street were left to more junior members. The result is sometimes a lack of aggressive pricing, related prices (spreads) that trade at levels that would seem unusual at other times of year, and decreased volume.

To demonstrate this effect in futures contracts, we constructed a simplistic annual analysis of volume in Ten-Year Government of Canada Bond Futures (CGB™) contracts on Montréal Exchange for the past 10 years. In Figure 1, we compare the volume of contracts traded in July versus the other non-roll months[1], and find that July volume is only 90% of the average. Further, a comparison of August, a roll month, versus the other futures roll months also reveals that the summer roll is a little less active than the rest of the roll months. Finally, we also compare July volume to June of the same year, months where no roll activity occurs, and the August roll month to February and find that July is reduced by about 15% while August volume is 5% lower than the non-summer roll month in the same year.

FIGURE 1

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	AVERAGE
CGB July Volume as Percent of Non-Roll Months	92%	104%	70%	92%	86%	96%	82%	88%	96%	92%	**90%**
CGB August Volume as Percent of Roll Months	98%	110%	90%	94%	93%	102%	94%	96%	103%	93%	**97%**
CGB July Volume Change versus June	-14%	-7%	-30%	-34%	-20%	0%	-14%	-10%	-17%	-8%	**-15%**
CGB August Volume Change versus February	12%	6%	-10%	-4%	0%	3%	-19%	-14%	-11%	-14%	**-5%**

Source: Montréal Exchange

1 Volume is always much higher in the roll-months of February, May, August, and November.

We suspect that, given the reduced volume and probable reduction in risk taking (i.e. aggressive liquidity provision) at dealing desks, trades of any type where liquidity is demanded will be more difficult in the summer months. The flipside is that, for some aggressive risk takers, this reduced volume and liquidity may present opportunities to provide liquidity when the normal risk takers who do so are…well, at the lake.

Examples of liquidity providing trades are: participation in the summer government bond auctions[2], keeping a close eye on futures basis in CGB and the Five-Year Government of Canada Bond Futures (CGF™) contracts, which normally keep a very tight relationship due to aggressive arbitrage activity at banks, watching for unusual spread widening or tightening in specific provincial or credit issues that isn't part of a general trend across the product line, and even odd disruptions to the asset swap levels of specific bonds. Each of these prices is normally kept in line by experienced managers who accept the spread or basis risk in exchange for profits after a holding period but, when staffing and risk taking is lighter, the spreads and/or prices can become more out of sync than in other months of the year.

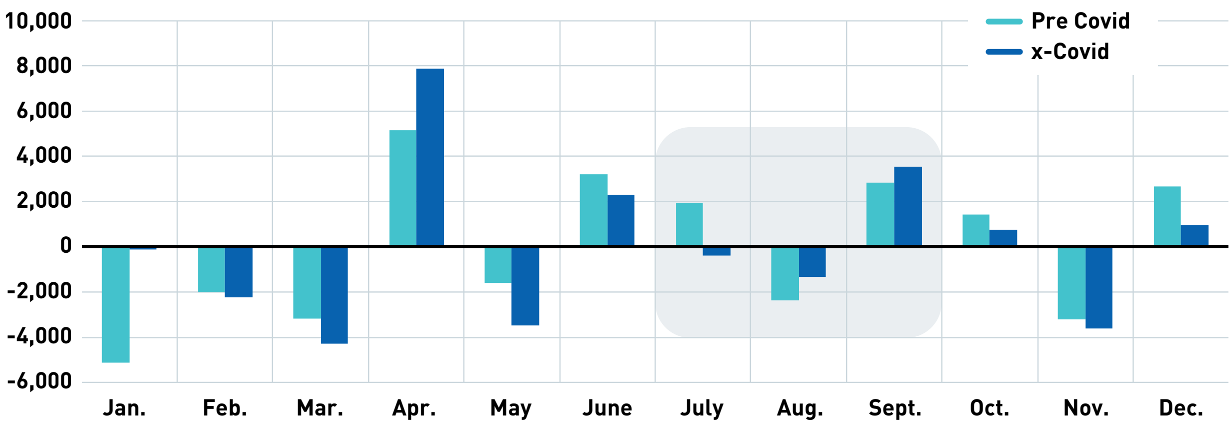
Statistical Issues

Another potential trade opportunity during summer exists around the "sometimes predictable" errors that seem to occur in some seasonal statistics in Canada. To be sure, seasonal adjustments to volatile indicators (and everything is seasonal in Canada, it seems!) is a difficult mathematical balance between eliminating the seasonal noise and coaxing out the statistical trend or observation.

One example, that has enjoyed some fame in past years but is increasingly difficult to analyze, is the tendency for the August employment release to be very weak while the September release is very strong, presumably compensating for an error in the July estimate. Readers can observe this phenomenon in Figure 2 where we have taken the seasonal employment number, calculated the change, differenced the monthly release by the average for the appropriate year to de-trend the observation, and then averaged each monthly remainder. We note that, in the figure, we have eliminated the 2021 and 2022 data as the enormous decline in employment in Q2 2021 and subsequent recovery over the next 6 quarters overwhelms any potential information in the averages.

FIGURE 2

Seasonally Adjusted Change in Employment, De-trended Monthly Average Excess 2003-2024



Source: Statistics Canada: Table: 14-10-0287-01

In spite of the pandemic induced difficulties, Figure 2 does still demonstrate a clear tendency for August employment to be well below trend and then for September to adjust for that seasonal slowdown in both the pre-COVID-19 (2003 to 2019) and x-COVID-19 (2003 to 2024 except 2020-2021) data sets. Recall that, since we used seasonally adjusted data, the fact that employers don't hire as many people during summer should be irrelevant – it is adjusted for already in the seasonal adjustment calculation by Statistics Canada. Some have surmised, we believe erroneously[3], that the statistics are incorrectly adjusted for the thousands of teachers that are not, technically, employed during summer months but are "re-employed" in September.

2 There are four auctions in July, four in August, and another on September 5th that will probably attract less speculative interest than auctions in other seasons.

3 We have no evidence for or against this theory except to say that there are nearly 7000 employees at Statistics Canada, many or most with advanced degrees, and we find it inconceivable that none of them have thought of this.

If managers buy into this hypothesis, opportunities could arise, depending on expectations and market reaction to the July, August, and September employment releases on the first Friday of the following month.

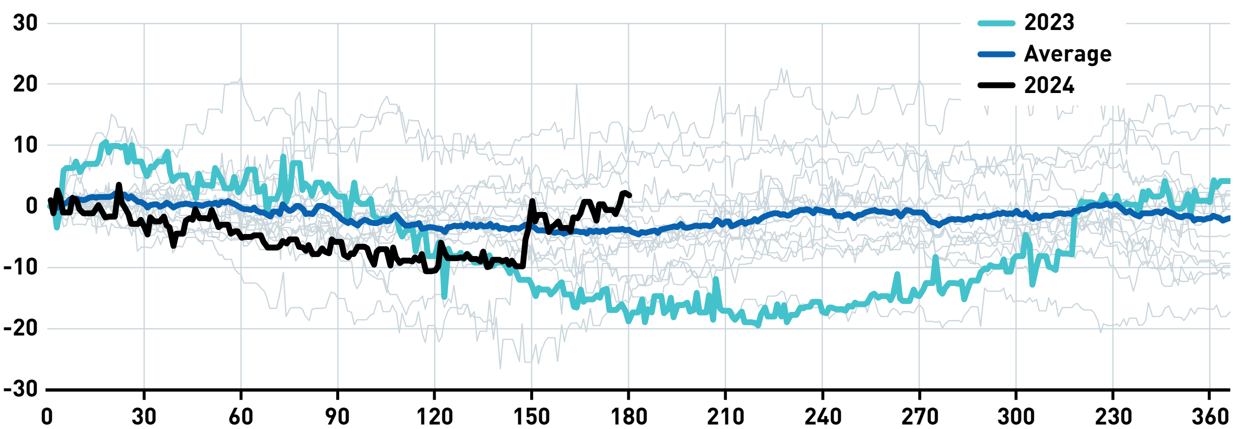
Seasonal Swap Spread Trade

Another seasonal opportunity that can present itself through the summer months is the tendency for swap spreads, especially the 5-year spread that is commonly used for mortgage hedging in Canada, to tighten through the spring and summer before beginning to normalize as autumn and winter approach. The seasonal aspect to Canadian housing sales, and therefore to mortgage hedging demand, is well-documented[4]. Essentially, stronger housing sales relative to the expectations of the banks' hedging models will translate to swap spread widening as banks have more hedging to do than they anticipated and seek to offset mortgage creation by paying fixed in the swap market. The opposite is true for a weaker than expected housing season.

We depict the seasonal tendency in all years except the financial crisis era (2007 to 2009) in Figure 3 where the average and most recent years are highlighted. Generally, at least in the recent era, swap spreads have tended to widen (move lower on the chart) about 5 basis points until the end of June or July and then tighten to the level at which they started the year once bank hedging demand wanes after the seasonal home selling season.

FIGURE 3

5y Swap Spread Change - Indexed to Day of Year



Source: BMO Capital Markets' Fixed Income Sapphire database

In the same figure, we point out that 2023 largely followed a "normal" path for spreads, although an extreme one given the nearly 20 basis point magnitude of the spread widening and retrace. We also point out a very different experience so far in 2024 where, around the end of May, the 5-year swap spread experienced an unusual reversal and has continued to tighten toward the top of the chart. Normally, this would indicate that bank hedging models were too aggressive and that weak housing sales have translated into lower mortgage creation putting the banks in an over hedged position that they would then receive fixed in the swap market to correct. At time of writing, only the May Canadian Real Estate Association statistics are available, and they don't indicate much softening of sales activity in 2024, but perhaps an opportunity lies in the mortgage season this year, as it does in so many other years in Canada.

Futures Contracts

Seasoned managers should recognize that, although liquidity may be lower in summer months, trading electronically in a multi-participant market in standardized products is likely to be more liquid than over-the-counter methods when trading desks are lightly staffed for summer. In the potential opportunities discussed above, the CGB (10-year) contract is almost always the quickest, most liquid way to buy or sell duration in reasonable size and the CGF (5-year) futures contract combined with a swap trade can gain the speculator entry into the 5-year swap spread using only derivatives, usually reducing balance sheet usage and charges (if any). Similarly, speculating on the path of interest rates and the expectations for rates given the latest economic releases is often best accomplished via short-term money market futures such as the Three-Month CORRA Futures (CRA™) (90-day overnight repo) contract. In almost all the examples cited here, a version of the trade exists in futures and grants the user the advantages of margin netting, easy financing, and leverage.

4 For example, "Canada's Seasonal Mortgage Trade", published by Montréal Exchange in 2017.

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