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MONTRÉAL EXCHANGE

A potential fixed income opportunity mid/post sell-off

After a selloff of 180 basis points from about a year ago, a sentiment shift may be taking place in Canadian fixed income markets providing opportunities for ambitious managers of bond portfolios.

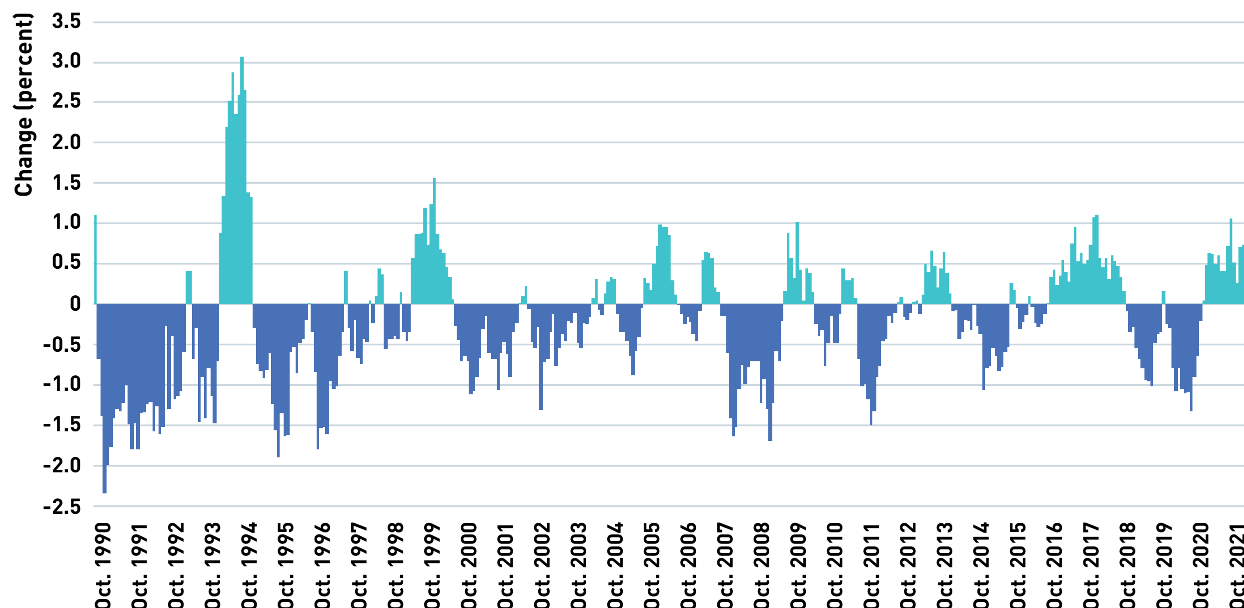
Description

In early May 2021, Canadian 5-year bond yields were around 90 basis points and had found a comfortable range near that level for several months. Beginning in August, yields began to rise very rapidly and reached 2.8%, a selloff of almost 200 basis points in just nine months. Since the drivers behind the rapid bond selloff including inflation, recovery, war and supply constraints have been well-covered and discussed already, we only highlight here some post-selloff observations.

First, the selloff has probably been the most extreme adverse move that any current fixed income portfolio manager has observed in their career. Figure 1 shows the 9-month change in 5-year Canada yields since 1990, and clearly depicts that the current selloff is the "worst" since 1994; a year with market conditions that were so legendarily awful for bonds that it has remained in the financial lore for almost three decades. While it is certainly possible that someone that was managing fixed income portfolios in 1994 is still doing so, the intervening 28 years would mean that manager must be, at best, nearing normal retirement age[1]. We suspect that only a handful of managers that witnessed the bond selloff of the mid-1990s are still in the industry.

FIGURE 1

9-month Change, 5-year Canada Yield



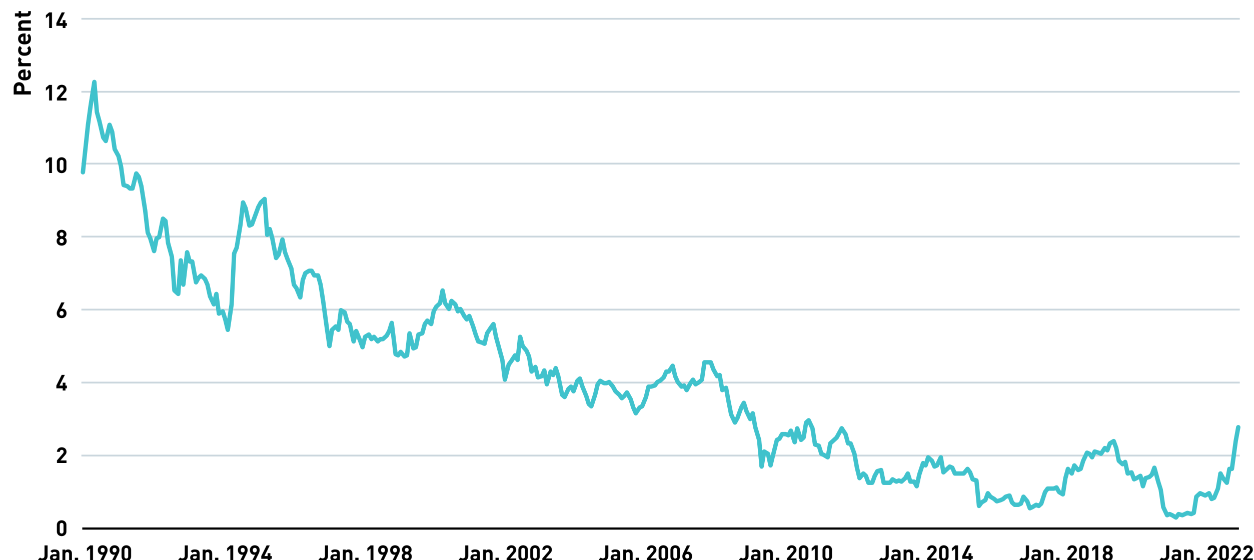
Source: Bank of Canada

1 Apologies to the inevitable managers that experienced both the 1994 and 2021/22 selloffs.

Second, despite the extreme selloff, Canadian interest rates[2] aren't really that high relative to history, as shown in Figure 2. In the figure, Canadian 5-year rates have exceeded the previous peak of mid-2018 but have only just reached levels from mid-2010 and remain below the 4% level that was considered "normal" for several years preceding the 2008 financial crisis.

FIGURE 2

Canada 5-year Yield

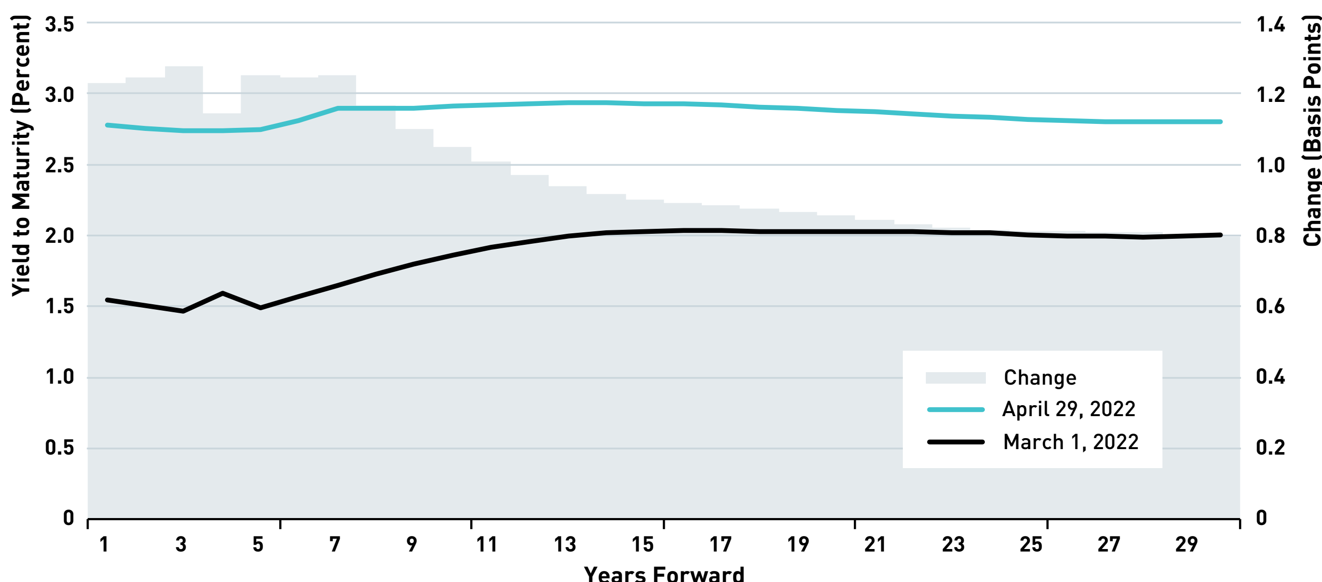


Source: Bank of Canada

Third. The forward 1-year rates – the 1-year bond yield implied by the current yield curve for various dates into the future –do not reflect "runaway inflation" despite a very significant selloff in bonds. As shown in Figure 3, forward 1-year yields beyond about 12 years moved from 2% to 2.75% but are then flat all the way out to 30 years forward. If current inflation rates were perceived to be anything but temporary, no rational investor would purchase 10-year and 30-year bonds at the yields these instruments currently imply for forward rates.

FIGURE 3

Forward 1-year Yields, Canada Bonds



Source: BMO Capital Markets' Fixed Income Sapphire database

2 We use 5-year rates in our examples as, absent quantitative easing, the 5 and 10-year yields are less influenced by Bank of Canada monetary policy and domestic demand for long bonds that distort Canadian interest rates in other areas of the curve.

Possible Sentiment Change

We recognize that markets and investors, in Canada and elsewhere, are at a crossroads currently where one path, that has its momentum waning, appears to indicate that interest rates are still too low and the other, an opinion that is gaining traction in investor's mindspace, is that the increase in longer term yields, continuing COVID-19 related effects, a potential for war to spread in Europe, and higher prices will push growth lower and the economy into slowdown or recession.

With no definitive answers on the future of rates, our impulse is to recognize several issues with the "inflation will continue to drive bond prices down" narrative[3]. First, nearly all central banks continue to insist that they see inflation as a temporary phenomenon while economic activity in the private sector recovers post-pandemic. Second, these same central banks are likely to err on the side of caution given their inability to generate inflation at their preferred or target rate over the past years. In fact, despite annual inflation rates between 5-10% in both Canada and the USA over the past several quarters, both countries have only just matched the CPI price levels that should have been achieved with 2% inflation since the beginning of 2008. Third, we note that a rise in interest rates over short periods of time such as in 1994, early 2000, 2006, and 2013[4], have usually resulted in economic slowdowns[5] in Canada; they occurred in January 1996, July 2001, April 2008 and in 2015.

Potential Opportunities

For those whose opinion differs substantially from the notion that the bond selloff may pause or reverse from here, the trade opportunity that arises from Figure 3 is rather obvious; sell or short bonds almost anywhere along the 5-year to 30-year portion of the curve. If yields need to be higher to reflect increased inflation risk, ALL those forward yields, and thus spot yields, should be higher.

For managers that believe a pause in the selloff, or even an outright reversal to the recent punishment in the bond market, is warranted, a few more interesting potential trades are possible.

First, a bold manager may choose to go outright long, or long relative to benchmark, 5-year bonds in the expectation that the yield has risen too far and fast and will drop in the near term. Figure 4 shows five years of history for the 5-year constant maturity bond yield in Canada; yields have already exceeded their pre-pandemic highs.

Even wary investors should recognize that 5-year yields of 2.72% are far more attractive than the yields of early March which had just crossed the 1.5% level. Additionally, at just a 15 basis point yield pickup to 10-year bonds, we feel many investors should favor the 5-year point over the 10-year point on the curve. An investor can, and should if they are able to, easily structure this trade in CGFM22 contracts[6] as the futures contracts currently trade about 3 cents cheap to bonds.

FIGURE 4

Canada 5-year Bond Yield

Source: BMO Capital Markets Fixed Income Sapphire database

3 As an aside, Robert J. Shiller's excellent book from 2019, "Narrative Economics: How Stories Go Viral and Drive Major Economic Events" describes how economic narratives, true or not, can drive markets.

4 We exclude the bond selloff of 2017 since it could not have caused the 2020 pandemic and recession.

5 Not a recession, which is rarer, especially in Canada, but a slowing of economic activity to less than 1% GDP growth on average over several quarters.

6 The M22 would need to be rolled to U22 in late May.

Second, long bond yields have sold off, as we saw in Figure 3, but not as much as 10-year bonds. The resulting plunge in the 10-30 slope may be an opportunity for some managers. At the very least, managers who do not benefit from the long-term liability hedging properties of these bonds, which makes them trade rich to shorter maturities almost all the time, should avoid buying the long end of Canada.

Aggressive investors could choose to enter a 10-30 steepening trade by buying the 10-year point and selling the 30-year point on the curve. These investors would be entering the trade at 5-year lows, as shown in Figure 5. Additionally, the trade carries positively, and rolls down slowly but positively; 10's roll down while 30's roll up, in fact. Investors familiar with the LGB™ contract could choose to enter this trade by buying the CGB™ contract and selling an equivalent DV01 of LGB contracts. The CGB is trading about 3 cents cheap to bonds, so the investor gets a discount on the long position although the LGB appears to trade a few cents rich to fair value[7] as well. Investors should be aware of the valuable wildcard option embedded in the LGB contract[8] – but the investor would be long that option in this trade construction and the unique wildcard option does not decay until the delivery period begins.

FIGURE 5

Canada 10-30 Yield Slope

Source: BMO Capital Markets[i] Fixed Income Sapphire database

Finally, there may be an opportunity to sell the body of the 2-5-10 bond butterfly[9] as yield curvature has collapsed recently. Figure 6 shows the level of the Canada 2-5-10 constant maturity yield butterfly quoted in the conventional way[10]. This metric of curvature has collapsed from about +20 basis points to -5 basis points in recent weeks and remains volatile.

7 We calculate a value of about 37 cents for the embedded wildcard option and the LGB contract currently trades 41 cents cheap to bonds.

8 Interested managers may request "Recap: First LGB Delivery Period" produced in April 2022 from their Montréal Exchange representative.

9 Interested readers can read more about 2-5-10 butterfly trades in "Understanding 2-5-10 Butterfly Trades in Futures" published by MX in May 2021.

10 Bond Butterfly = (2 x 5-year yield – 10-year yield – 2-year yield)

FIGURE 6

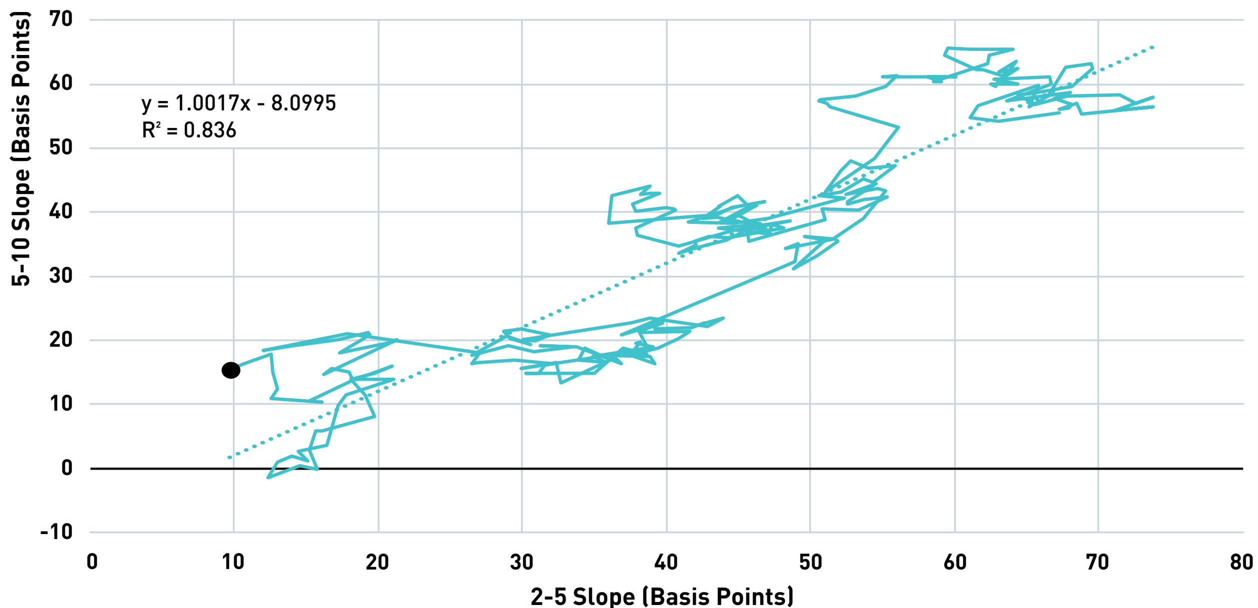
Canada 2-5-10 Bond Butterfly

Source: BMO Capital Markets[i] Fixed Income Sapphire database

Figure 7 shows a regression of the 5-10 slope versus the 2-5 slope for about a year. During the regression period, the two metrics were highly correlated with an r-squared of about 0.84, and the butterfly level is now about 13 basis points from the predicted level. To be fair, a rapidly falling 2-5-10 is consistent with the end of a central bank hiking cycle where yields reflect a series of rate hikes followed by an economic slowdown that causes a pause or reversal of monetary policy tightening. Managers willing to wager on the statistical correlation holding into the future may choose to enter the trade despite the notion that a changing economic narrative may have ended the recent correlation between 2-5 and 5-10.

FIGURE 7

Canada 2-5 v. 5-10 Yield Slope



Source: BMO Capital Markets[i] Fixed Income Sapphire database

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