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MACROHIVE

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MONTRÉAL EXCHANGE

How to Use TMX Futures to Trade Different Macro and Crisis Scenarios

- The US economy is proving strong on the back of resilient household balance sheets, despite still-high inflation. This suggests the Federal Reserve may hike more than expected.
- The Canadian economy is performing well, too. However, the average Canadian consumer appears more fragile than the average American consumer. Therefore, the Bank of Canada may hike less than the Federal Reserve.
- We examine the risk of a banking crisis in the US and Canada.
- Based on futures activity, we find investors are uncertain about central bank terminal rates.
- We consider how investors should position in different scenarios of dovish central banks, hawkish central banks and a bank crisis.

1. The US Macro Picture

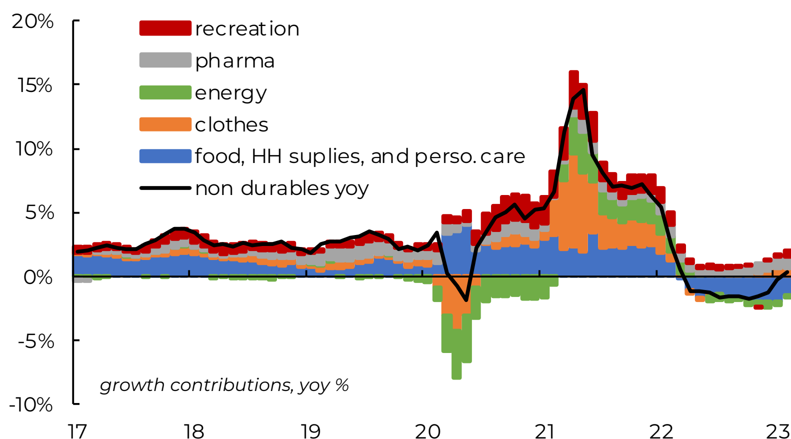
US Growth Is Strong

US GDP growth appears above 2% – at least according to the Atlanta Fed GDPNow estimate. A robust consumer balance sheet and resilient earnings growth for corporates have been important supports.

Looking at the details, the main area of weakness is goods spending. However, this reflects normalisation from extreme policy easing during the pandemic; underlying consumption fundamentals remain strong. For example, non-durable goods spending (29% of consumer spending) will continue to normalize as houses run out of inventories they built during the pandemic (Figure 1). This narrative is playing out; core (control group) retail sales increased +0.6% MoM through June, up from a revised +0.3% MoM in May.

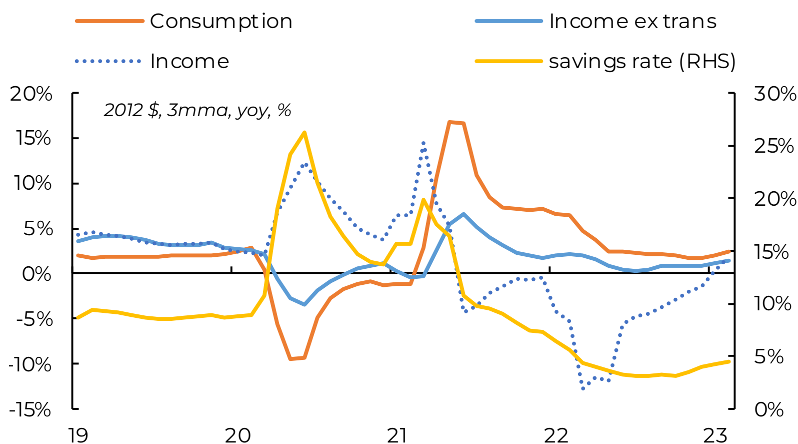
Moreover, household incomes fell sharply in 2021-22 after government transfers ended, but a large decline in the household savings rate offset the income decline. Also, from mid-2022, real household incomes excluding transfers accelerated on steady employment and real wage growth (Figure 2). The consumption recovery has become self-sustaining and is gaining momentum.

FIGURE 1
Retail Sales and Goods Shipments Are Weak



Source: Macro Hive, Bloomberg

FIGURE 2
Consumption Recovery Gains Momentum



Source: Macro Hive, Bloomberg

Core US inflation Still High

The latest data shows headline inflation is returning to the Federal Reserve's (Fed) 2% inflation target; the three-month inflation pulse (the past three months' inflation annualised) is now 2.7%. On that basis, the Fed appears to have done its job. However, most of this disinflation is due to a 17% annualised plunge in energy prices. Therefore, the Fed should turn its eyes to the trend in underlying inflation.

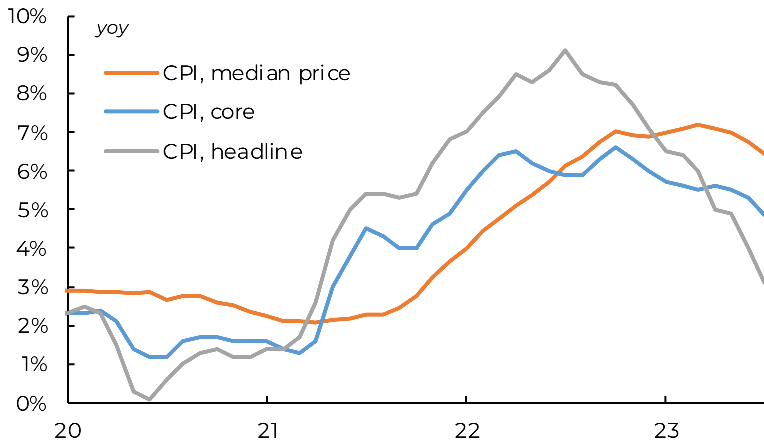
We use the Cleveland Fed's median price CPI because it is a better measure of inflation trends than core inflation when prices are volatile. The YoY median price CPI has only just crept below 6.5% for the first time since July 2022 (Figure 3). Breaking inflation down into Chair Jerome Powell's preferred three categories – core goods, shelter, and core services excluding shelter – we find limited downside in future inflation outturns.

Core goods inflation continues to rise (Figure 4). Meanwhile, used car prices have converged to Manheim used car auction prices. And while auction prices have fallen through April and May, Manheim expects them to stabilise due to low inventory. Ahead, used car inflation could remain high due to a long-term decline in new car affordability.

Meanwhile, shelter inflation remains high. This comes alongside increased rental indices, which could signal further upside to shelter CPI – backed by reports of rising or stable rents. Lastly, core services excluding shelter has proven volatile but keeps rising (Figure 5).

FIGURE 3

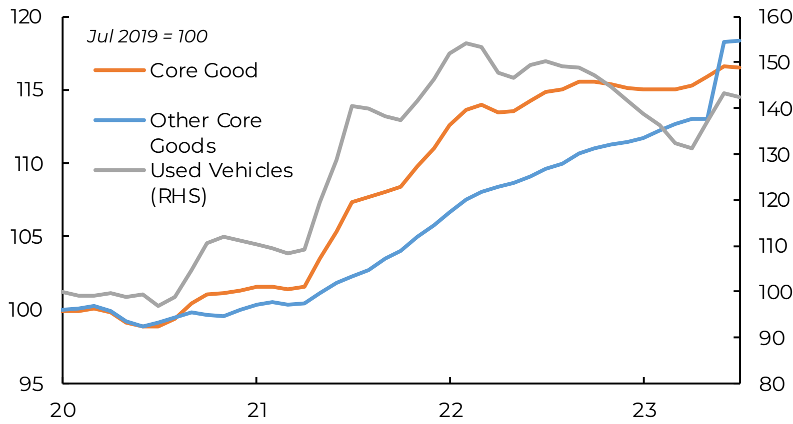
May Median Price CPI Inflation Remained Near 7%



Source: Macro Hive, Macrobond

FIGURE 4

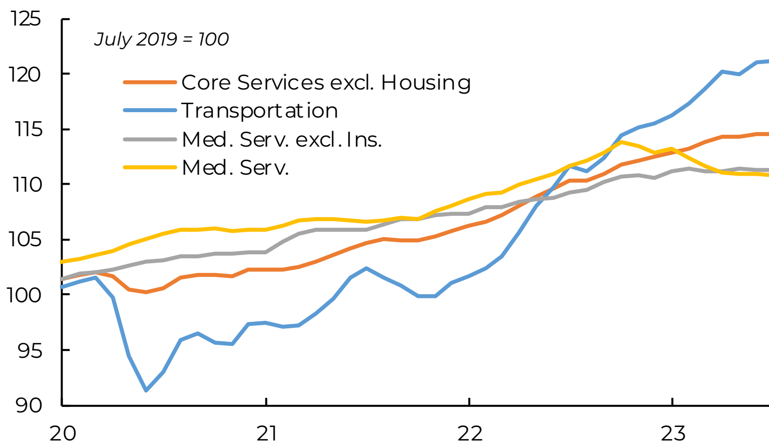
May Core Goods Inflation Remained High



Source: Macro Hive, Bloomberg

FIGURE 5

May Core Services Inflation Remained High



Source: Macro Hive, Bloomberg

2. The Canadian Macro Picture

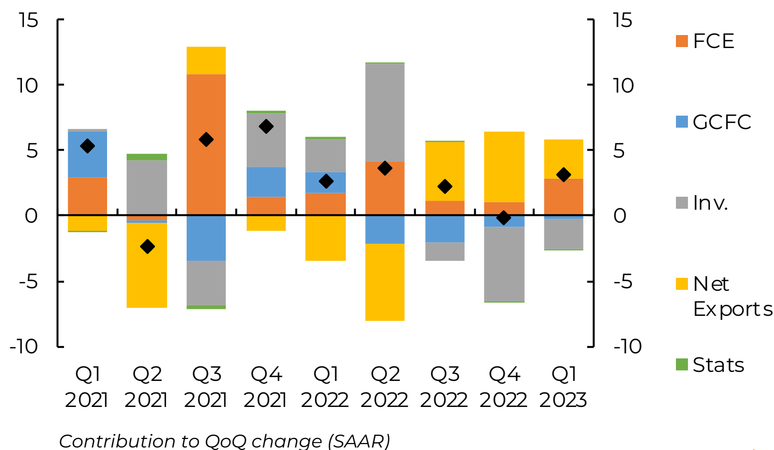
Canadian Growth Is Solid, But Consumer Weaker Than in US

The Canadian economy is holding up, though less well than the US economy. Canada's economy expanded +3.2% QoQ SAAR through the first quarter, 0.8pp higher than the Bank of Canada (BoC) had forecasted. Strength came as consumer spending surged 5.7% through the period, on drained savings (Figure 6). However, the consumer outlook is weaker in Canada than in the US because consumer purchasing power will worsen as Canadians experience higher property costs and a further strain on savings with limited fiscal stimulus. Weaker consumption has already started.

Other than consumption, strong goods exports drove the solid first-quarter outturn. Mining and transportation exports contributed most, rather than typical oil and gas exports, which fell in line with lower prices. Nominal exports to the US, which represent 76.6% of all Canadian exports, grew 1.2% QoQ. Consequently, we expect the US economy to keep supporting Canadian exports and, therefore, part of the Canadian economy (Figure 7).

FIGURE 6

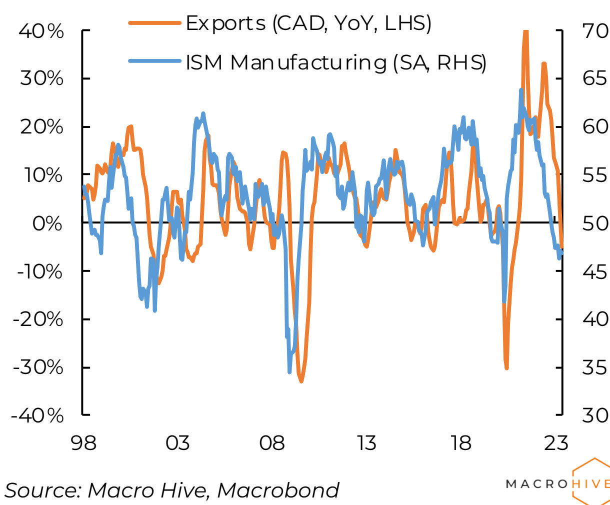
Canadian Consumption Remains Strong



Source: Macro Hive, StatCan

FIGURE 7

Canadian Exports Led by US Strength



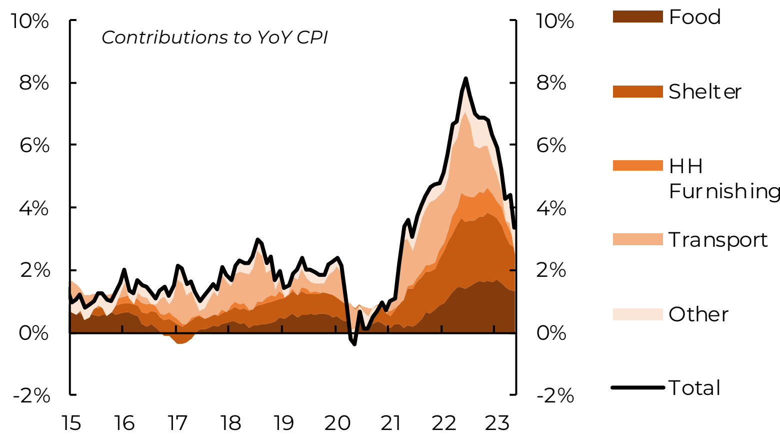
Source: Macro Hive, Macrobond

Canada Inflation Still Too High

CPI fell to +2.8% YoY in June from +3.4% YoY in May, taking the Q2 average below the BoC's forecast of +3.6% YoY (Figure 8). However, the BoC will struggle to be dovish following the release. First, lower fuel prices (-21.6% YoY) drove much of the slowdown, due to base effects. Excluding fuel revealed a headline inflation rate still above target (+4.0% YoY). Second, annualised momentum of the core measures (to which the BoC consistently turns) have, at best, moved sideways (Figure 9). Third, while services inflation has slipped to 4.2% YoY from 4.6%, increasing by just +0.1% MoM, a similarly small monthly increase was followed by a larger +0.4% MoM increase earlier in the year. And fourth, residential property prices have found a second wind with limited supply driving house prices higher once more. The BoC will likely remain hawkish with progress likely to remain slow.

FIGURE 8

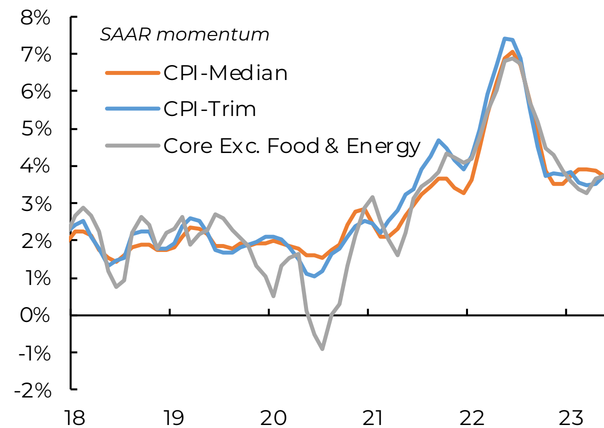
Base Effects Led Inflation Lower



Source: Macro Hive, StatCan

FIGURE 9

Stubborn Core Inflation Momentum



Source: Macro Hive, StatCan

3. Impact of US Banking Issues and Comparison to Canada

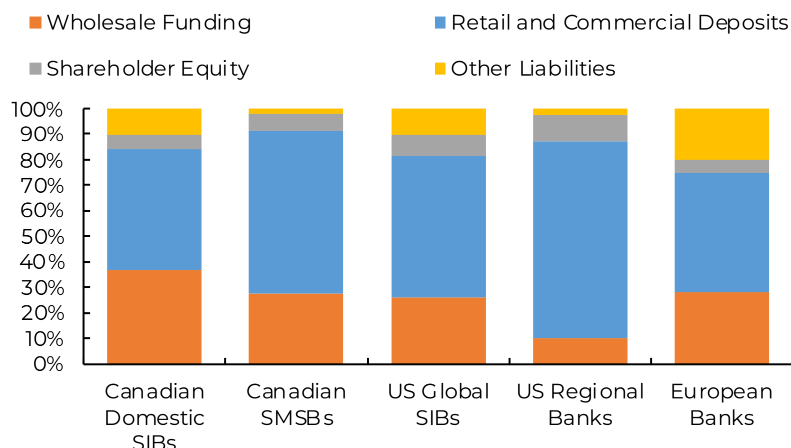
Compared with Canadian banks, US bank funding relies more heavily on deposits from retail and corporates (Figure 10). The high concentration of deposits to overall funding can leave banks exposed to a significant withdrawal, i.e., a bank run. This can be a particular issue when banks have large unrealised losses on their balance sheet, as is the case with US banks. They have moved a large amount of their securities portfolios from an 'available for sale' designation to a 'held to maturity' designation so they will not have to be marked to market. Sudden, significant depositor withdrawals force banks to liquidate their bonds and realise these losses. This is what happened to Silicon Valley Bank (SVB), which, on 8 March, announced it must raise $2.25bn to make up for losses.

Looking forward, the 2023 Federal Reserve Bank Stress Test found little risk for 23 of the largest US banks. However, the latest update provided no insight into exposure to interest rate increases across these banks. This is alarming because the Fed continues to raise rates. Instead, the Fed only applied a new 'exploratory market shock' to six globally systematically important banks (G-SIBs). Since these larger global banks are known to have better hedging strategies in place, the losses incurred from the new shocks are minimally different from those in the severely adverse scenario. Consequently, we lack insight into the banks we believe have greater exposure to rate hikes.

Canadian banks appear better placed than US ones. They have more diversified funding sources, with nearly 40% of Canadian domestic SIBs funding coming from wholesale funding, such as medium- to long-term debt and commercial paper. Greater reliance on wholesale funding reflects a larger share of loans and mortgages on Canadian banks' balance sheets. However, this means Canadian banks rely more on funding sources susceptible to the price fluctuations that come with market stress.

FIGURE 10

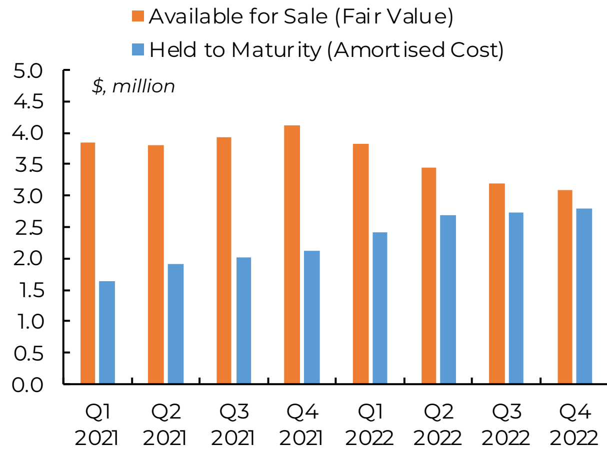
Large Canadian Banks Rely More on Wholesale Funding, Less on Deposits



Source: Macro Hive, Bank of Canada

FIGURE 11

US Banks Move Much of Their Securities Portfolio From AFS to HTM Accounts



Source: Macro Hive, FRED

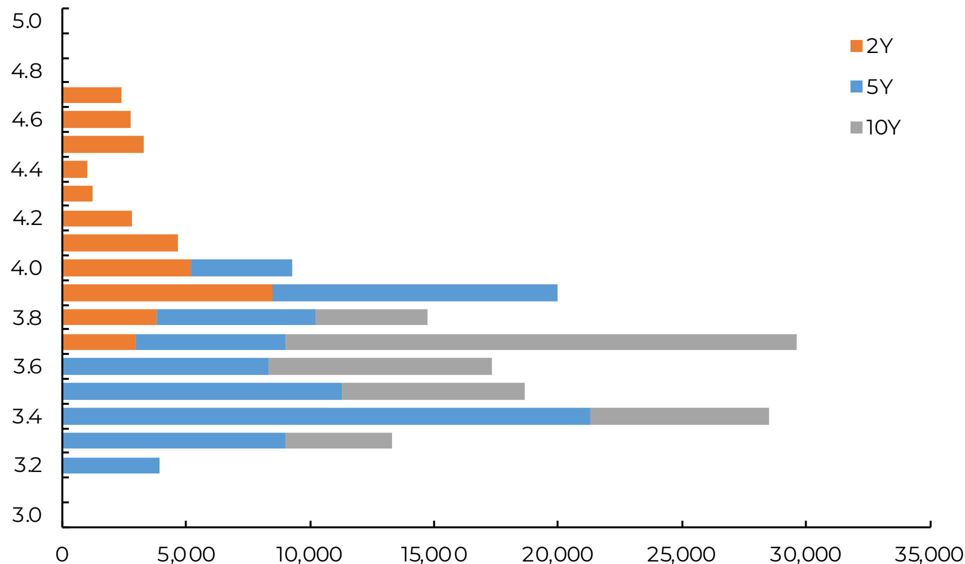
4. What Have Investors Done?

The US and Canadian macro backdrop has been better than expected, forcing investors to adjust their views repeatedly. For US markets, we find that for the 2Y contract, volumes have been most active between 3.7% and 4.7% yields over the past three months (Figure 12). For the US 10Y, investor activity has clustered around 3.5%.

Meanwhile, for Canadian markets, investor volumes have been spread across futures with implied 2Y yields ranging from 3.5% to 4.8% (Figure 13). Yet like the US markets, activity around the Canadian 10Y has been more constrained, with the heaviest activity between 3% and 3.5%.

FIGURE 12

Investor Activity in US Bond Futures Over Past 3 Months

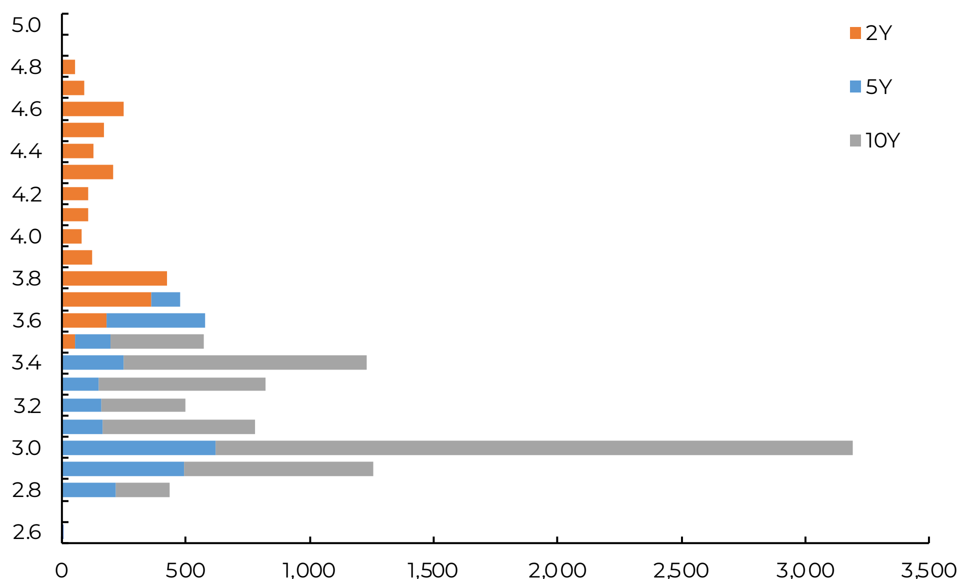


Note: Trading volumes (000s) over past three months by yield of trading day. Calculated using the 30 Jun, 29 Sep and Dec contracts for 2Y; and 5Y; 20 Sep and 19 Dec for 10Y.

Source: Macro Hive, CBOT, CME

FIGURE 13

Investor Activity in Canadian Bond Futures Over Past 3 Months



Note: Trading volumes (000s) over past three months by yield of trading day. Calculated using the Jun, Sep and Dec 2023 and Mar 2024 contracts

Source: Macro Hive, TMX

5. How to Trade Canadian Bond Futures in Different Macro Scenarios

We think the Fed has little choice but to maintain a hawkish stance. The US economy is strong, with a consumer that has shown little signs of slowdown. Meanwhile, core inflation measures remain stubbornly high with few signs of disinflationary progress. Consequently, the Fed will likely be able to deliver on their hinted July and November hikes.

By comparison, the Canadian economy is holding up, but the average consumer is more fragile. This means the BoC may be unable to follow as hawkish a path. However, our base case could be wrong, so we run through three scenarios and how to position for them using TMX bond futures.

Scenario A: The Bank of Canada Turns Dovish by Easing Aggressively

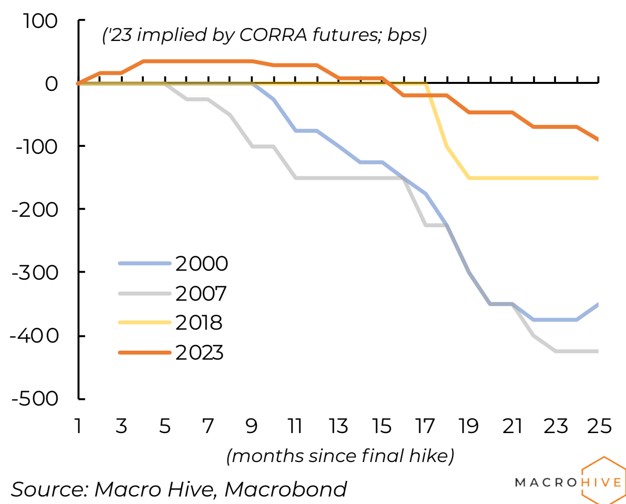
There is much uncertainty around the lagged effects of earlier BoC hikes, especially on the Canadian consumer. Businesses could be operating under the assumption of a still-resilient consumer. However, past hikes could suddenly catch up to consumers, prompting both consumer and business spending to slow sharply. This could force the BoC to cut rates sharply.

Currently, the market is pricing a far shallower cutting profile following the final hike than the BoC has typically delivered in the past (Figure 14). This suggests that when the BoC starts to cut rates, it does so by more than expected. Therefore, if the economy slows, the amount of easing priced by futures could be too small. In this scenario, the following trade could make sense:

Buy the TMX 3M Corra September 2024 future (Exchange: CRA; Bloomberg: CORU4 Comdty).

FIGURE 14

BoC Cuts Underpriced



Source: Macro Hive, Macrobond

Scenario B: The Bank of Canada Turns Hawkish and Hikes Again

Another scenario is that consumer resilience reflects less interest rate sensitivity than in the past, so the lagged effects of hikes will have less impact. Moreover, core inflation has remained stubbornly high, suggesting the consumer and labour market are still very strong. This environment could force the BoC to initiate a mini hiking cycle. With this backdrop, the following trade could make sense:

Sell the TMX 3M Corra September 2023 future (Exchange: CRA; Bloomberg: CORU3 Comdty).

A variation of this scenario is that BoC may pause, waiting to see what happens. In this case, the market could price hikes further out the curve, so 2Y yields would move more than 3M yields. Therefore, the following trade would make sense:

Sell the TMX 2Y September 2023 future (Exchange: CGZ; Bloomberg: CVM3 Comdty).

Scenario C: Escalating Banking Crisis

The Silicon Valley Bank failure in March 2023 taught us that a banking crisis can erupt at any moment, especially when central banks are tightening policy. Since March, those fears have abated. But as higher interest rates erode banks' net interest rate margins, we could see more balance sheet weakness. If this flares into a crisis, central banks could intervene. For example, they may cut rates temporarily. In this scenario, front-end yields would collapse in anticipation of these cuts. But further out the curve, yields would fall less because the cuts would be considered temporary. With this backdrop, the following trade would make sense:

Buy the TMX 2Y September 2023 future (Exchange: CGZ; Bloomberg: CVM3 Comdty) and sell the TMX 5Y September 2023 future (Exchange: CGF; Bloomberg: XQM3 Comdty). The spread is currently at 119bps and would likely tighten in the case of a banking crisis.

Bilal Hafeez is the Founder and CEO of Macro Hive – a leading independent research firm. Prior to MacroHive, Bilal was Global Head of International Fixed Income Strategy at Nomura between 2016 and 2019. Before that, Bilal held various senior roles at Deutsche Bank between 2002 and 2015, including Head of Multi-Asset Research, Advisor to the CEO, Head of Asia Research in Singapore and Global Head of Foreign Exchange Research. Bilal started his career at J.P. Morgan in 1998. During his sell-side career, Bilal was rated #1 market strategist by Euromoney and Institutional Investor for most years between 2004 and 2013. He also pioneered FX investment and smart beta benchmarks. Academically, Bilal was an Honorary Visiting Professor of Finance at Cass Business School. He studied Economics at St John's College, Cambridge.

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