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MONTRÉAL EXCHANGE

How Canadian Derivatives Can Help Unlock Value in Today's Capital Markets

The last 10 years have seen mounting challenges for institutional investors. Megatrends such as aging populations and changing social attitudes have created pressure to deliver higher returns and generate value through responsible investing. With more asset classes emerging, there are now even greater opportunities to leverage diversification as a source of value creation.

Historically, institutional investors pooled their investments into domestic markets and a few asset classes such as fixed income and equities. As these funds outgrew their domestic markets, they started to progressively diversify their holdings from domestic to international markets and by asset class (infrastructure, futures, swaps and more). This created an opportunity for TMX Group to expand its product range and extend its trading hours to meet the evolving needs of our clients.

By extending trading hours to almost 24 hours, the Montréal Exchange allows investors in other parts of the world to execute Canadian trades in their local time and reduce interest rate risk, especially in spread trades between Canada and their local market (i.e., Asia Pacific markets) in the fixed income space. The net benefit is that Canada's financial markets are able to play a bigger role in market liquidity and price transparency.

Understanding the impact of COVID-19 on investments

The complexity of managing performance and risk exposure against market volatility, and now a pandemic that has significantly affected world economies, make it difficult to meet the appropriate liquidity and funding requirements for investment pools. The CFA Institute conducted a survey of its global members in April 2020 to gauge their assessment of the durability of volatility and its impact on various asset classes. Forty-two percent (42%) of respondents indicated that they are investigating potential changes to strategic allocations as a result even as there is a neutral outlook on liquidity in government bonds.

While the Canadian sovereign bond yield curve remains low in the front end due to policy rates, this appears to be a short-term phenomenon in response to the uncertainties around the pandemic. As such, strategic investors could consider the 5-year Government of Canada Bond Futures contract (CGF™) or the 10-year Government of Canada Bond Futures contract (CGB™) for liquidity in their portfolios.

How Canadian policies contributed to market liquidity

During the Global Financial Crisis of 2008-2009, Canada and its financial institutions avoided the full brunt of the disruptions to financial markets in comparison to the US, the UK and much of Europe. There were several reasons for this, such as the central bank's approach to monetary policy and Canada's regulatory regime, which includes a cap on leverage at an asset-to-capital ratio of 20 to 1 and high capital requirements. All of the factors that helped the Canadian economy emerge relatively unscathed from the financial crisis have also helped maintain international investors' interest in Canada.

More recently, Canada has made significant contributions to domestic and international benchmark reforms. As jurisdictions worldwide move away from survey-based to transaction-based reference rate benchmarks, enhancements were made to the Canadian overnight repo rate average (CORRA) with the aim of establishing a less volatile and more reliable benchmark for the overnight rate and developing a robust futures market. With this in mind, Montréal Exchange launched CORRA Futures, a three-month futures contract based on the CORRA benchmark, in June 2020.

The Canadian derivatives market has accelerated very quickly in the last 10 to 15 years, attracting more international investors. As the needs of our clients evolved, this created opportunities for Montréal Exchange to expand its suite of product offerings. From front-end contracts like BAX™ Bankers' Acceptance Futures based on CDOR and CORRA Futures, to 2- 5- and 10-year Government of Canada Bond Futures, we are making it possible for our clients to trade along every single point of the yield curve, with increased market participation and liquidity as a result.

By including Canadian exchange-traded derivatives in their asset allocation strategy, investors can also embrace a responsible investing philosophy. This is especially true for investors who are prioritizing environmental, social and governance (ESG) factors in their investment strategy. Last year, we introduced S&P/TSX 60 ESG Index* Futures (SEG™), which is a liquid and cost-efficient way to gain or manage exposure to ESG risks and opportunities.

Extended trading hours could equal less exposure

Capital markets have become more globally connected in recent years. While there is still a need for purely domestic funds, institutional and retail investors are looking to diversify their asset base. This need presents opportunities to attract international investors to Canadian derivatives and demonstrate the value they bring to overall portfolio performance.

When investors can only access certain regions during set periods of time, their risk exposure increases exponentially as they wait for markets to open. Canadian markets are an attractive proposition for international investors, so it is important to offer them after-hours trading in their local time. This was our experience when MX extended trading hours to European investors in 2018. In 2020, derivatives trading from Europe represented between 6% and 10% of volumes.

We know that Canada has traditionally been popular among Asian investors due to the CAD-JGB spread trade. According to Statistics Canada, net flows from Japan into Canadian bonds rose by 300% in the first 10 months of 2020 compared to 2019. Extending trading hours to make MX more accessible to investors in Asia Pacific will enhance the visibility of Canadian derivatives among investors in one of the biggest and fastest growing markets in the world. This in turn increases capital flows in both directions as well as market liquidity, which benefits all participants in the capital market system.

Simon Hughes joined TMX Group in 2019 as the Head of Institutional Sales, EMEA for the Montréal Exchange's listed derivatives business. Located in the UK, Simon's mandate is to grow TMX's derivatives business on an international scale. Simon's previous professional experience covering APAC also allows him to significantly contribute to business development efforts in that specific region in his current role. Simon has an extensive background in trading and sales in fixed income, derivatives and FX, with over 30 years of experience in capital markets. His depth of client coverage includes some of the largest asset managers in the world, coupled with close ties to some large sovereign wealth funds.

For more information

T +1 514 871-3501
irderivatives@tmx.com

m-x.ca