BoC Decision (April 2020): New Provincial and Corporate Bond Purchase Programs

In today's rate announcement and Monetary Policy Report (MPR), the Bank of Canada (BoC) did not publish quantitative economic forecasts like the International Monetary Fund did yesterday because of the elevated degree of uncertainty associated to COVID-19.

The BoC's immediate focus is to preserve well-functioning financial markets and that situation is far from perfect. But owing to the several purchase programs launched in March, financial conditions have improved. As a result, the assets held by the BoC stood at $275B on April 8th (12% of GDP), compared to $120B (5% of GDP) in February, before the COVID-19 outbreak. Most of the balance sheet expansion so far is related to the BoC's intervention in the repo market and purchases of Bankers' Acceptances. Today, the BoC enhances its term repo facility to permit funding for up to 24 months. Also, the BoC is temporarily increasing the amount of Government of Canada T-Bills it acquires at auctions to up to 40%.

Provincial and Corporate Bond Purchase Program

Two core elements of today's announcement is the launch of provincial and corporate bond purchase programs. These two new programs will be operational in early May. The new provincial and corporate bond QE programs are not open-ended or unlimited, a way to prevent moral hazard among issuers.

First, the BoC plans to buy up to $50B of term provincial debt on the secondary market. As a comparison, as of 2019Q4, Statistics Canada's National Balance Sheet Accounts estimated the total book value of domestic outstanding provincial bonds at around $800B. This new program will improve liquidity in the provincial bond market. The Provincial Money Market Purchase (PMMP) program that has been running in the primary market since late March has improved market liquidity at the subnational level. For instance, Newfoundland and Labrador, unable to issue in the primary market, was particularly looking for urgent assistance and running out of cash. However, had it been left alone, the PMMP would have provided an incentive for provinces to issue more short-term debt at the expense of long-term debt. A key aspect of this morning's provincial bond buying program is that qualified maturities are up to 10 years, meaning that a key segment (30-Year) of the provincial bond market is currently excluded from the program.

Second, the BoC will buy up to $10B of IG corporate debt in the secondary market with maturities of up to 5 years. The large quantity and poorer quality of debt issued by Canadian companies in recent years had already been flagged as a key financial vulnerability by the central bank. In comparison, the Fed is buying IG corps in both the primary and secondary markets and recently decided to go further by beginning the purchase of high yield corporate ETFs.

Without surprise, the overnight rate target was left unchanged at 0.25% as Governor Poloz does not see a good cost-benefit incentive to bring the policy rate below zero. The pace of federal benchmark bond purchases through the Large Scale Asset Purchases (LSAP) program is maintained at a minimum of $5B per week. The weekly balance sheet data indicates that GoC securities held by the BoC rose by $5.6B during the first week of the program in early April. LSAP for this week and the next one are tilted towards the 0-to-5 year segment of the curve.

What could come next

Altogether, the BoC announced more measures during the last month and a half than during the entire 2008-09 Financial Crisis. In the near future, the BoC's balance sheet evolution in terms of size and composition will depend on the most urgent needs and the evolution of the economy. Depending on market conditions, HY corporate debt and municipal debt could be included in the central bank's basket of asset purchases.

Further out, boosting the LSAP would be the easiest thing to do in case the BoC needs to backstop the federal government's balance sheet. The objective behind an increase in LSAP would be to prevent the yield curve from steepening despite ballooning federal deficits, rather than bringing down longer-term rates to zero. After all, Canada already benefits from the Fed's unconventional policies international spillovers, particularly with respect to term premium compression and support to equity prices. Speaking of, the Fed's balance sheet has rapidly expanded in the last month (to US$6T, 27% of GDP) without creating major hiccups in FX channels. During previous rounds of Fed QEs, the loonie generally appreciated. This time around, the depressed crude oil prices and market risk-off sentiment have kept a lid on the Canadian dollar.

Finally, there are more market talks about yield curve control (YCC), a potential option in the BoC's unconventional toolkit. YCC has been successful so far in another small-open, resource-based economy: Australia. Since the RBA has set a target on 3Y yields at around 0.25% in mid-March, the 0-3Y segment of its yield curve fell like a stone. The Aussie 2Y benchmark yield stands near 0.20% and the 10Y near 0.90%, creating a large 70bps 10Y-2Y spread. We do not see YCC as the next move for the BoC as its 150bps cumulative policy rate cut has already contributed to steepen the curve (5Y-2Y at 17bps; 10Y-2Y at 39bps).

Bottom Line: Markets often talk about the Fed's *big bazooka*. Today's bold moves by the BoC definitively surpassed market expectations. The $60B provincial and corporate QE programs alone will easily bring up assets held on the balance sheet to 15% of GDP, close to the RBA's 14%. Combined with future LSAP, total assets held by the BoC should rise above 25% of GDP before year-end. In this unprecedented crisis, BoC officials are like a strong team of firefighters who will pour a lot of water on the next hot spot related to financial stress and market illiquidity. Markets should be alert for more BoC announcements later this Spring.

Sébastien Lavoie | Chief Economist
514 350-2931 | lavoies@vmbl.ca