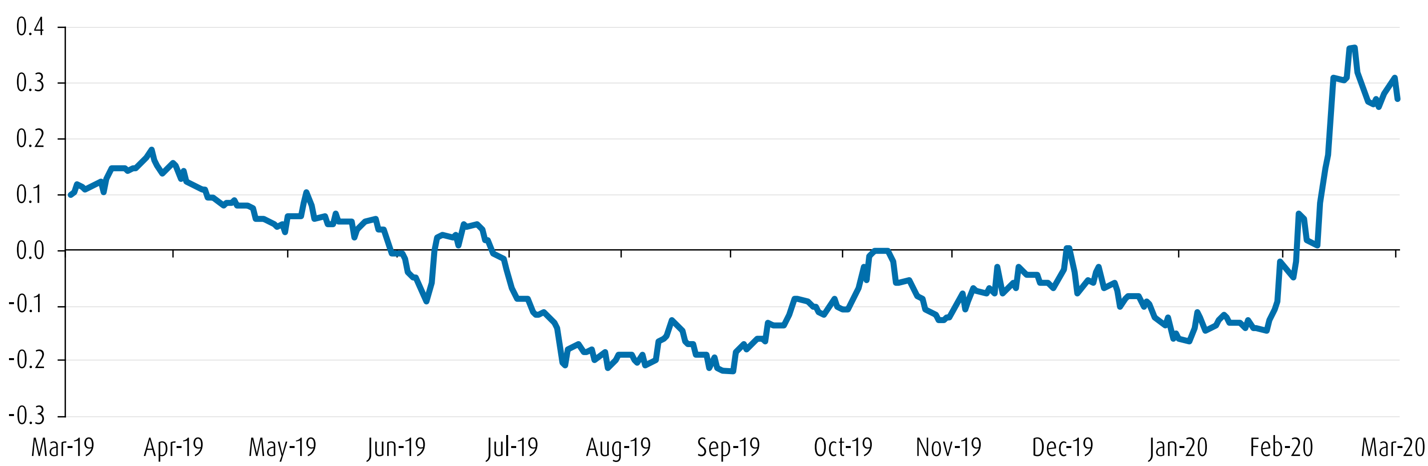
Fixed Income and the Coronavirus Chronicles

With the economic shock and possible recession triggered by COVID-19 in Q1 bond credit spreads widened quickly as equity markets crashed. Government bond yields have recovered some of that drop since early-March (Chart 1). We have seen yield curves steepen in response to the mammoth global economic stimulus package announcements, most recently the $2 trillion bill in the U.S. While we are not out of the woods yet, these recent moves suggest the bond market may be looking through the deep dislocation in economies in Q1 and Q2 to a rebound in economic growth later this year.

CHART 1: CANADA 10 YEAR TREASURY YIELDS IN RESPONSE TO STIMULUS

Source: Bloomberg, Mar 31 2020

CHART 2: 10 YR VS 2 YR TREASURY YIELD SPREAD



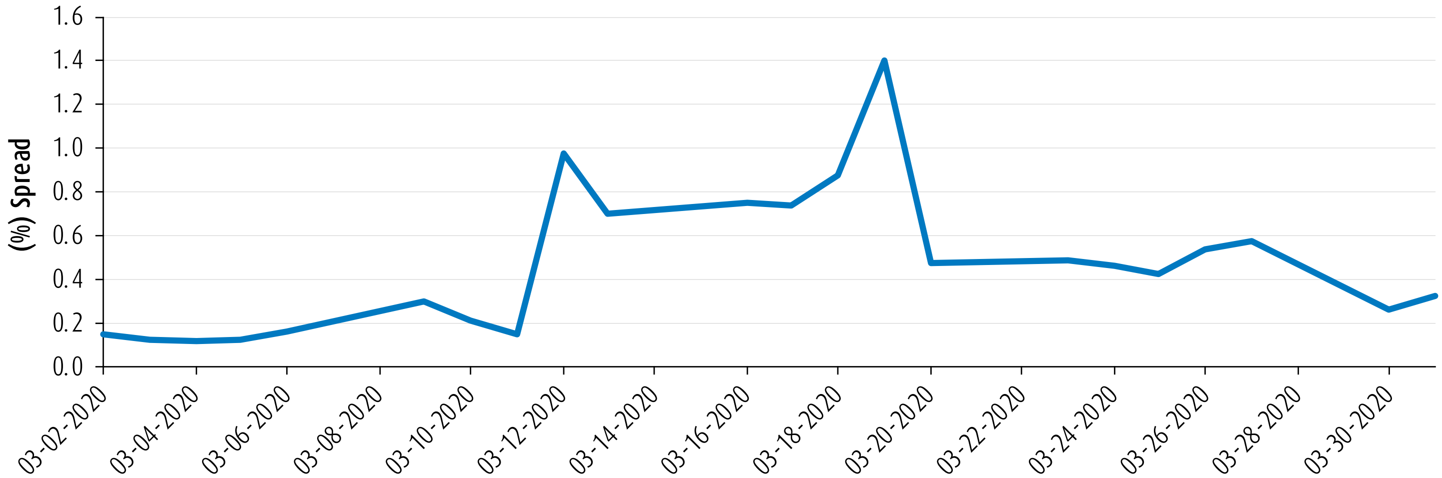
Source: Bloomberg ,Mar 31 2020

Looking back over the quarter it is important to note that ETFs have done their part in providing liquidity in a challenging market. We have fielded many questions on the widening of bid-offer spreads and while they may seem extremely wide, they are in line with, or better than the underlying bond bid-offer spreads. In Canada, we have seen corporate bonds going no bid from the bond dealers, volumes decline, and we have lost the ability to trade the underlying at times. Canadian market makers have continued to provide two-sided liquidity for ETFs. National Bank reports as of Mar 31 2020, fixed income ETFs traded >$12bln in value over the past three weeks, which is in line with normal levels, even as the underlying securities were trading much less or, in some cases, not at all. ETFs are an excellent tool to execute fixed income trades in these challenging markets.

Spreads

When markets are not functioning normally and liquidity is challenged, spreads will widen since the liquidity of an ETF is affected among other factors by the liquidity of its underlying. Because ETFs provide a tool of instant liquidity, that functionality of execution comes at a price, the spread. If you're looking to sell into a one sided market you should expect to pay a cost to get that liquidity. Below is a snapshot of the spreads on BMO Aggregate Bond ETF, the largest fixed income ETF in Canada.

CHART 3: BMO AGGREGATE BOND INDEX ETF (ZAG) AVE BID-ASK SPREAD Mar 1 - Mar 20 2020



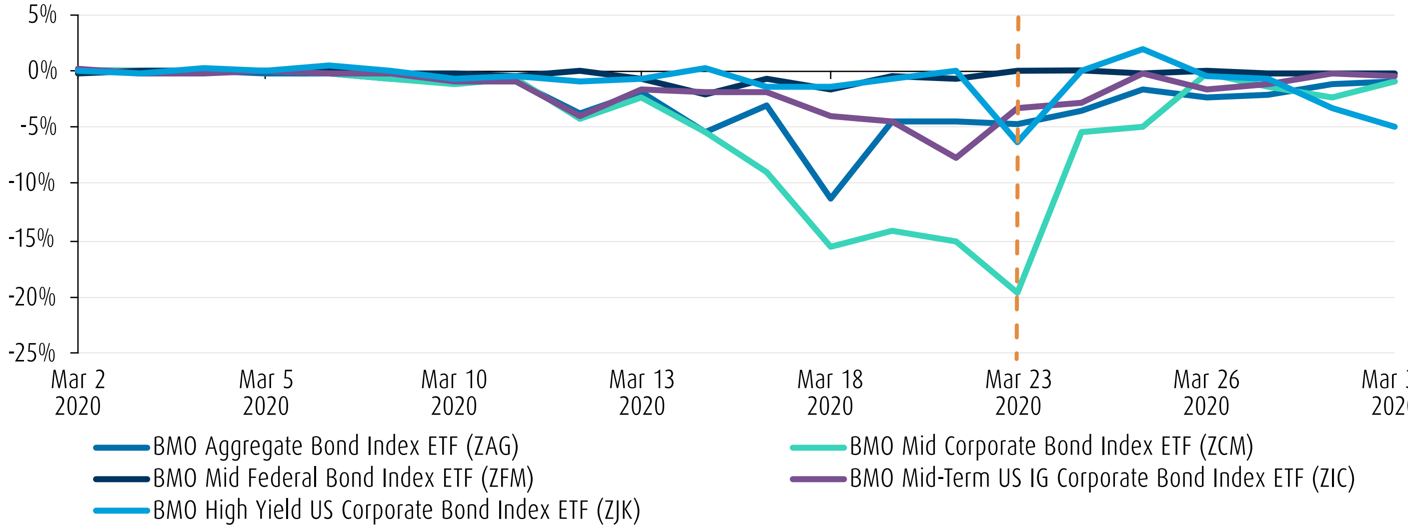
Source: Bloomberg, Mar 31 2020

Dislocation: NAV vs. Price

When liquidity dried up beginning March 12th 2020, when many bonds went "no bid", we saw NAVs becoming stale - not reflecting the current liquid value of the bonds. This means that during this period, the NAV is no longer a reliable way to measure if an ETF is trading at a premium or a discount. While we would normally have a concern if an ETF is trading at a discount or a premium, during these times it should be seen as a benefit of the ETF given that a NAV will be slower to react and not reflect the updated bond price and liquidity as seen through the ETF. ETF pricing has become the more reliable price discovery mechanism with market maker "fair value" a more realistic measure of true value than NAV.

On Mar 23rd 2020, the Federal Reserve announced a stimulus tool (Secondary Market Corporate Credit Facility (SMCCF)) that will purchase US IG corporate bonds and US-listed ETFs that hold US IG bonds, with the ability to buy up to 20% of any ETFs. While this program is focused on US issuers and short term bonds with less than 5 years to maturity it has had a ripple effect in Canadian markets. We expect to see with this announcement more fixed income ETFs which were trading at deep discounts to begin trading at a premium to NAV, see chart below.

CHART 4: PREMIUM/DISCOUNT TO NAV (Mar 1st -31st 2020)



Source: Bloomberg, Mar 31 2020

Looking at Chart 4 you can see greater price/NAV dislocation in Canada relative to the US. This is because the Canadian fixed income market trades predominantly over-the-counter (OTC) relative the US which has better online trading systems. In Canada NAV pricing is dependent on dealer quotes causing this more pronounced dislocation. In the chart you can see **ZAG** (BMO Aggregate Bond Index ETF) with 70% exposure to government bonds, and 30% corporate bonds is impacted by credit spreads widening, but not to the same level as **ZCM** (BMO Mid Corporate Bond Index ETF) which is 100% corporate bonds bearing the greatest price/NAV dislocation. You can see **ZFM** (BMO Mid Federal Bond Index ETF) fares the best with no corporate credit exposure, trading tighter than the other Canadian fixed income exposures shown. In the U.S. you can see **ZIC** (BMO Mid-Term US IG Corporate Bond Index ETF), with 100% investment grade corporate credit exposure, shows dislocation but not to the same extend as its Canadian counterpart, **ZCM**. **ZJK** (BMO High Yield US Corporate Bond Index) holds up well considering it is 100% non-investment grade corporate credit.

BMO Global Asset Management

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