Government of Canada Real Return Bond Consultations Summary

In September and October 2019, the Department of Finance and the Bank of Canada conducted public consultations for the real return bond (RRB) program. Over 40 market participants responded to the consultations, covering a range of stakeholders from clients to dealers to regulatory bodies.

The consultations questionnaire focused on three main aspects of the RRB program:
1) the usage of RRBs for investors, 2) long-term trends in investor demand and pricing, 3) secondary market activity and development of related markets.

The comments received are an important consideration in the upcoming Debt Management Strategy 2020-21 and are summarized in this document.

The original questionnaire can be found here.

Usage of RRBs for Investors

Overall, participants of the RRB program are split between two major groups: those that use RRBs as an insurance tool or as part of portfolio indexing and those that use RRBs opportunistically as a tool to generate returns.

In terms of alternatives to RRBs, participants generally preferred other sovereign inflation linkers and real assets, with some respondents reporting no ready replacements for RRBs in their portfolio.

A significant number of respondents reported that RRBs are considered a separate class of assets within their portfolios with the majority reporting that, in the current market environment, the level of issuance is sufficient to meet their needs.

Long-Term Trends in Investors Demand and Pricing

Larger pensions and insurers in the last few years have made significant moves towards alternative assets and as a result, their overall demand declined.

In the current environment, expectation for future demand is mostly pessimistic, with most expecting lower demand over the next ten years. This downward trend in demand for RRBs can be explained by three main factors:

1. The lower liquidity of the RRB market;
2. Lower inflation risk reducing the need for inflation protection; and,
3. The generally low yield environment leading investors to seek higher yielding asset classes that offer some protection against inflation.

Due to lower demand and a generally illiquid market, only a small portion of market participants indicated that the break-even inflation level between RRBs and nominal 30-year bonds is a good indicator for inflation expectations. Nonetheless, a few participants suggest that movements in break-even inflation are good indicators of trend for future inflation.

Secondary Market Activity and Development of Related Markets

Market participants universally reported that they consider the secondary market liquidity for the RRB program to be poor. A number of responders found that liquidity only improves around auctions and that illiquidity is a significant barrier to entry for both clients and dealers. The lack of a derivative market for RRBs is largely attributed to this systemic illiquidity.

A number of participants highlighted that inflation linked markets across the world have historically suffered relatively poor liquidity. With mostly buy and hold investors, some level of illiquidity exists regardless of issuance level or program size. Some of the market participants believe that the global uptick in demand for long bonds disproportionally affected RRBs' relative pricing, driving down the yield for nominal bonds without significantly impacting the real yield of RRBs.

Next Steps

In response to the feedback from these consultations, the Government will reduce the size of the RRB program from $1.8 billion annual issuance to $1.4 billion across four auctions.

In collaboration with the Bank of Canada, the Government will continue to monitor the performance of its debt strategy and make adjustments to ensure that the outcomes of the program remain consistent with its objectives of securing low cost and stable funding and ensuring market well-functioning in its security markets.