At our first securities finance webinar of 2017, the BNY Mellon Markets team discussed Canadian and US equity trends and strategies for driving agency securities lending revenue in these markets.

**Three Key Takeaways**

**Macro indicators point to a reasonably benign environment for equities.** US bond yields and the dollar are stabilizing. In Canada, oil prices could potentially help balance the equity market if pressures on the Canadian dollar (CAD) begin to build.

**Canada’s forward momentum looks set to continue.** There is a reasonable expectation for more M&A and financing activity which could translate into increased agency securities lending revenue opportunities.

**Collateral flexibility continues to be key.** Borrower balance sheet constraints, growing inventories and the potential for higher interest rates present both challenges and opportunities. Pivoting quickly between cash and non-cash collateral will be important.
Simon Derrick’s Macro View

The Dollar Looks to Stabilize

The new US administration’s expected fiscal and trade policy changes, and how these may affect monetary policy, are in the spotlight. The market is focusing on potential tax cuts and increased infrastructure spending which could put upward pressure on US yields. Despite high expectations about infrastructure spending and tax cuts toward the end of 2016, which led to a sharp rise in US yields and the dollar, there now seems to be a degree of caution. Yields are beginning to moderate, and the dollar is beginning to stabilize.

What Can We Expect in 2017?

The dynamics are quite complex. The new US administration has identified the importance of dollar strength while also noting that a strong dollar might present issues in the short-term*. Then there is the Federal Reserve’s cautious stance on dollar strength though rate hikes are on the table for 2017. International pressures also have a role to play. The recent collapse in some core European yields had investors seeking it elsewhere, and this increased demand for dollar investments brought a downward pressure on US yields. With these complex dynamics, the dollar will probably remain slightly lower rather than higher with bond yields staying stable or experiencing slight downward pressure. This will probably result in a reasonably benign environment for US equities.

USD FOREX Cumulative Flow vs. DXY (All Investors)

*Source: BNY Mellon iFlow®
Increasing Pressure on the Canadian Dollar

To understand the drivers behind the Canadian dollar, you must look beyond the interest rate markets to a 15-year correlation between CAD and oil prices. Even in the past twelve months, the recovery of the Canadian dollar has more closely tracked oil prices than interest rates. However, interest rates cannot be downplayed entirely, and recent inflation data may make the Bank of Canada less dovish than it has been over the last few months. Taking these two drivers together, oil prices doing relatively well and the potential for rising interest rates, and adding a cautious US Federal Reserve, pressures on the Canadian dollar may begin to build. This will come at an interesting time because the market is also fairly short of Canadian dollars.

Another consideration for the Canadian dollar involves foreign exchange reserves. If there is a slightly weaker dollar environment and oil prices continue to do well, this scenario may encourage a sharp pickup of inflows into foreign exchange reserves in Asia, the Middle East and beyond. Over the past seven years, one of the alternative reserve currencies has been the Canadian dollar.

With all of these dynamics, what will be the effect on the Canadian equity markets? We might see a sustained rally in the Canadian dollar over the next three months with potential knock-on effects for the Canadian equity market. However, with oil prices doing reasonably well and a resurgent US economy, there is still some good news for Canadian equities.
Focus On Agency Securities Lending

Looking Forward in 2017

On the positive side for the US and Canadian markets in 2017, interest rate increases might result in a rise in net interest margin on cash collateral reinvestment. Prospectively, increased mergers and acquisitions (M&A) activity may lead to more agency securities lending earnings opportunities. However, the effects of money market fund reform also need to be considered. With the market settling into the post-reform environment, prime funds are seeing some investment flow return and are now taking more advantage of term investments. This has the effect of increasing competition for attractive assets thereby pushing down yields for agency securities lending cash collateral reinvestment. The wild cards in all this are the potential for lighter regulation, tax cuts, fiscal policy changes, Federal Reserve monetary policy and market volatility, to name just a few.

Canada – the Resource Sector Leads the Way

The resource sector has a strong connection with the Canadian agency securities lending market. As resource prices began to tumble in early summer of 2015, there was a corresponding increase in volume-weighted average fees for Canadian equities, as traders began executing their directional short strategies. This marked the return of specials in equities in the Canadian agency securities lending market. In addition, energy companies either reduced or eliminated their discounted dividend reinvestment plans (DRIPs) which are a valuable securities lending trade in Canada.

Volume Weighted Average Fee data sourced from IHS Markit™ Securities Finance and Commodity Research Bureau data sourced from Bloomberg

Marketplace agility is a common attribute of top performing lenders. An example of this is the ability to accept various forms of collateral and nimbly adapt to current market conditions.

Rob Chiuch
In sharp contrast to 2015, there was a rebound in the resource sector during the second half of 2016 and a corresponding resurgence in discounted dividend reinvestment plans, which added incremental revenue for agency securities lending participants. Another major factor in the return of specials was that 2016 was a record year for Canadian equity sales. The energy sector led the way as companies took advantage of rebounding stock prices to recapitalize through either secondary offerings or equity links to securities such as rights offerings.

Collateral flexibility continues to be a key trend globally, and Canada is no exception. The market has gone from 100% non-cash sovereign debt collateral to a more European-style model which is a mix of non-cash sovereign debt, equities and cash collateral. The type of collateral can actually make or break a securities lending trade in the Canadian market, and more flexibility can mean a greater chance of capturing incremental risk-adjusted returns.

What does 2017 hold for Canadian agency securities lending? The positive environment from 2016 looks poised to continue. On the back of the resource sector recovery, the expectation is for more M&A and financing activity which could result in increased agency securities lending revenue opportunities. Then there is the potential housing bubble. Mortgage financing stocks have been a large and valuable short in 2016, and this trend should continue into 2017 given the almost daily discussions around the housing market. There is also regulatory change which will continue to influence the structure and nature of the Canadian agency securities lending market. With regulatory change, the expected trend is for continued collateral diversification and an increased demand for term.

**The US – Some Hurdles but Also Success**

Equity securities lending in the US faced many challenges last year. In 2016, market volatility dominated the scene. This volatility reflected recovering crude oil prices, Brexit and US elections. Over the course of the year, there was a general downward trend in fees for the top 50 US shorted equities, except for two blips caused by risk arbitrage trades in both Procter & Gamble and Lockheed Martin. There were bright spots in the short space such as declining energy prices at the beginning of the year driving short interest (which lead to more agency securities lending opportunities).
Going into 2017, there are still some hurdles. Specials are at a historical low. Internal inventory is high among broker-dealers who are also faced with increased balance sheet and liquidity constraints due to regulatory reform.

Even in this challenging environment, there is cause for some celebration. For BNY Mellon, 2016 was possibly the best year for US equities securities lending since the 2008 financial crisis in terms of earnings growth. One of the main factors driving this success was collateral flexibility, and this trend looks set to continue into 2017. Collateral flexibility allows traders to anticipate and nimbly execute agency securities lending transactions. It also keeps beneficial owners in sync with the trend towards non-cash collateral in the US which also looks to continue through this year. Why will this trend continue? The potential for rising US interest rates in 2017 may make cash collateral more attractive to lenders, but regulation and market forces can make it a more expensive option for borrowers. Market trends could also spark a reduction in broker-dealer internal inventories in 2017, and these securities could be pledged as collateral in agency securities lending transactions. Also on the horizon is the pending proposal to change 15c3-3 legislation to allow US-based broker-dealers to pledge equities as collateral in the US market.

Collateral Flexibility Is the Key

With collateral flexibility, market participants are in a better position to take advantage of agency securities lending opportunities in today’s constantly changing environment. Just last year, there was an abundance of non-cash collateral in the equities space until the market sold off, and the market quickly transitioned to cash. This year, the macro environment is evolving; regulation is a significant catalyst of change; and market dynamics are changing rapidly. Market participants with broader collateral schedules are in a better position to capture opportunities and perhaps see a real difference in their ultimate agency securities lending performance numbers.
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Footnotes

*https://www.bloomberg.com/politics/articles/2017-01-23/mnuchin-says-excessively-strong-dollar-may-have-negative-impact  

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