MONTRÉAL EXCHANGE

March 2025

What Now for CORRA Contracts?

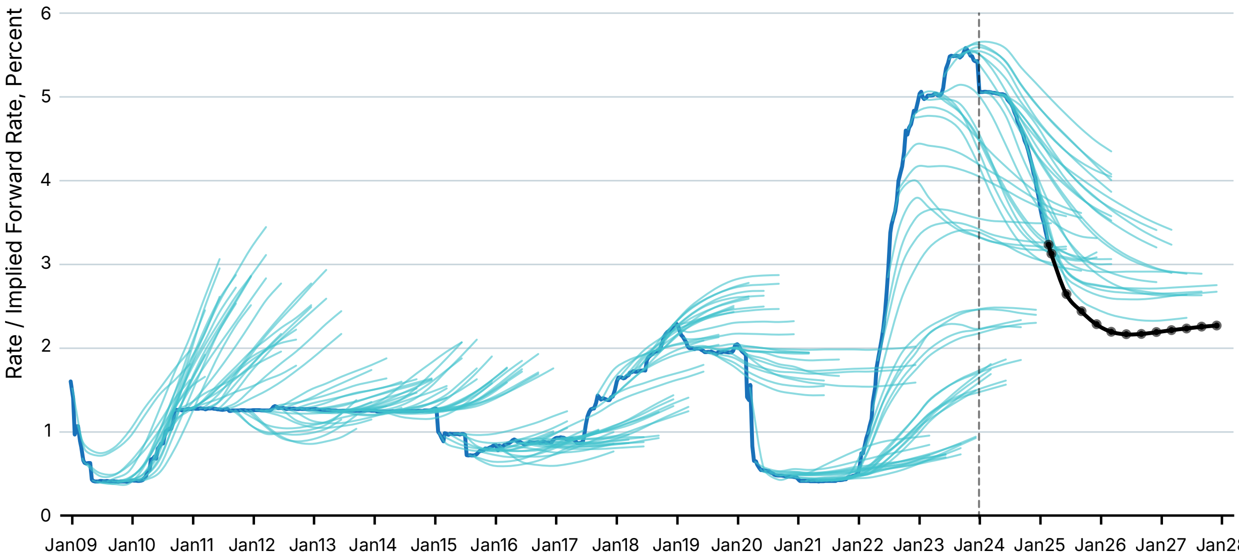
We update[1] the legacy "BAX Spaghetti" chart to incorporate the replacement of Three-Month Bankers' Acceptance Futures contracts (BAX®) with the now-standard Three-Month CORRA Futures (CRA™) contract. In doing so, we ask whether the "easy money" of rolldown may be nearing an end (for now), tariff war notwithstanding.

Updated Figure for CORRA

Although BAX contracts endured into the June 2024 contract, CRA contracts had already become the preferred front-end instrument when the former were phased out[2]. To update our time series chart that we have used in the past to depict various eras of attractive front-end rolldown, we used a cutoff date of December 2023 for BAX contracts and continued into 2024 with CORRA contracts. Figure 1 shows the resulting overlay plot. A dashed line divides the data into two portions: the left shows legacy BAX pricing, while the right displays the new standard of CRA prices.

FIGURE 1

CDOR/BAX, Jan 2009 to 2024 – CORRA/CRA, Jan 2024 to present



Source: Montréal Exchange

1 Interested readers can find the previous update, Is This Really the End?, published by Montréal Exchange in March 2023 and the original article in this multi-year series, Evolving BAX: Nearly a Decade of Easy Rolldown, from November 2017.

2 At the time of writing, CRA open interest exceeded 1.3mln contracts in open interest, making it the short-term rate derivative of reference.

In the figure above, the 90-day futures curve, whether that of BAX contracts before 2024 or CRA contracts after 2024, is shown in teal, while the blue line shows either the Three-Month Canadian Dollar Offered Rate (CDOR) or the Three-Month CORRA weighted average[3] rate. To interpret the figure, anytime the teal "strand of spaghetti", which depicts the futures curve on each date, lies above the blue line, futures contract prices implied short-term interest rates higher than were eventually realized, and vice versa. A buy-and-hold long position would eventually[4] have made profits on the expiry date for the contract if it was established when the teal futures curve was above the blue spot curve.

Minor Adjustments Due from BAX to CORRA

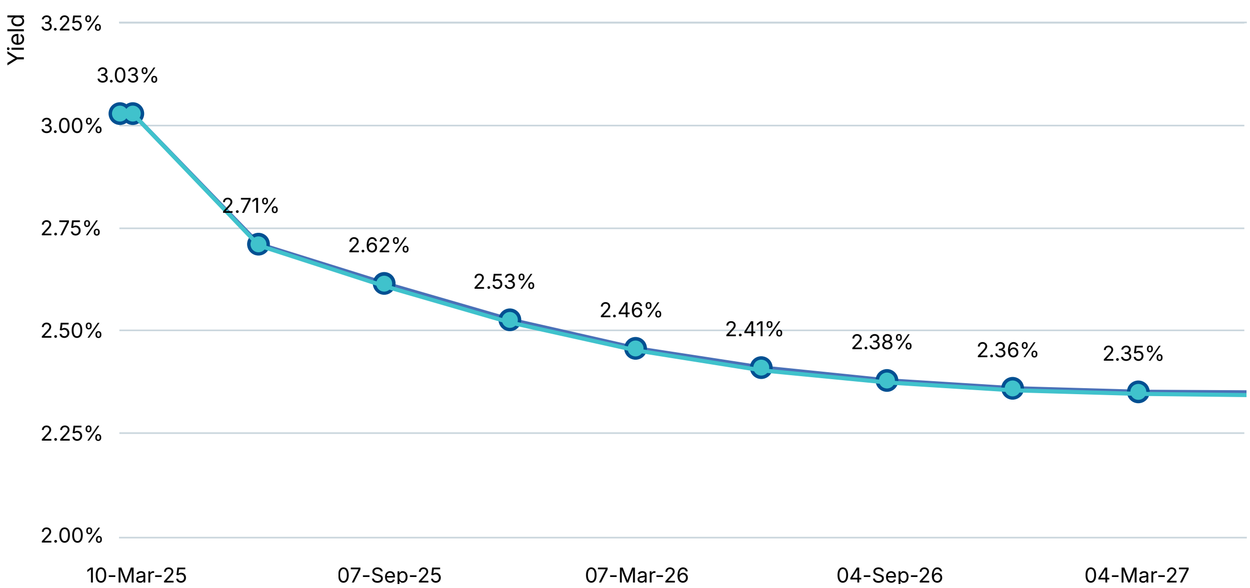
BAX contracts were settled based on the Three-Month CDOR level observed on a single date. In contrast, CORRA contracts are settled based on a weighted average of observations over a 90-day period. We have used the weighted average calculated from the CORRA Compounded Index published daily by the Bank of Canada[5]. The effect of this averaging is evident in the figure as, after January 1, 2024, the short-term rate no longer "steps" upward or downward on days when monetary policy action is taken but instead trends in a smoothed manner. We feel this preserves the nature of the chart better from a visual perspective since the teal "spaghetti" lines converge to the blue settlement level in the same way that the BAX contracts did prior to the contract change in 2024.

More Accommodation Expected

Since CRA contracts can be used to derive[6] overnight rate expectations from current prices, they are efficient tools to express views on Bank of Canada decisions. The spot curve in Figure 2 currently anticipates about three additional rate cuts by September. Recall that since these rate cuts are already priced into the contract, a buyer of a CRA contract needs more policy accommodation to be priced into the curve to profit. If the Bank cut about three more times in the next six months, these contracts would break even or, in terms of relating Figure 2 to Figure 1, the teal futures curve would be neither above nor below the eventual spot rate.

FIGURE 2

CRA Spot Curve



Source: Montréal Exchange

3 We explain the change from a single observation to an average in the next paragraph.

4 Note that the chart conveys no information about the path the trade took to eventual profitability.

5 This index is very useful for calculating the compounded daily rate between any two dates. Readers can find it at https://www.bankofcanada.ca/rates/interest-rates/corra/#index.

6 For more, refer to So Long BAX Model published by Montréal Exchange in October 2023.

Easy Money Periods Come and Go

The blue zones in Figure 1 indicate long periods when it could be considered “easy” to make money from the long side of the BAX and CRA contracts. With significant rolldown favouring the long position, many managers pursue a long-term hold strategy and tolerate the daily volatility in pursuit of the eventual rolldown. These periods are related to the monetary cycle, albeit only loosely at times markets anticipate central bank moves but almost always over or under-anticipate the eventual monetary policy.

Other periods like that between January 2022 and January 2024, a period between the most recent blue zones in the figure, are challenging periods for long positions as the front-end futures curve fails to anticipate the speed and magnitude at which the central bank will raise interest rates. Long positions experience losses that eventually cause margin calls and emergency exits from positions that initially appeared to have attractive rolldown.

Not yet “Long in the Tooth”

Trade tensions with the United States are posing challenges for the Canadian economy. Whether or not the U.S. government’s actions continue, a visual inspection of Figure 1 and the most recent blue zone may be almost as effective a strategy for deciding which way to play the front-end. While the most recent period of “easy money for buy-and-hold” in the front-end of the yield curve is more than a year old now, it is still the shortest period of the past 16 years covered by the figure. However, we must acknowledge that CRA contracts already imply considerable monetary policy accommodation and don’t exhibit the historical rolldown that proved attractive at previous periods. This portion of the yield curve slopes downward currently, not upward. However, history still indicates that the Bank of Canada is often more aggressive, for extended periods, when pursuing easy monetary policy.

For the Moment, These Are “Traders Contracts”

Given current volatility, unpredictable announcements, and, dare we say, the unknown direction and/or goals of our southern neighbour, “buy and hold” CORRA opportunities may not be the most evident trades at the moment. Even those managers with plenty of risk tolerance and an appetite for volatility must monitor their positions constantly for the next announcement or reversal of previous announcements. Perhaps the pace of unanticipated news will slow in future, and volatility will become more manageable and predictable, but, for now, the news cycle controls the front-end of the yield curve. Managers may choose a direction and, if doing so on a strong view, CRA futures[7] or the Two-Year Government of Canada Bond Futures (CGZ®) bond contracts are efficient ways to trade these convictions rapidly. Still, we anticipate very few managers view these trades as long-term holds as they might have done in the past, with the potential for rolldown due to an upward-sloping curve and a more predictable U.S. government policy.

7 The Bourse also makes available for trading 4 nearest expiries from One-Month CORRA Futures (COA), another great tool to manage interest rate expectations.

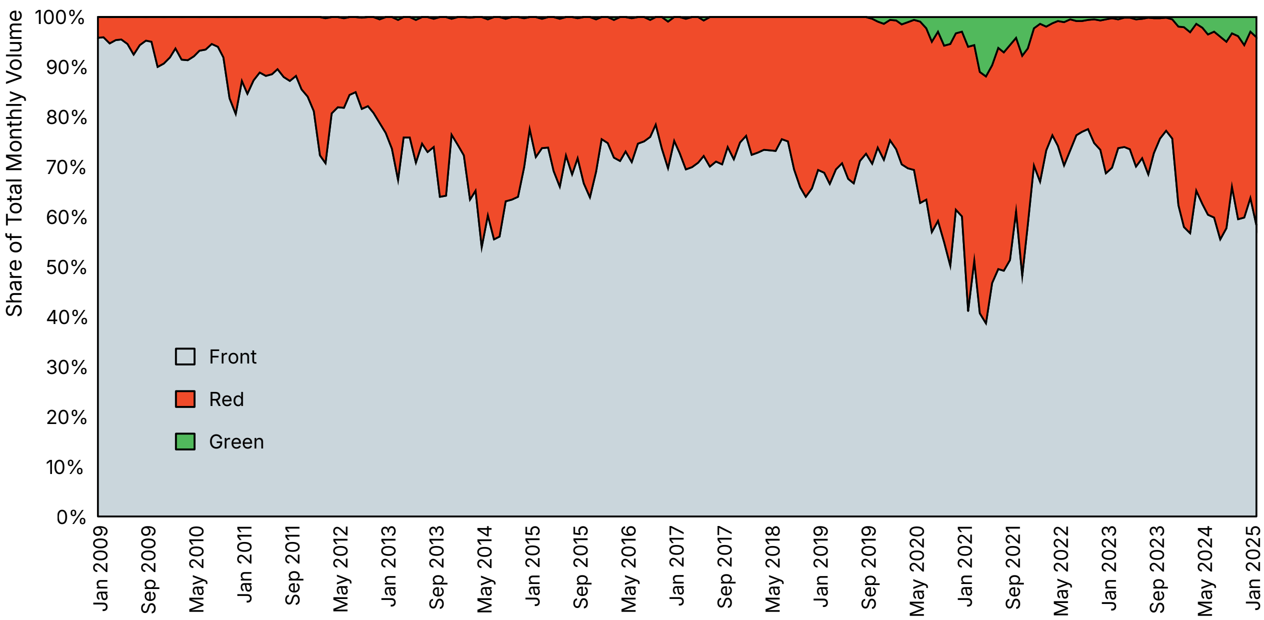
Greens Are Back!

Finally, managers have again embraced the use of longer-term contracts for several quarters, perhaps stemming from additional liquidity developments for CRA as it overtook and ultimately replaced BAX in 2024. For some months, the 9th through 12th contracts attracted little attention, a phenomenon that appears to have ended.

Figure 3 shows the mix of contracts represented by the daily trading volume for about a decade and a half. For a few years between mid-2020 and mid-2022, about eight expiry cycles, managers embraced enough green contracts, the 9th through 12th contract, to represent 6-12% of the trading volume. There followed a few lean years where very few of the contracts farther out the curve were traded but that period has now ended as green contracts have now rebounded and are approaching over 5% of trading volume in CRA futures in some months.

FIGURE 3

BAX/CRA Volume by Series, Jan09 to Present



Trade where your risks lie: more CORRA alternatives

As previously mentioned, the One-Month CORRA Futures (COA™) is also a popular tool for risk management and speculative positioning in the front-end of the yield curve. In addition to the thinner exposure to Canadian rate expectations, it provides a variety of trading strategies to benefit from monthly and seasonal repo market dynamics as well as targeted change in the Bank of Canada overnight rate. These use cases are discussed in depth (with detailed examples) in the One-Month CORRA Futures: Timely Trade Opportunities article[8] published a few months ago.

Further, Options on Three-Month CORRA Futures (OCR™)[9] listed by the Exchange are powerful instruments that allow participants to customize their CORRA positions and better manage non-linear risk. As liquidity grows in the underlying CRA contracts, participants should see value in getting involved in the CORRA options market as they provide an opportunity to hedge, trade and more efficiently optimize Canadian short-term interest rate exposure. The Exchange currently lists for trading the nearest four (4) quarterly contract expiries that garner increasing participation through multiple outright, strategies and block transactions.

8 https://www.m-x.ca/f_publications_en/futures_flash_article25_en.pdf
9 https://www.m-x.ca/en/markets/interest-rate-derivatives/ocr

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