OBSERVATION

TD Economics

August 20, 2013

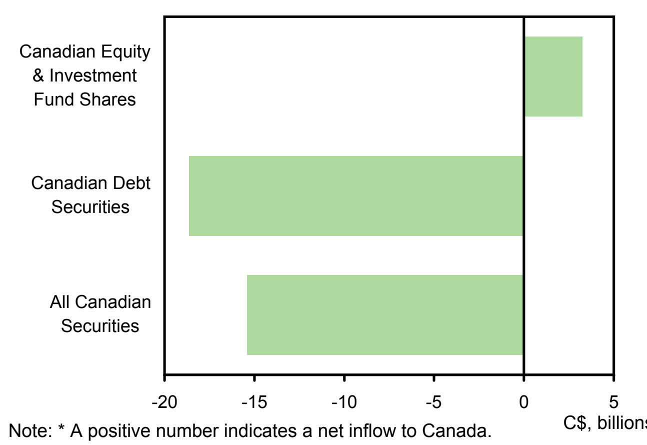
HAS THE BLOOM GONE OFF THE ROSE FOR CANADIAN BONDS?

Highlights

- In June, net foreign purchases of Canadian securities fell by $15.4 billion. The headline was driven by a sharp $19 billion outflow from Canadian government bonds. The June data release marks the first decline this year and the largest drop on record for debt securities. Foreign purchases of equities and money market instruments provided very small offsets to the headline figure.
- Reassuringly, the outflow was driven mainly by coupon payments and the return of principal from maturing investments, rather than outright selling on the secondary market. In layman's terms, demand for bonds lessened in June, but supply also noticeably tightened given maturity schedules.
- Over the past year, foreign interest in Canadian government bonds has waned – the six-month moving average of outflows is $2 billion versus the $11 billion posted in October 2012. Interest in Canadian corporate bonds has picked up, but not enough to offset the larger government category.
- U.S. Federal Reserve tapering talk and an end to the six-quarter long recession in the euro zone may encourage foreign investors to think twice about Canada. We expect a knee-jerk reaction, temporarily drawing investors away from Canadian securities. Over the longer-term, foreign investor appetite for Canadian corporate bonds and equities ought to perk up as Canadian economic fortunes improve.

Are foreign investors bailing out of Canadian bonds? The data released on Friday suggested this has been the case – in June, at least. Declines in federal government bonds led the way, more than offsetting the increase in private corporate bonds and Canadian equities. These flows should prove fleeting. The federal government's AAA-rating will keep investors interested in Canadian bonds over the foreseeable future once markets return to primary drivers like fiscal fundamentals. As Canada's economy improves, helped in part by a U.S. revival, demand for Canadian corporate bonds and equities should also benefit.

NET FLOWS* OF CANADIAN SECURITIES IN THE MONTH OF JUNE



Note: * A positive number indicates a net inflow to Canada.
Source: Statistics Canada/Haver Analytics.

Selling spree of Canadian bonds in June

In June, net foreign purchases of Canadian securities fell by $15.4 billion. This was largest decline on record and marked the first dip into the red this year. The headline was driven by a sharp decline in Canadian government bonds worth $19 billion. The large drop was driven by two compounding factors. First, an unusually large amount of proceeds maturing (i.e. bonds maturing exceeded purchases from net new supply). Second, there was a greater-than-average share of maturing funds invested abroad compared to the past (i.e. less foreign interest in Canadian debt). Unfortunately for the headline, foreign purchases of equities and money market instruments provided only very small offsets in June.

While it might seem like it upon first glance, investment sentiment has not soured for Canadian gov-

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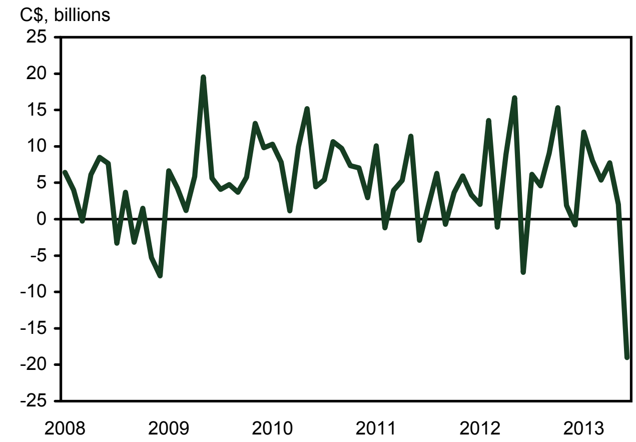

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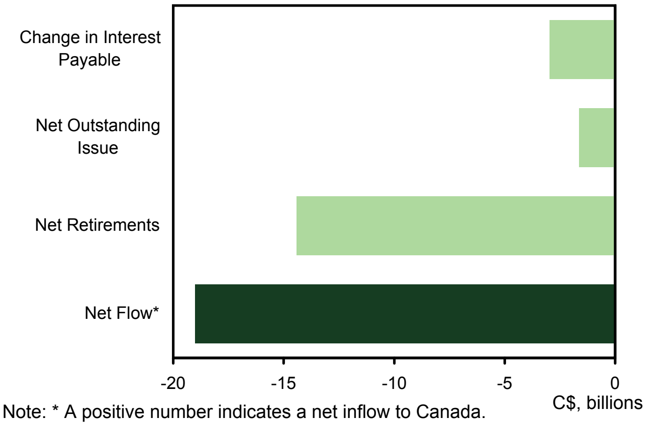
Source: Statistics Canada/Haver Analytics

PORTFOLIO TRANSACTIONS IN CANADIAN BONDS IN JUNE



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Source: Statistics Canada/Haver Analytics.

ernment bonds. The vast majority of the outflow in June was due to coupon payments and the return of principal from maturing bonds versus sales in the secondary market. This seasonal pattern in coupon payments and maturities occurs both in June and December. As a consequence, the large negative outflows recorded in June 2013 is actually typical. This seasonal quirk will gradually fade as the federal government has begun to smooth its maturity profile to four dates instead of two. At the same time, the recent data do suggest that foreign investors are somewhat less inclined to direct the proceeds from their previous investments back into Canada.

Is Canada no longer an international darling?

As Canada's economic performance outpaced that of the U.S. from 2007-11, foreign investors flocked to Canada because of its relatively sound banking system, resource-heavy financial markets, and a strong housing market. Since the recovery began, foreign funds flowing into Canadian securities equalled nearly $100 billion per year.

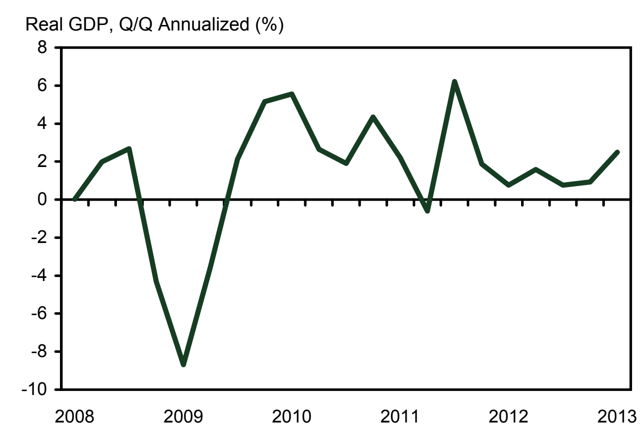
Of late, the global investing community has taken note of Canada's slower economic growth profile. There has been growing concern regarding real estate over-valuation, household indebtedness and a heightened vulnerability over the medium-term due to the United States' increasing efforts to become energy independent. Pipeline approvals are also an unknown which calls into question Western Canada's ability to transport its oil to meet international demand.

Some of the softness in foreign demand has also reflected concerns about imbalances in the Canadian economy. The good news there is that we believe adjustment will occur in housing and household debt without any major harm to the economy. As such, even though the Canadian economy is likely to under-perform that of the U.S. over the next few years, Canada should still record a respectable 2-2.5% rate. Canada enjoys solid longer-term growth prospects, competitive business tax rates, and generally good demographics.

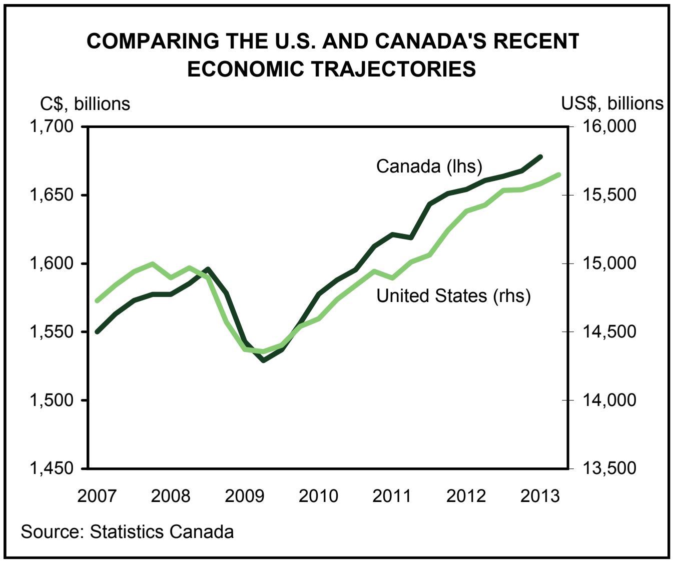
Foreign interest in Canadian government bonds has also waned – the six-month moving average is $2 billion versus the $11 billion posted in October 2012. The recent slowdown in trend inflows into Canada is most likely tied to U.S. developments. Increasing optimism surrounding medium-term U.S. growth prospects could give the U.S. Federal Reserve a catalyst to scale back asset purchases. On this point, Canada has been a significant beneficiary of Quantitative Easing (QE) south of the border, as U.S. funds were looking for a home.

Canada's government debt will still be viewed as a safe

CANADA'S ECONOMIC PERFORMANCE SINCE 2008



Source: Statistics Canada



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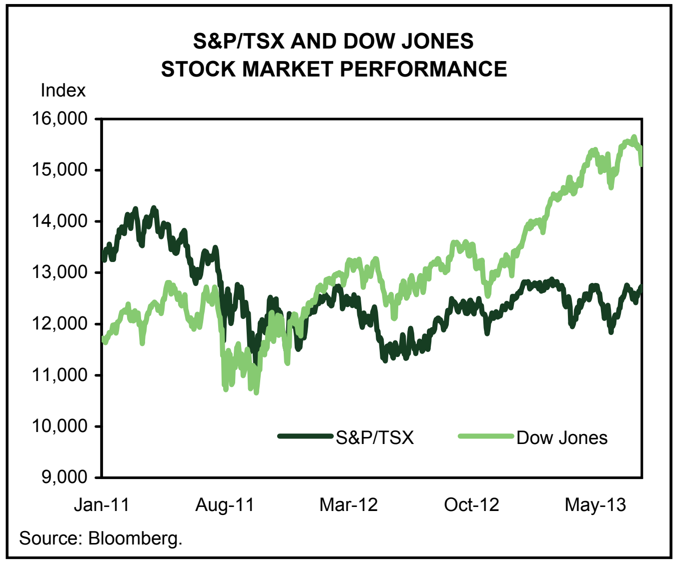

Source: Bloomberg.

haven given the federal government's AAA credit rating. The Canadian federation (federal and provincial governments) holds a comparatively healthy fiscal position among major industrialized nations. While a period of relative calm in the ongoing saga of the European fiscal debt crisis and stronger-than expected inflows of revenues to the U.S. government has pushed the theme of sovereign risk to the back burner, many deeper and long-standing issues remain and will undoubtedly demand attention from global investors. Against this backdrop, Canada's superior fiscal fundamentals will once again stand out.

Financial markets already reacting to Canada's backseat placement

The Canadian dollar has already been feeling the brunt of the renewed sense of U.S. economic optimism. The loonie is down 8% versus the greenback since April 2011. According to Bloomberg's Correlation-Weighted Indices, the loonie has lost 0.7% of its value in 2013 relative to nine other developed-nation peers. Currencies in countries with current account deficits, including Canada, are being disproportionately penalized at the moment markets start building in U.S. Fed tapering. Going forward, the story for the currency will be continued weakness with the loonie landing in the 90-95 U.S. cents come year end.

Canada's equity market indices have also not experienced the same post-2009 gains recorded by its U.S. counterparts. In fact, the S&P/TSX Composite Index is down 13% since April 2011; many Canadian energy and material stocks are currently in bear market territory. A flat commodity price profile is not providing much support to the stock market. Note that energy-related stocks represent about half of the S&P/TSX benchmark index on a weighted basis. The index contraction is quite stark relative to the benchmark indices of the U.S. and Japan who are posting double-digit increases over this same period. Germany and the U.K. are also in the positive over this time period.

Bottom line

Foreign investors have flocked to Canada in order to "safely" secure a return. But, after five years of outpacing the United States, Canada is poised to take a back seat over the next two years. All is not bad news. The export-based nature of the Canadian economy stands to undoubtedly reap the rewards if the U.S. economy accelerates and economic growth, even modest growth, is restored in the euro zone.

All else equal, the differences in economic growth across the two countries could mean that global investors look outside Canadian bonds and equities to maximize their overall portfolio returns. This should only be a knee-jerk reaction. Demand for Canadian corporate bonds and equities ought to perk up as Canadian economic fortunes improve. Appetite for Canadian government bonds should also return over the medium term once: (1) markets re-focus their attention to underlying fiscal fundamentals; and (2) governments continue to make progress eliminating their deficits and lowering their debt burdens.

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