OBSERVATION

TD Economics

June 3, 2015

SELLING CANADA SHORT

Assessing Foreign Investor Interest in Canada

Highlights

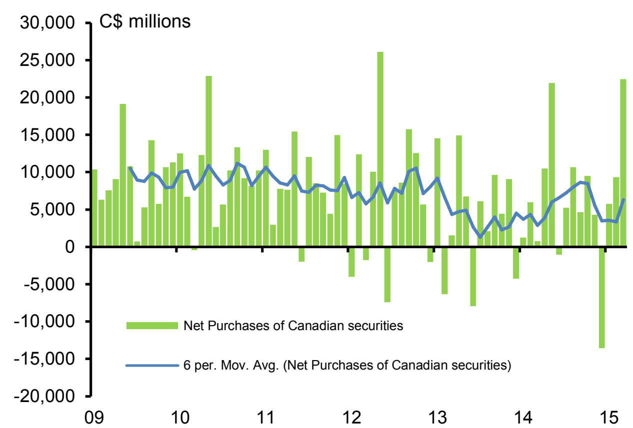
- After being viewed favourably early in the economic recovery, the notion of "short" or sell Canada became a growing theme as oil prices collapsed in the second half of 2014.
- However, international investors have not entirely turned their backs on Canada; with portfolio inflows having picked up so far in 2015. Foreign direct investment in Canada did take a hit in Q1, but it remained in positive territory. And, the housing markets with the most foreign investor activity – Toronto and Vancouver – have picked up momentum so far in 2015.
- Overall, Canada's economy is down but not out, and stronger growth in the second half of 2015 is expected to keep Canada attractive for foreign investors.

Canada had been widely touted as a favourable place to invest during the recession and earlier in the recovery due to Canada's relatively strong financial sector and government fiscal position. However, as oil prices collapsed in the second half of 2014, market sentiment seemed to have soured on Canada. The notion of "short" or sell Canada became a growing theme in international circles, as falling oil prices added to concerns about an overheated housing market and high household indebtedness. A few months later, however, it seems the bears have not been proven right. Data so far in 2015 show that investor flows into Canada have remained resilient and sentiment on the Canadian dollar has picked up.

Foreign portfolio inflows perk up

The timeliest data on investment flows in and out of Canada are Statistics Canada's international securities transaction data, which we have up until March 2015. As a whole, foreign interest in Canadian securities was gaining momentum in early 2014 before the collapse in oil prices, and this quickly changed in the second half of last year (see Chart 1). However, focusing on the six-month moving average trend, which smooths out volatility on a monthly basis, it shows that net foreign purchases have more recently rebounded.

CHART 1: FOREIGN DEMAND FOR CDN SECURITIES REMAINS SOLID

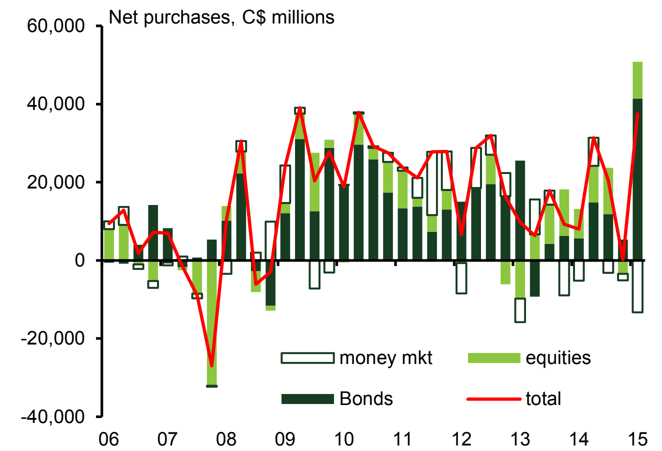


Source: Statistics Canada

The loss of interest in Canadian securities as oil prices plunged was concentrated in equities. However, inflows into equity markets have been positive for the first three months of this year, and were particularly strong in March. Corporate equity issuance has also strengthened in recent quarters, suggesting Canadian corporations are increasingly confident about investor interest in Canada (see Chart 2). As oil prices plummeted in the latter part of 2014, the TSX fell 16% peak-to-trough. The index has managed to advance roughly 2.5% so far in 2015. That

Derek Burleton, VP & Deputy Chief Economist, 416-982-2514
Leslie Preston, Economist, 416-983-7053

CHART 2: NET FLOWS INTO CDA BY TYPE



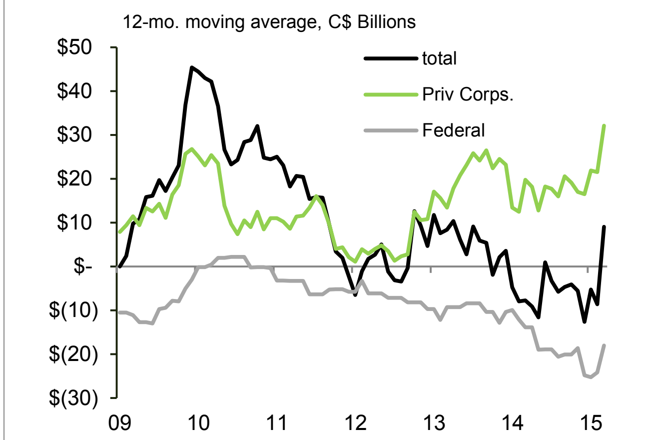
Source: Statistics Canada/Haver Analytics

said, the TSX has continued to lag many other major equity indices so far in 2015, and even more so when compared in currency-adjusted terms.

Where foreign buying has been more resilient, and has gained significant momentum in recent months, is in bond purchases. In particular, foreign investors have maintained a healthy appetite for Canadian corporate bonds, and picked up a bit more recently (see Chart 3). In the first quarter of 2015, foreign purchases of Canadian bonds were mainly new issues of private corporate bonds denominated in foreign currencies. That continued the increased tendency of Canadian corporations to issue debt abroad, a trend which has strengthened since early 2013. This trend has coincided with the general depreciation in the Canadian dollar.

As bond yields once again headed lower earlier this year, Canadian private corporations took advantage of low borrowing rates and strong investor demand for fixed income investments, and issued $40 billion in net new bonds (see Chart 4). This surge in bond issuance, when combined with the equity issuance, set a new quarterly issuance record.

CHART 4: NET NEW BOND ISSUANCE



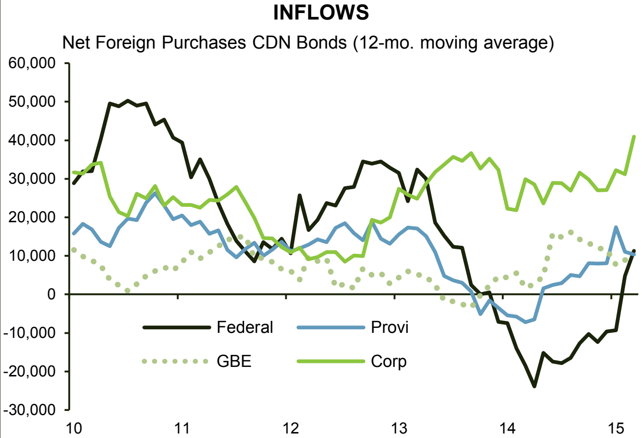
Source: Statistics Canada/Haver Analytics

The increase in issuance in Q1 was not confined to Canadian companies. U.S. issuance activity has also been breaking records so far in 2015 on a similar rush-to-borrow before rates rise. Canadian issuance has also been fairly widespread across sectors. Financial corporations have seen very strong net issuance over the past year, but nonfinancial corporate issuance activity has also picked up.

Overall foreign investor presence has risen

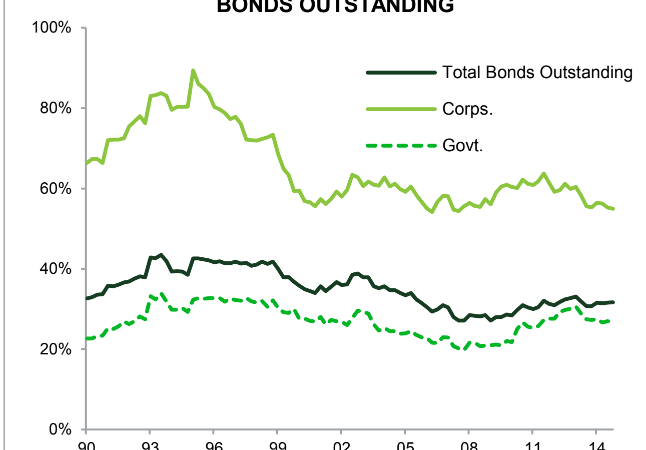
Looking at the overall prevalence of foreign investors in Canadian bond markets, the share of Canadian bonds

CHART 3: CORPORATE BONDS SEE LARGEST INFLOWS



Source: Statistics Canada/Haver Analytics

CHART 5: FOREIGN-OWNED SHARE OF CDN BONDS OUTSTANDING



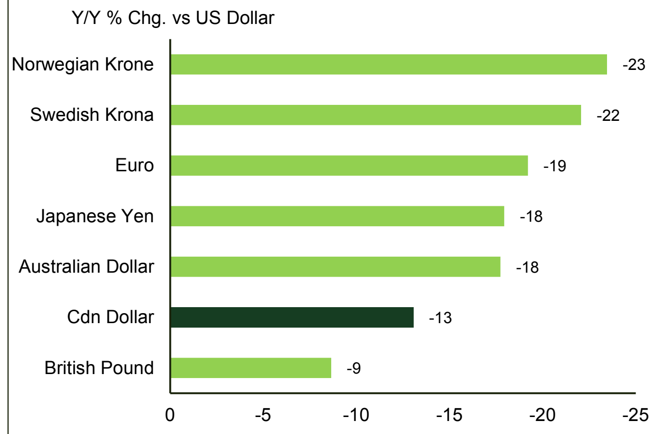
Source: Statistics Canada/Haver Analytics held by foreign investors has been rising since 2008, after roughly ten years of declining (see Chart 5). Foreign investors own roughly a third of outstanding bonds in Canada. That increased portion has been driven largely by rising foreign holdings of government bonds – and more specifically federal government bonds (see Chart 5). The Bank of Canada has suggested that this trend has reflected the increased use of the Canadian dollar as a reserve currency since the financial crisis[1]. This reflects in part a desire by international central banks to diversity their currency reserves away from the U.S. dollar, and recognition of the Canadian federal government's AAA credit rating – a designation shared by only about a dozen countries worldwide. The May 2015 federal budget, which trumpeted a return to a balanced budget and the relatively low overall public debt burden, has only helped to keep government bonds well bid and kept comparable longer-term yields below those in the United States.

Meanwhile, foreign investors have the largest presence in the corporate bond market, owning over half of corporate bonds outstanding. That share rose initially after the recession, but has actually fallen slightly since mid-2011. As discussed in the previous section, strength in foreign purchases of Canadian corporate bonds has occurred against a backdrop of healthy net new issuance activity, so the share of corporate bonds outstanding held by foreign investors has not increased.

Foreign direct investment takes a hit in Q1

Foreign direct investment (FDI) in Canada did take a hit in Q1, with inflows $13.7 billion lower than in Q4. FDI can swing widely on a quarterly basis, often due to larger deals, but even on a four quarter moving average basis, direct investment in Canada has ebbed slightly from its late-2013 peak. Foreign direct investment in the energy and mining sectors was down $2 billion in Q1 to $3.3 billion. FDI in Canada peaked immediately prior to the financial crisis when the economy was growing strongly, and oil prices and investment in Canada's oil sands were booming. In the years immediately after the recession, direct investment flows into Canada were lower, and were vastly outpaced by portfolio inflows. In 2013-14, direct investment picked up a bit, so the decline in Q1 is a bit discouraging. However, it is not severe enough when viewed on a trend basis to raise too many red flags.

CHART 6: LOONIE HAS HELD UP RELATIVELY WELL



Source: Bloomberg, as of May 29, 2015

Despite dire predictions, Canadian real estate has held up in major centres

One asset class that the foreign media love to hate is Canada's housing sector. Canada's market is painted as one of the most overvalued globally, standing on the precipice of a crash. However, housing data so far in 2015 do not bear that out, at least outside of Alberta. Sales in Canada's largest markets – Toronto and Vancouver – are up strongly so far in 2015, and rising prices in these housing markets continues to drive price gains at the national level. The MLS HPI, which adjusts for the mix of houses sold in a given month, is up roughly 5% over the first four months of 2015 in both Greater Vancouver and Toronto.

While it is impossible to measure how much of real estate activity is driven by "foreign" money, according to surveys done by CMHC[2], Toronto and Vancouver have the highest percentage of foreign investment in condominium units. The Bank of Canada also recently cited in its Financial System Review that "the influence of foreign investors in the Toronto housing market, and in other large urban centres, may be increasing, particularly in the luxury segment"[3]. If money originating from outside of Canada finds housing in Canada too risky, it doesn't seem to be driving a cooling in either of these major urban markets yet.

The Loonie holds its own

The overall resilience in interest in Canadian assets has been reflected in the Canadian dollar's performance. It has held up relatively well against a broadly appreciating U.S. dollar. The Canadian dollar has been on a longer-term depreciating trend, which saw it fall from parity with the US dollar in late-2012, to a low of 78 cents in mid-March. The collapse in oil prices since mid-2014 and the surprise rate cut by the Bank of Canada had hastened its decline. However, the loonie has actually held up well over the past 12 months compared to many other global currencies (see Chart 6).

A change in market sentiment on the loonie can also be seen in speculative positions in the Canadian dollar, which are net long for the first time since last July. This is in contrast to the fact that speculators have spent the vast majority of the last two years shorting the Canadian dollar.

The Bottom Line

Canada's economy is larger than the oil and gas sector. While the plunge in oil prices in 2014 soured investor sentiment initially, particularly for Canadian equities, interest appears to be picking up. Canadian corporations have taken advantage of that interest by undertaking record issuance activity which has been snapped up by foreign investors. Even the housing markets where foreign interest is highest have been enjoying healthy activity thus far in 2015. There is a risk that oil prices could see more volatility in the near-term, crimping investor sentiment. But, the U.S. economy is expected to accelerate in the second half of the year and this should help boost activity in Canada's non-energy export sectors. This should help Canada's economy turn in a decent performance in spite of the severe shock in the energy sector. Relatively better growth overall should help to keep Canada relatively attractive to foreign investors.

Derek Burleton, VP & Deputy Chief Economist
416-982-2514

Leslie Preston, Economist
416-983-7053

ENDNOTES

1. http://www.bankofcanada.ca/2015/05/fine-tuning-framework-bank-market-operations/#footnote-8

2. CMHC. Fall 2014. Rental Market Report.

3. Bank of Canada. Dec 2014. Financial System Review.