Investment Insights

Foreign Investment in the Canadian Bond Market

The 2007-08 U.S. housing market collapse and subsequent credit crisis shocked global markets and triggered the bankruptcy of important financial institutions. While the U.S. economy was reeling, its neighbour to the north appeared to be weathering the storm with relative grace, causing foreign investors to take notice. Since the financial crisis, there has been a significant increase in foreign investment in the Canadian debt market.

Today, six years after the most intense part of the credit crisis, will foreign investors continue to flock to the safety of Canadian bonds? This paper discusses the reasons behind increased interest in Canadian debt, recent trends in foreign investment flows, and the potential effects on Canadian institutional investors.

The Canadian Bond Market

In 1975, the Canadian bond market was valued at $93.5 billion, and since then it has grown at a rate of 8.8% per year to $2.6 trillion. This market size is meaningful, although it is dwarfed by the U.S. bond market, valued at $35.5 trillion. As seen in Figure 1, corporate bonds make up the largest segment of the Canadian market, accounting for 34%, provincials account for 25%, while federals and term securitization each make up roughly 20% of the market.

Since 2008, there has been a noticeable increase in the pace of growth of foreign investment in the Canadian bond market, as illustrated in Figure 2. While the Canadian bond market expanded at a rate of 9.1%, foreign investment expanded at 11.4%, and as of June 30, 2014, foreign investment accounts for 31%, or approximately $809 billion, of the $2.6 trillion Canadian bond market. Government of Canada bonds were the primary recipient of this foreign interest, growing at 13.0% over this period, while foreign investment in corporate bonds grew at 8.9%.

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1 Source: Stats Canada
2 Calculated using a compound annual growth rate (CAGR)
3 Source: Stats Canada
4 Securities Industry and Financial Markets Association (SIFMA), June 2014
Foreign investment in Canadian bonds has grown strongly on an absolute basis over the past twenty years. Interestingly, despite the rapid growth that followed the credit crisis, the current level of foreign investment in Canada remains below the historical average of 35%. Given that context, concerns from investors about a flight out of Canadian bonds from foreign investors might be overblown. By comparison, the percentage of U.S. bonds held by foreign investors is approximately 27%, which lines up quite closely with Canadian figures.

Figure 3 illustrates how foreign investment peaked in the early 90s at 42%, subsequently slid to 27% in 2007, and eventually resurged to current levels as investors flocked to safety after the credit crisis. Canadian debt rose to very high levels in the mid 90s, the loonie hit all-time lows, and the yield advantage Canadian bonds held over their U.S. counterparts diminished. As a result, sentiment towards Canada deteriorated globally and the Canadian bond market

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5 U.S. Department of the Treasury, June 30, 2013
experienced outflows from foreign investors. Subsequently, the federal government implemented
more responsible fiscal management, and in the aftermath of the credit crisis, these efforts helped
to attract investors looking to protect their capital, bringing a revival of foreign investment flows
to Canada.

On an absolute basis, it is true that Canada’s debt level is more sizable than it was 30 years ago,
but relative to other developed countries, Canada remains in good standing. In conjunction with
the current below-average position of foreign investment in Canadian bonds, this equates to
potential for further growth.

**Demand for Canadian Bonds**

During the credit crisis, foreign investors were enticed by Canada’s relatively unscathed banking
system and housing market. These factors built on already compelling reasons for investors to
clock to Canada, including a low level of political risk, a relatively resilient economy with
significant strength in natural resources, a stable currency, a credible central bank, strong
financial sector fundamentals, and a transparent and liquid securities market. These elements
help explain why Canada is one of two G7 nations with a stable AAA credit rating from all the
major agencies on its federal government bonds. The Bank of England’s decision to hire former
Bank of Canada Governor, Mark Carney, is further evidence of the international finance
community’s respect for Canada’s monetary discretion.

Political and fiscal forces have a considerable influence on interest rates, and therefore, on bond
prices. Canada’s strong track record for political stability and responsible fiscal management at
the federal level help build a compelling case for foreign portfolio investment and create a
receptive market for government and corporate bond issuance. Canada is also a bigger market
than other credit-worthy “havens” like Australia, Sweden, and Norway, making it a natural fit for
many investors looking to diversify away from riskier assets.

Prior to 2008, U.S. bond yields were higher than their Canadian counterparts. The credit crisis hit
the U.S. with much more intensity than Canada, and through the peak of the crisis there was a
strong demand for safety, pushing U.S. yields lower. This demand for safety was not as prevalent
in Canada and thus Government of Canada bonds held a yield advantage over U.S. Treasury
bonds for terms of 10 years or less. This ignited a natural attraction to Canadian bonds in an
effort to diversify away from the instability of the U.S. market. While the U.S. was implementing
quantitative easing, the increased investment in Canadian bonds from foreigners helped push
rates lower so that the Bank of Canada did not have to step in and implement any easing of their
own.
Foreign Investment in Canadian Bonds During 2013

In 2013, a new trend emerged: foreign investors started drawing funds away from Canadian bonds. As economies across the globe continued to recover – the U.S. managed to navigate through its fiscal cliff and the tapering of its bond buying program, while risks of a European breakup faded – investors felt less need for safe haven bonds. In general, Canada was not looking like the most attractive place for low-risk investing; notably, yields on U.S. Treasuries were higher than those on Government of Canada bonds, not helping Canada’s case in a yield-hungry environment. Further, the Canadian dollar was depreciating relative to the U.S. currency. As a result, foreign interest waned through 2013, with foreigners investing only $26 billion in Canadian bonds, marking a 64% decrease compared to the average annual flows from 2009–2012 and the slowest year of inflows since 2008.

As illustrated in Figure 5, there have been consistent positive inflows into Canadian bonds from foreign investors on a quarterly basis from 2009 until the second quarter of 2013, when the first significant outflow from bonds occurred, at $9.2 billion. This included a $12.9 billion outflow from government bonds, which was countered somewhat by a $3.7 billion inflow into corporate bonds. During the last two quarters of 2013 and into 2014 we have continued to see outflows from government bonds, but increased interest in Canadian corporate bonds has offset this to result in modest net inflows into bonds. Overall, foreign
demand for Canadian assets has not diminished completely, but rather, has been redeployed toward the higher end of the risk spectrum.

**What are the Implications for Canadian Institutional Investors?**

Foreign investment in Canadian bonds has grown significantly since the credit crisis to reach $809 billion as of June 30, 2014, representing 31% of the Canadian bond market. Demand has been fuelled by the Canadian economy’s resilience through the credit crisis and its low levels of political risk, stable currency, AAA credit rating, and well-functioning financial market. The Canadian economy benefitted from this demand during the credit crisis as it helped bring rates down without quantitative easing, and investors profited from an increase in bond values while other assets were under valuation pressure.

Global economies showed stronger signs of recovery in 2013, allowing investors to breathe easier and reduce their focus on diversification into safe haven bonds, allocating more to riskier assets instead. U.S. Treasury yields rose above those in Canada over the course of 2013, and the U.S. dollar appreciated relative to most other major currencies. These factors helped increase foreign investment in the U.S., while other countries, including Canada, saw interest from foreigners drop off relative to previous years’ levels.

We expect that on occasion, there will be periods of fairly rapid flows into and out of capital markets that have short-term effects on Canadian interest rate levels. In 1994 and 2013, for example, when U.S. interest rates rose over short periods of time, the Canadian bond market experienced a meaningful decline in demand from foreign investors. Over the long term, however, Canadian interest rates are and will continue to be driven primarily by inflation, demographics, and productivity. While foreign investment in Canadian bonds is an important factor in the Canadian market, it is one of many, and we think the long-term effect on fixed income investments in Canada will be minimal compared to more influential drivers.

For additional details, please contact your PH&N IM institutional portfolio manager, or call 1-855-408-6111 or email institutions@phn.com
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