Public Sector Debt
Economics and Strategy

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Market View — A thank you note to foreign investors *– Love, Canada*

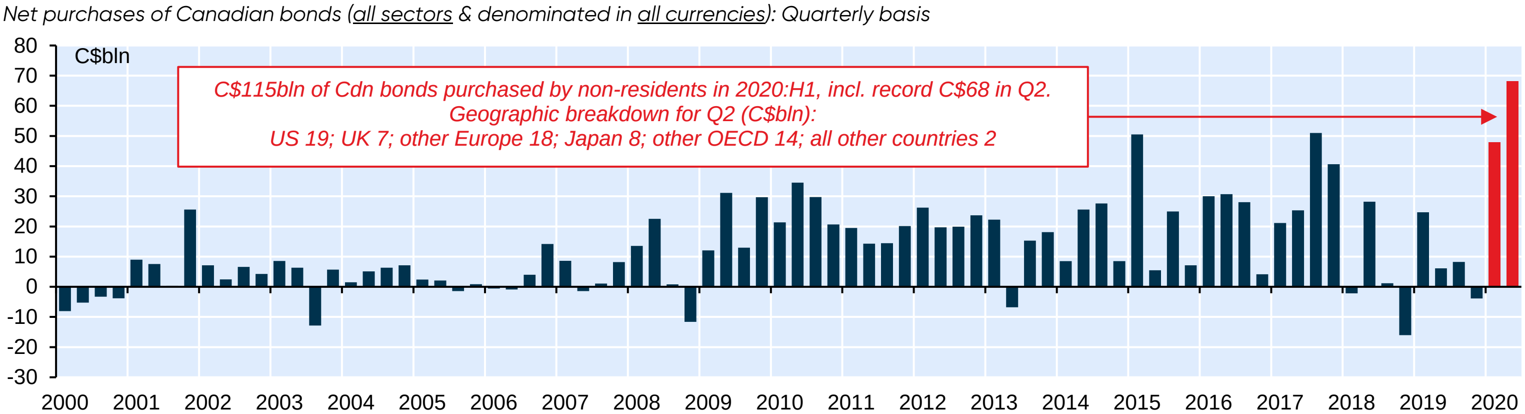
By Warren Lovely

Canada's Q2 current account dropped today. As might be expected with a release that details ~C$340 billion in two-way flow of goods, services and investment in a single quarter, there were a number of sub-plots. Here are some key takeaways from our perspective, with a particular focus on the ebb and flow of Canada's transactions in portfolio securities with the rest of the world:

- Canada's Q2 current account deficit, at C$8.6 billion (SA, quarterly rate) was a fair bit better (i.e., a smaller shortfall) than many expected. Before you wave the pom poms, consider that two-way trade in goods and services absolutely collapsed due to the virus. Investment income was also smashed, although there's going to be a nice bounce coming in Q3. An interesting tidbit: because no one was really traveling during the second quarter, Canada's related travel balance—which is almost always in deficit—swung into positive territory. Again, this is something of pyrrhic victory;
- On the financial side of these accounts, records were also being set. Most notably, Q2 saw an unparalleled amount of Canadian debt securities put into the hands of international investors. Specifically, non-residents grabbed just over C$80 billion in the three-month period (net of maturities and secondary sales), absolutely crushing the prior quarterly record of C$46 billion;
- What exactly were foreign investors taking down in Q2? Well, it was primarily 'Canadian bonds', some C$68 billion worth. The last time non-residents scooped up that many Canadian bonds in a single quarter, well that was… oh wait, never! Short-term markets got their share of international attention too, as net foreign buying in Q2 amounted to C$12 billion—not exactly a record tally but still about 10X the average quarterly inflow registered during the prior decade. The quotes around 'Canadian bonds' are very deliberate. As we continually caution, reported purchases of our bonds by non-residents include foreign currency issues. Take a closer look and you'll find that less than 20% of Q2's record interest in so-called Canadian bonds was steered towards C$ issues;
- So foreign investors were seemingly happy to take on marginal Canadian risk in Q2, they just preferred to do it in USD or EUR. Which brings us to another interesting tidbit: non-residents were also reducing their holdings of the Canadian currency and deposits in Q2, and in a very big way. They offloaded C$32 billion in Q2, adding to the C$37 billion drop observed in Q1. As we say, the CAD is no safe haven and tends to be sold, not bought, during times of stress. Thankfully, conditions have improved, risk sentiment turning decidedly positive in Q3, leaving international investors presumably less inclined to pluck more feathers off their CAD holdings;
- Bear in mind that Canadian investors put money to work outside the country in Q2, including direct acquisitions (i.e., outbound FDI) and net buying of foreign equities (a bold play, but one that paid off given the recovery we've seen in global equity markets). Tally up all the inflows and outflows and the punch is this: Canada continues to finance a current account deficit by importing wave upon wave of portfolio capital from abroad. This is a BOP funding strategy that's been in place since the *prior* crisis;
- At the risk of being too theatrical, Canada—its governments and corporations—is effectively walking around international capital markets with cap in hand, asking well-heeled foreign investors to finance our way of life. They've tended to oblige. And hey, at least we give them positive yield and some added compensation in spread when they buy our rates and credit products;
- This trend of seeking international assistance to fund economic and fiscal imbalances isn't going away. Government deficits won't be erased easily/quickly, given the need to shore up fragile economies and rebuild lost capacity. In other words, 2020 won't be the only year with extraordinary public sector borrowing requirements. We emphasize that foreign direct investment hasn't really been the solution for Canada, as outbound flows have exceeded inbound interest in 16 of the last 20 quarters—a hefty five-year cumulative gap of more than C$160 billion that makes the importation of foreign portfolio capital all the more vital;
- So thank you kindly *Mr. and Mrs. Foreign Bond Investor*. You're helping to keep the lights on in Canada. Although you're likely still digesting that last big bite of Canadian debt, we've got a heaping plate of new bonds ready for you. Just say the word and our governments and corporations will happily ladle it out (with even more courses coming after next month's Throne Speech).

Chart: Records everywhere… including unprecedented buying of 'Canadian bonds' by non-residents

Net purchases of Canadian bonds (all sectors & denominated in all currencies): Quarterly basis



Source: NBF, Statistics Canada | Note: Includes net foreign purchases of Canadian bonds denominated in foreign currencies, which comprises the vast majority of Q2's interest

Economics and Strategy

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