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Market View – Who's holding? [Ownership trends for Canada's growing stockpile of debt]

By Warren Lovely

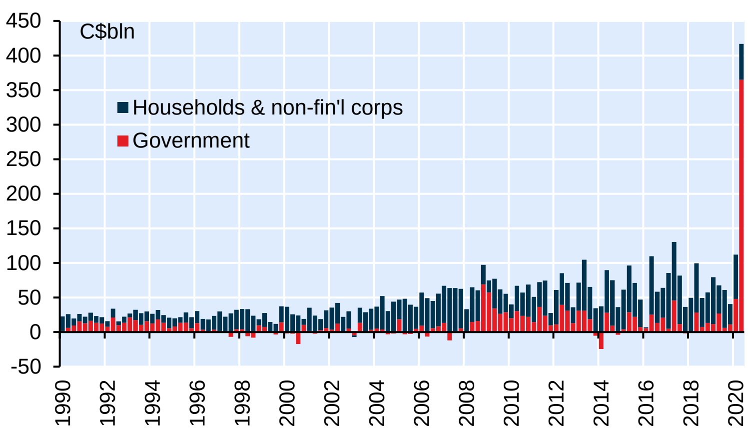
Once a quarter we're treated to the national balance sheet accounts. In the good old days, as in before COVID, these data might have been classified somewhere between "arcane" and "mildly interesting". (We've long considered the detailed ownership stats and related financial flows compelling, but you would have counted us in the minority.) But now more than ever, issuers and investors can find valuable intel here, including where marginal debt is being placed. That's important stuff when debt is expanding ever-so-rapidly.

Here are 10 takeaways from the latest NBS data dump. We're happy to go (much) deeper down the rabbit hole with any that wish to follow:

1. **Canada, as a country, is borrowing more money than ever before.** No surprise there. Domestic non-financial sectors secured $417 billion of new credit from April to June—a quarter that will forever be synonymous with COVID-19's wrath and destruction. Notwithstanding the evident bounce back in Q3 GDP and reported progress getting (some) displaced Canadians back to work, the third quarter and a good number of quarters due to follow will continue to see outsized debt issuance/credit growth.

Chart: Record borrowing in Q2, with 90% from government

Total funds raised by domestic non-financial sectors (quarterly)



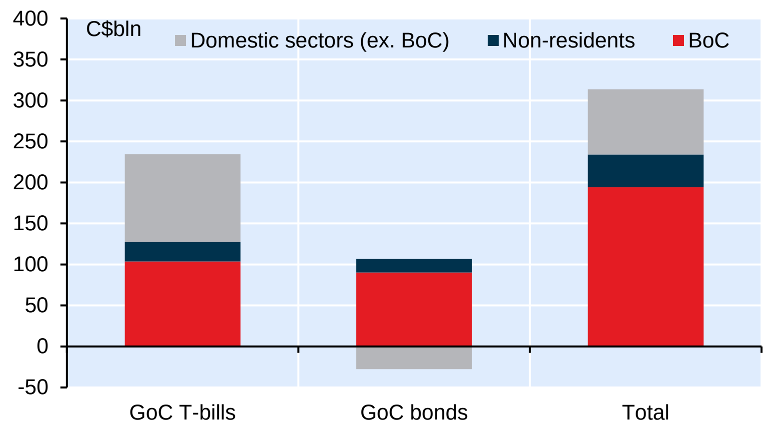
Source: NBF, StatCan | Note: Excludes borrowing by domestic financial institutions & non-residents

2. **No question, governments are bankrolling the recovery.** Of the $417 billion of new borrowing cited above, almost 90% was traced back to Canada's government sector. The $365 billion of new government credit created in Q2 topped 18% of GDP and was 5-times larger than the prior record. This money financed large-scale stimulus (notably income supports) and much-needed liquidity lifelines as virus shutdowns took hold. Seeking to understand why federal and provincial credit ratings are under pressure? Look here. Lacking a self-sustaining recovery, Canada's economic heartbeat will continue to be government financed for some time… even if we manage to sidestep a seriously disruptive second wave. (More fiscal colour can be found in a fresh release of Canada's government financial statistics for Q2. Warning: It was a *very* ugly quarter.)

3. **More than anyone, the Government of Canada gorged on cheap debt in Q2.** Granted, Ottawa did this in order to keep the proverbial lights on while the economy and financial markets absorbed an unprecedented body blow. Much of the very first leg of virus-related financing was sourced from the T-bill market, with Ottawa more recently moving to term out its debt. One key question: who took down all this new federal debt? The answer, by and large, was the Bank of Canada. The central bank accounted for over 60% of the total increase in holdings of GoC debt last quarter. Non-residents helped clear some of what was left, although we caution that international attitudes towards Canada can be fickle, as CAD is surely a peripheral currency for many. In the GoC bond market itself, the BoC's QE program, combined with non-resident interest at the margin, meant domestic investors outright *cut* their holdings in Q2. That while Canada's overall float of sovereign bonds was rising appreciably.

Chart: BoC financed majority of GoC borrowing in Q2

Change in market value of holdings of GoC T-bills & bonds (Q2)



Source: NBF, StatCan | Note: Quarter-over-quarter change

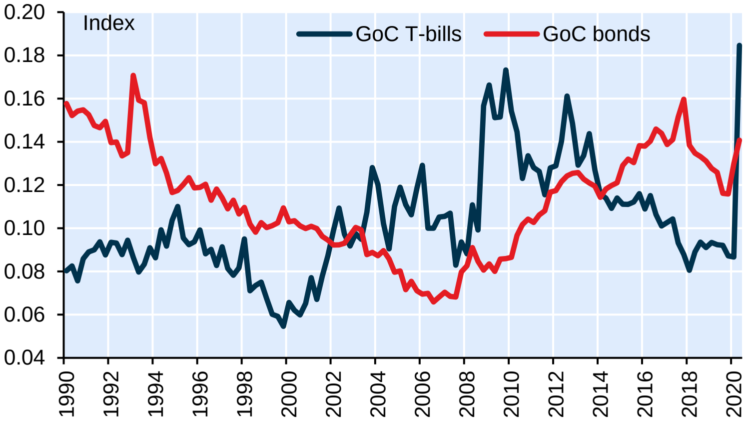
4. **BoC QE is significantly altering debt ownership in this country.** The central bank's share of outstanding GoC T-bills (33%) was higher in Q2 than ever before. No other sector/investor group held more of these bills. Mind you, these holdings have since moderated, as some of Q2's emergency bill stock is scaled back and termed out. Meantime, the Bank's Q2 share of outstanding GoC bonds, at 22%, was likewise a record, even if non-residents collectively own more of these bonds. BoC engagement in the sovereign bond market is no short-term phenomenon. Since the end of June, the market value of the Bank's holdings has climbed a further $60 billion, as QE and regular auction allocations absorb the lion's share of net bond supply. While this week's data on international securities transactions showed non-residents lightened up on GoC bonds in July, the QE vacuum hasn't left much for domestic investors to clean up. Of course, should the feds opt for more stimulus and cement large deficits in the upcoming parliamentary session, QE alone may not clear the bond market. Consider that a potential catalyst for curve steepening, even in the absence of a Fed-style switch to average inflation targeting. Tune into the *Speech from the Throne* to assess the fiscal leanings of Trudeau's minority government.

5. **It follows that the distribution of GoC debt is relatively more concentrated (at least by sector).** Looking across 24 sectors/investor types, ownership of GoC T-bills has never been so heavily concentrated. And what of GoC bonds? Based on current market value, the BoC along with non-residents jointly controlled over one half of the GoC bond stock at mid-year. For the first time in the available history (data back to 1990), domestic investors are minority stakeholders in this country's sovereign

bond market. Not to geek out too much, but we quantified sectoral concentration via a Herfindahl-Hirschman Index (HHI), which is a commonly accepted framework. A normalized HHI will vary between 0 and 1, with higher numbers signifying greater concentration—exactly what we're seeing with GoC debt. To be clear, we're focusing on sector concentration here, as opposed to diversification across individual market participants.

Chart: Ownership of GoC bills & bonds more concentrated

Normalized Herfindahl-Hirschman Index of concentration in GoC debt markets



Source: NBF, StatCan | Note: Based on market value of holdings across 24 individual sectors from NBS accounts; does not control for relative concentration with a given sector

6. **The BoC has directly and indirectly pushed investors into other sectors.** Yes, the BoC is playing in CMBs, and has implemented credit easing (CE) for provis and even corps. But it has hardly shouldered other investors aside. Rather, the BoC's enthusiastic embrace of QE and its decisive move into GoC debt markets has encouraged (forced?) domestic investors to source product elsewhere. This is happening at Canadian banks, pension managers, insurers, mutual funds, other private financial players. It's likewise evident across the general government sector (which is not to be confused with the monetary authority).

Table: Key domestic investor groups move out risk spectrum

Change in market value of bond holdings: Select sectors (2020:H1)

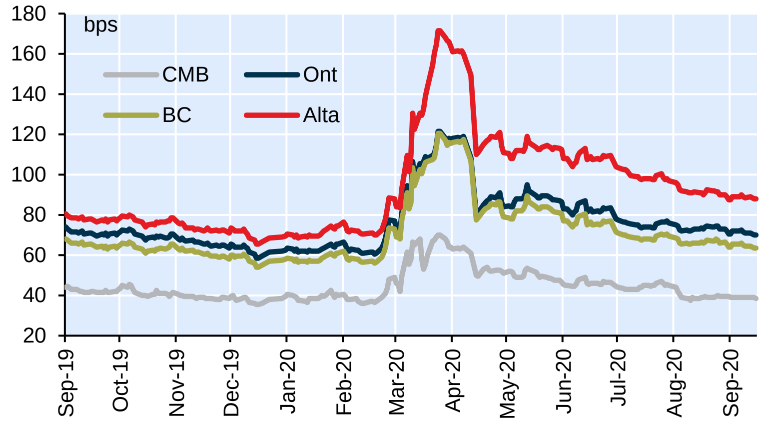
C$bln	GoC	Provi	Local	Other*
Bank of Canada	88.9	5.1	0.0	7.1
Banks & quasi-banks	9.3	42.3	0.6	10.1
Pension & insurance	-4.7	18.1	2.1	4.5
Other private financial	-10.0	14.0	0.5	15.1
General gov'ts	-10.7	4.2	1.3	4.5

Source: NBF, StatCan | Note: Two quarter cumulative change; partial list of investor sectors/types presented vertically, type of bond listed horizontally; other Canadian bonds includes corps, CMB, GBEs, other public sector, etc.

7. **In a sense then, BoC QE has precipitated a redistribution of credit risk in Canada's debt capital markets, seemingly without a commensurate pick-up in yield or spread.** A series of adverse provincial and corporate rating actions means the weighted average credit quality of the average domestic bond portfolio has suffered, particularly since the central bank is hogging so much of the high-quality sovereign paper. Meanwhile, the yield to investors on today's available debt stock is skinnier, even though intrinsic credit quality has deteriorated. That's a by-product of pushing policy rates to their effective lower bound and flooding financial markets with liquidity. Ontario 10-year bonds, something of a bellwether, today yield just 55% of what was on offer at the start of the year, making current coupons fully 100 bps lighter. Unemployment rates may still be far removed from pre-virus levels, but provincial credit spreads are closing in on a full recovery. Moreover, credit differentiation (in terms of spread) has also been walked back in recent months, despite divergent economic, fiscal, supply and credit rating pressures.

Chart: Credit spreads tighten, differentiation fades

10-year constant maturity credit spreads vs. GoC curve (daily)



Source: NBF

8. **With record deficits to cover, provinces are accessing debt capital markets in unprecedented fashion; they've nonetheless found a receptive audience.** This may surprise you, based on point #3, but the value of outstanding provincial bonds grew every bit as much as GoC bonds in Q2. The market value of all provincial bonds moved within a hair's breadth of $1 trillion—not exactly a threshold the sector aspired to. Thankfully, a broad collection of yield-starved investors have scooped up this paper. As of Q2, 76% of total outstanding provincial term debt was held domestically. As a group, insurance and pension funds remain the largest sectoral player in provis, accounting for 37% of total holdings as of Q2. Their combined share was down ~3%-pts from the end of last year, which essentially went to chartered banks and mutual funds. For the record, the BoC accounted for just 0.5% of total provincial bond holdings as of June and is still less than 1% today. Non-residents (and international financings) look to remain an important outlet for the provinces, given funding needs may prove sticky/slow to recede. Overall, on a sectoral basis, the provincial bond buyer base is more diversified today than it was last year, appearing less concentrated than GoC bonds to boot.

9. **Debt remains contained at the municipal level, notwithstanding COVID-related pressures.** If you participated in *NBF's 9th Annual Municipal Borrowers Conference*, held this week, you would have been reminded of limitations around the incurrence of debt. (You would have also heard a lot about federal-provincial support during this extraordinary time.) The BoC has not been buying muni bonds, although as a key element of the general government sector, a case could be made. Nonetheless, controlled muni borrowing has largely been comfortably digested by the usual suspects (e.g., lifecos, pensions, banks, mutual funds). Provincial governments have also stepped up their holdings of muni bonds, indirect support from the upper level of government.

10. **Be careful when interpreting non-resident holdings of, or flows into, so-called "Canadian" bonds.** Whether it's the national balance sheet accounts or international securities transactions, detailed sectoral breakdowns do not readily distinguish Canadian debt by currency of issue. That's why the foreign ownership share of Canadian corporate bonds has always appeared so high. Fact is, over 90% of foreign investment in Canadian corporate bonds is denominated in foreign currencies, not CAD.

Table: A detailed look at who holds the over $5 trillion in Canadian debt securities

Market value and share of total holdings: Canadian debt securities by type of paper & holdings by detailed NBS sector (2020:Q2)

	Cdn	Canadian short-term paper			Canadian bonds				
Holdings (C$bln, market value)	debt securities	All Cdn ST paper	Gov't of Canada	Other sectors	All Cdn bonds	Gov't of Canada	Provincial gov'ts	Local gov'ts	Other sectors*
Total all sectors	5,077.8	817.3	387.9	429.4	4,260.5	778.5	998.1	82.8	2,401.1
National balance sheets	3,283.2	635.5	346.8	288.8	2,647.7	546.3	754.4	72.7	1,274.3
Households & non-profit institutions	118.8	6.8	1.1	5.7	111.9	20.8	24.1	18.8	48.2
Corporations	2,803.5	531.8	323.4	208.3	2,271.7	479.1	623.8	31.7	1,137.1
Non-financial corporations	111.0	65.3	19.4	45.9	45.7	4.0	3.7	0.0	38.0
Financial corporations	2,692.5	466.5	304.0	162.5	2,226.0	475.1	620.1	31.7	1,099.1
Bank of Canada	321.1	140.5	129.5	11.0	180.7	167.9	5.1	0.0	7.6
Chartered banks & quasi-banks	571.9	175.5	112.7	62.8	396.4	69.0	138.5	5.4	183.4
Insurance & pension funds	985.4	82.7	29.8	52.9	902.7	185.9	371.1	21.4	324.2
Total other private financial institutions	503.4	61.0	27.6	33.4	442.5	38.9	97.8	4.6	301.2
Financial gov't business enterprises	310.6	6.8	4.3	2.5	303.9	13.4	7.5	0.3	282.7
General governments	361.0	97.0	22.3	74.7	264.0	46.4	106.6	22.1	88.9
Federal general government	7.5	0.4	0.1	0.3	7.1	6.2	0.3	0.0	0.6
Other levels of general government	261.7	74.4	22.2	52.2	187.3	30.4	64.9	21.4	70.6
Provincial & territorial governments	220.2	64.2	22.1	42.1	156.0	27.6	53.0	16.5	58.9
Local governments	41.5	10.2	0.1	10.1	31.3	2.8	11.9	4.9	11.7
Social security funds	91.9	22.2	0.0	22.2	69.7	9.8	41.3	0.8	17.8
Non-residents	1,794.5	181.8	41.1	140.6	1,612.8	232.2	243.6	10.2	1,126.8

	Cdn	Canadian short-term paper			Canadian bonds				
Distribution of holdings by security type (%)	debt securities	All Cdn ST paper	Gov't of Canada	Other sectors	All Cdn bonds	Gov't of Canada	Provincial gov'ts	Local gov'ts	Other sectors*
Total all sectors	100%	100%	100%	100%	100%	100%	100%	100%	100%
National balance sheets	65%	78%	89%	67%	62%	70%	76%	88%	53%
Households & non-profit institutions	2%	1%	0%	1%	3%	3%	2%	23%	2%
Corporations	55%	65%	83%	49%	53%	62%	62%	38%	47%
Non-financial corporations	2%	8%	5%	11%	1%	1%	0%	0%	2%
Financial corporations	53%	57%	78%	38%	52%	61%	62%	38%	46%
Bank of Canada	6.3%	17.2%	33.4%	2.6%	4.2%	21.6%	0.5%	0.0%	0.3%
Chartered banks & quasi-banks	11%	21%	29%	15%	9%	9%	14%	7%	8%
Insurance & pension funds	19%	10%	8%	12%	21%	24%	37%	26%	14%
Total other private financial institutions	10%	7%	7%	8%	10%	5%	10%	6%	13%
Financial gov't business enterprises	6%	1%	1%	1%	7%	2%	1%	0%	12%
General governments	7%	12%	6%	17%	6%	6%	11%	27%	4%
Federal general government	0%	0%	0%	0%	0%	1%	0%	0%	0%
Other levels of general government	5%	9%	6%	12%	4%	4%	7%	26%	3%
Provincial & territorial governments	4%	8%	6%	10%	4%	4%	5%	20%	2%
Local governments	1%	1%	0%	2%	1%	0%	1%	6%	0%
Social security funds	2%	3%	0%	5%	2%	1%	4%	1%	1%
Non-residents	35%	22%	11%	33%	38%	30%	24%	12%	47%

Source: NBF, StatCan | Note: Canadian debt securities includes issues denominated in CAD as well as securities denominated in foreign currencies; other Canadian bond sectors includes corps, CMB, GBEs, other public sector, etc.

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Paul-André Pinsonnault
Senior Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rate Strategist, Economics and Strategy
warren.lovely@nbc.ca

Taylor Schleich
Associate, Rates Strategist, Economics and Strategy
taylor.Schleich@nbc.ca

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