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Foreign investors bet on the wrong horse?

By Warren Lovely & Alpa Atha

The latest release of Canada's international transactions in securities data tells us that foreign investors loaded up on Canadian portfolio assets in August. Non-residents acquired a net C$26.3 billion of Canadian securities in August, the largest one-month tally since foreign investors were called on to partially finance an enormous wave of COVID-induced issuance back in April 2020.

August's net buying of Canadian securities builds on a sizeable July tally, leaving the two-month total of net foreign buying at a lofty C$40.4 billion. As it happens, Canadians bought the equivalent of just C$10 billion in foreign securities during that two-month period, the resultant net capital inflow via portfolio transactions amounting to C$30 billion.

Hindsight, as they say, is 20-20. But from the looks of things, some of these foreign investors may have bet on the wrong horse. What do we mean? Well, of the ~C$40 billion of net foreign purchases, the overwhelming majority went to Canadian debt securities (C$38.3 billion or 95% of the July-August all-security total). Relative to U.S. Treasuries, Canadian rates held their ground while foreign investors were loading up in the summer. But in case you missed it, Canadian rates have been violently repriced more recently, Bank of Canada rate hike expectations brought forward in a big way. Sure, rates are getting re-priced globally, but Canada has, if anything, underperformed U.S. Treasuries across the curve since the summer, implying larger unhedged losses on a lot of Canadian bonds vs. U.S. equivalents. E.g., The Canada-U.S. 2-year yield differential which ended August at +21 bps had widened to +25 bps by the end of September and today hovers around +40 bps.

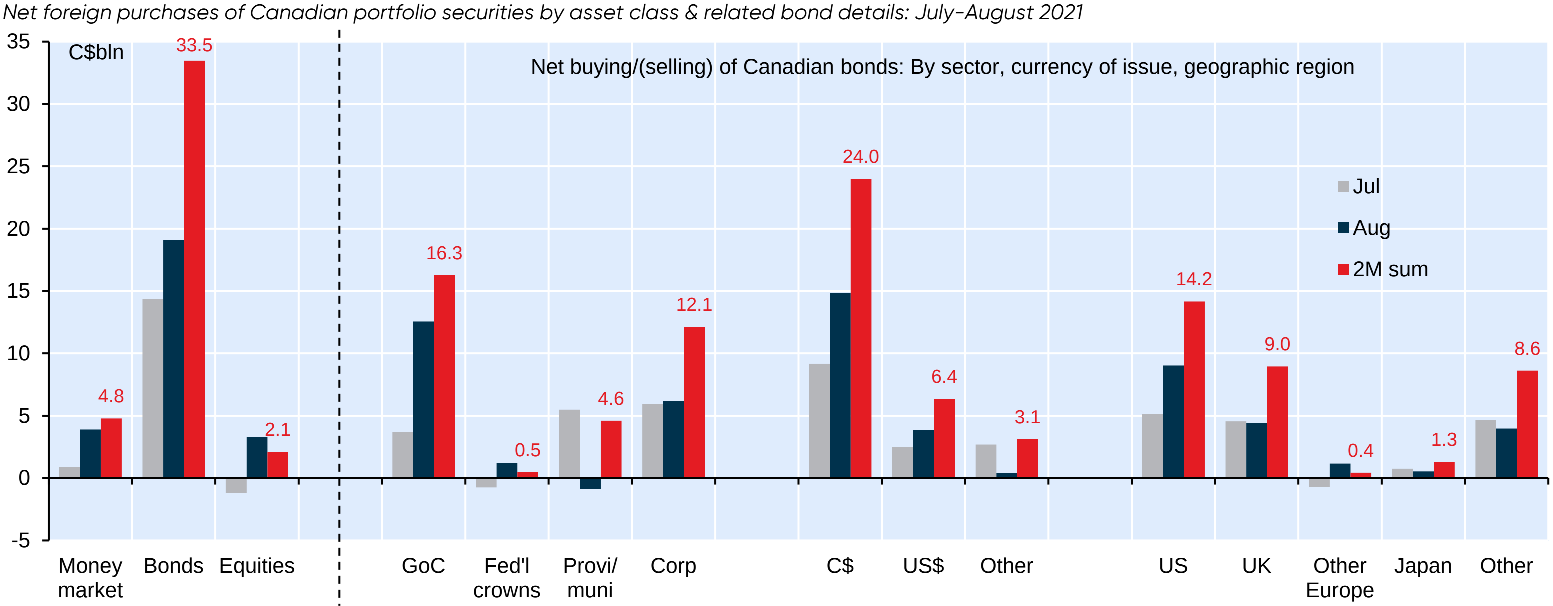
Sure, foreign investors could have dumped their positions in Canadian rates ahead of the more recent selloff, sidestepping recent absolute and relative losses. Others may simply grin and bear it, looking through bouts of under- and outperformance and seeing Canada's fixed income market as a means of diversifying a global bond portfolio. Moreover, it should be noted that foreign exposure to so-called 'Canadian bonds' is not exclusively expressed in Canadian dollars, as some net buying has been steered to international markets. It follows that non-resident purchases extend beyond purely GoC bonds, with some foreign investors embracing Canadian public sector credit in the domestic market (where spread compression has helped offset a bit of the back-up in benchmark yields). Finally, it's not yet clear that market expectations as it relates to prospective BoC rate hikes are on the mark, although recent data prints (September LFS and a fresh BOS survey out just today) point to buoyant growth and limited slack. It may take a bold investor to step in and get long ahead of Wednesday's CPI or the more-important late-month BoC rate announcement.

Moving on… non-resident purchases of Canadian stocks have been comparatively miniscule over the period in question, totaling just C$2.1 billion in July and August combined. Here again, some foreign investors may be kicking themselves for failing to take on more Canadian equity exposure, as the S&P TSX has proceeded to outperform the S&P 500 of late. Since the end of August, the S&P TSX Composite Index has gained 1.8% whereas the S&P 500 Composite is off 1.0% (at the time of writing). This is a trend we expect to continue, based on the superior performance recorded by Canadian stocks during earlier periods of elevated inflation—a theme we explored in a *Hot Chart* last week.

We won't pretend to have fully called the severe back-up in rates; few (if any) did. To be clear, foreign buyers of Canadian bonds are hardly the only ones licking their wounds these days. Recent price action has sent domestic investor heads spinning too. Nor is Canada alone in seeing yields surge, with many peripheral bond markets hit hard. Nonetheless, for foreign investors that loaded up on Canadian bonds during the summer, it's safe to say any lingering positions likely feel a bit uncomfortable. Moreover, these bond investors may well be looking wistfully at their counterparts that are long Canadian stocks, an equity position that provides a superior inflation hedge relative to what can be secured in America's stock market.

Chart: Non-residents acquired C$40 billion of Canadian securities in July-August… 95% of it debt, little in equities

Net foreign purchases of Canadian portfolio securities by asset class & related bond details: July-August 2021



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