

## Canada can't afford to bleed capital like this

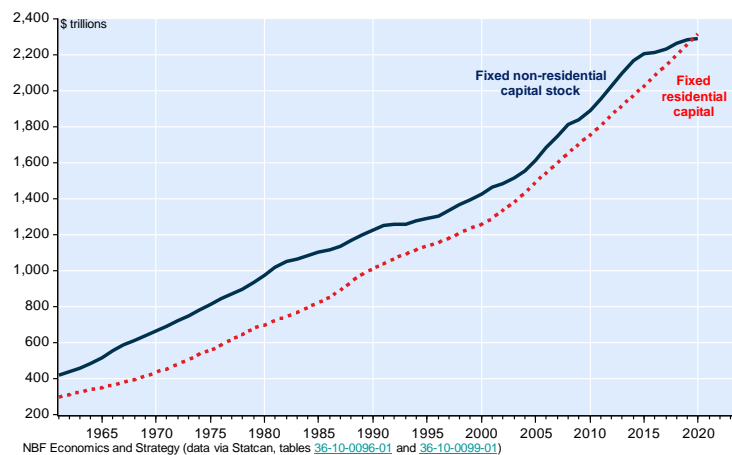
By Stefane Marion

We have entered a new regime where countries and companies must make their networks more resilient in a post-pandemic world, while addressing investor concerns about the energy transition as well as social and governance considerations. In our view, this will necessitate a significant effort to replace existing capital stock in OECD economies at a time when many governments are already highly indebted. The ability to retain/attract private capital will therefore be critical to avoid an abrupt transition to this new regime. Canada, as a small open economy, cannot stand still and must do a better job of growing its capital stock to take advantage of a highly successful immigration policy and harness the productive power of a growing workforce of highly skilled people.

Unfortunately, growth-enhancing investment is lagging in Canada, a trend that was evident even before the pandemic. A recent Statistics Canada [report](#) noted that as of 2020, the volume of residential capital stock now exceeds non-residential capital stock for the first time since 1961, when the data was first recorded (chart).

### Canada: Residential assets account for the bulk of our capital stock

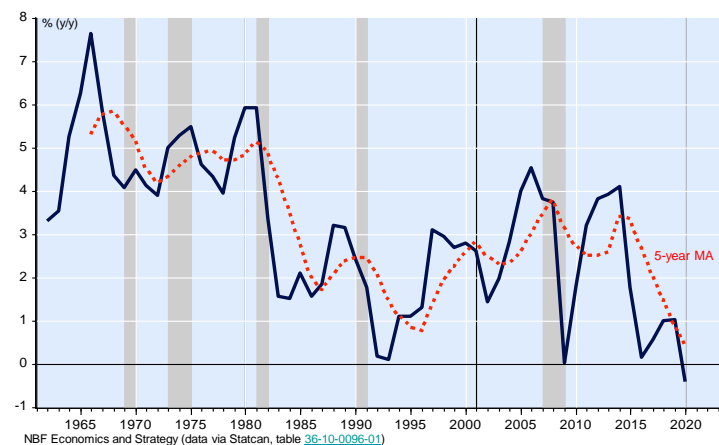
End-year net stock of capital (2012 constant prices)



The lack of growth in the private capital stock (75% of the total) is particularly troubling. We estimate that the nonresidential private capital stock contracted for the first time last year (chart). While the pandemic most certainly exacerbated this decline, we note that the 5-year moving average has been on a downward trend for several years.

### Canada: Private non-residential capital stock is declining

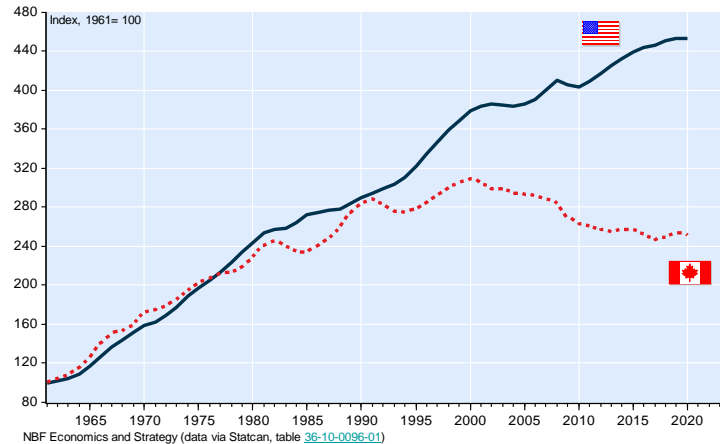
Net stock of fixed private non-residential capital (end-year constant dollars)



Though sustained lower investment in the mining, quarrying, and oil extraction sector explains this decline, we find that the manufacturing sector is not faring any better. Canadian factories are currently operating with the lowest capital stock in 35 years (chart).

### Canada: Capital stock in manufacturing is at a 35-year low

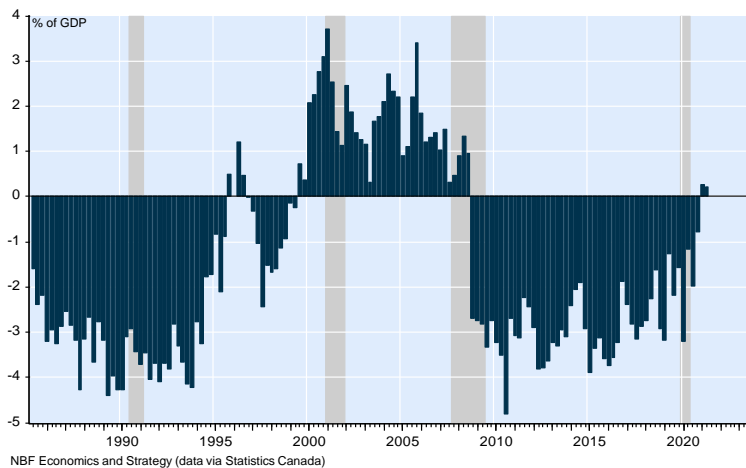
End-year net stock of capital in manufacturing, Canada and the U.S. (chained 2012 dollars)



Whatever the cause of this lack of private investment, we must turn it around. Canada is very dependent of foreign money to finance its current account which is likely to return into deficit in 2022. If our growth prospects look unattractive in a post-pandemic world, capital flight could ensue.

### Canada: Current account should return to deficit in 2022

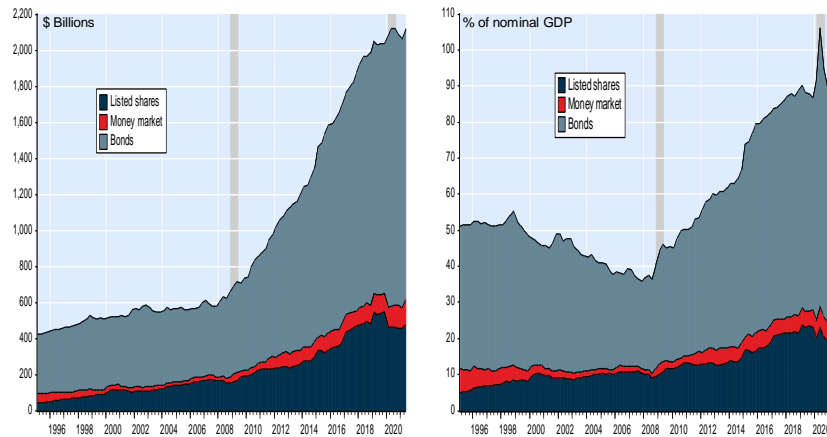
Current account balance (seasonally adjusted)



And foreign investors are too important to ignore. As of the second quarter of 2021, they held more than \$2 trillion in Canadian securities, 70% of which were government and corporate bonds (chart). Today, more than a quarter of federal and provincial bonds are held by foreigners. For corporate bonds, the figure is closer to 50% and for listed shares, the proportion is about 30%. Corporate Canada has never been more dependent on foreign capital.

### Foreigners' portfolio holdings of Canadian securities

Book value, end of quarter; latest observation: Q2 2021

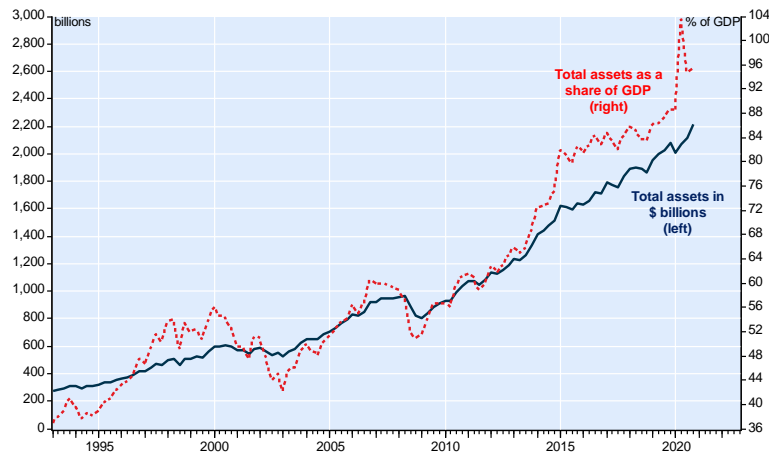


NBF Economics and Strategy (data from Statistics Canada)

It is worth noting that this increasing reliance on foreign money has occurred despite the growing influence of Canada's pension funds. According to the most recent data available, the market value of assets held by Canadian trustee pension funds was over \$2 trillion, roughly the size of Canada's GDP. This is a significant increase from a 36% share in the early 1990s (chart).

### Canada: Pension funds are now as large as GDP

Market value of assets held by Canadian trustee pension funds

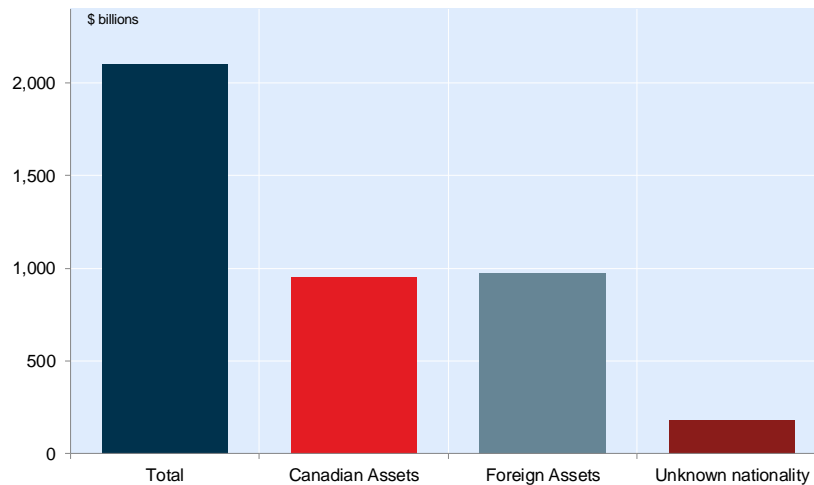


NBF Economics and Strategy (data via Statcan, tables [11-10-0077-01](#))

As the growth of Canadian pension funds continues, so does their appetite for non-domestic assets. According to Statistics Canada's most recent [report](#), the total market value of foreign assets was \$972 billion in the first quarter of 2021, exceeding that of Canadian assets for the first time ever (chart).

### Canada: Pension funds own more foreign than domestic assets

Market value of assets by foreign and domestic holdings held by trustee pension funds (as of Q1 2021)

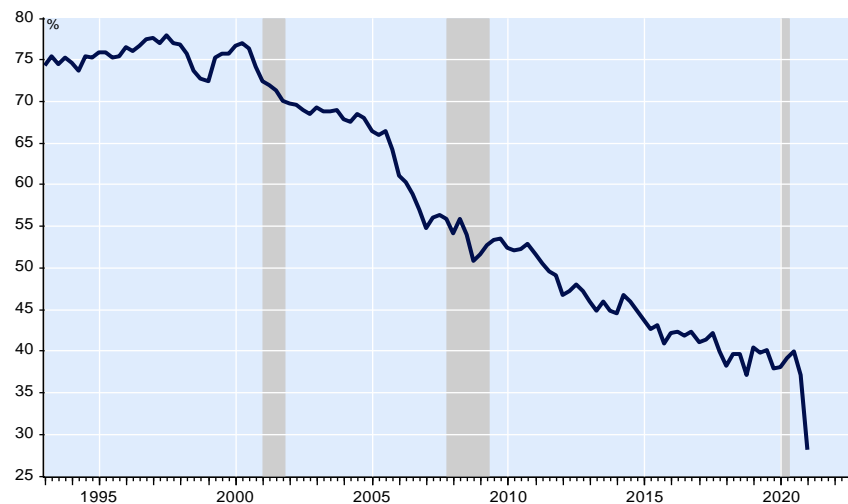


NBF Economics and Strategy (data via Statistics Canada, table [11-10-0085-01](#))

The sector that has been most affected by this flight to foreign assets is the Canadian equity market. Whereas in the early 1990s, pension funds held about 75% of Canadian companies in their total equity allocation, this share has dropped to less than 30% (chart). By comparison, pensions funds still maintain a domestic bias for bonds with domestic assets accounting for 86% of that portfolio.

### Canada: Pension funds flee domestic stocks

Share of Canadian equities in total equity assets held by trustee pension funds

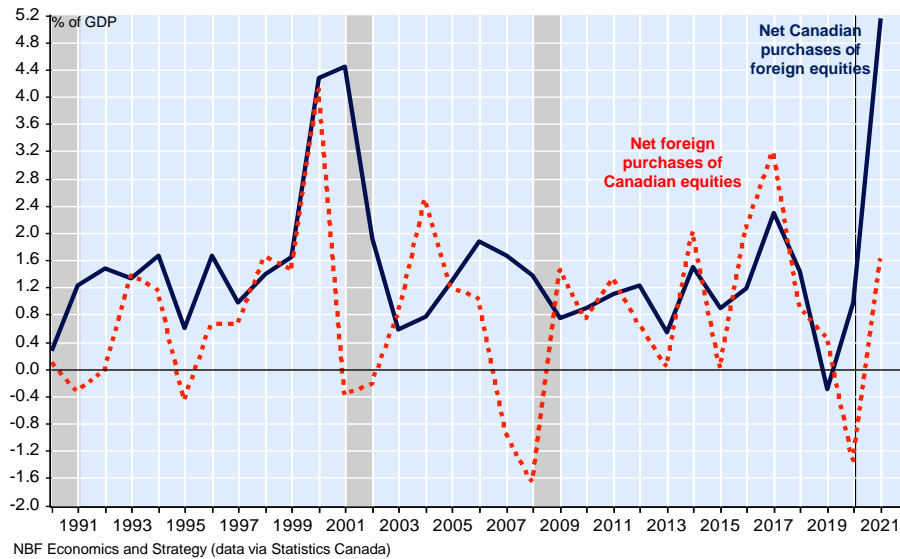


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The domestic divestment away from Canadian equities has been particularly large in the past year. In the twelve months through September 2021, net Canadian purchases of foreign equities surged to \$130 billion (this includes pension funds as well as other domestic investors). As a share of GDP, this amounts to 5.2% of GDP, a record outflow that more than offset net foreign purchases of Canadian equities – chart.

### Canada: Record investment in foreign equities

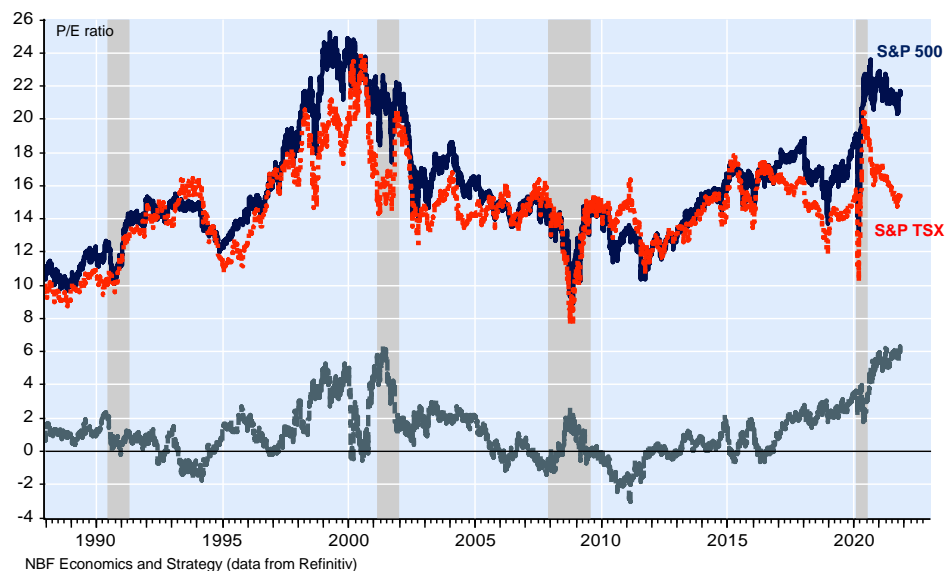
Net purchases of equity and investment fund shares (12-month rolling sum as of September of every year)



This is justified under the guise of so-called ESG considerations. But who exactly are the net beneficiaries of Canadian capital? U.S. companies, primarily in the information technology sector that benefit from index-based investing. While some of these firms may pass the “E” test in ESG, we would argue that many of them have a questionable track record when it comes to passing the “S” and “G” test in ESG. The same is true for some emerging markets that also receive Canadian capital. This puts our domestic companies in a difficult position relative to foreign corporations. Currently, the earnings yield of S&P/TSX constituents is 40% higher than that of S&P 500 companies (6.5% versus 4.6%). This suggests a much lower cost of capital for U.S. companies. Despite being one of the best performing equity markets in 2021, the S&P/TSX is therefore trading at a record discount to the S&P 500 - chart.

### S&P/TSX: Trading at a discount to the S&P 500

12-month-forward P/Es for the S&P 500 and S&P TSX



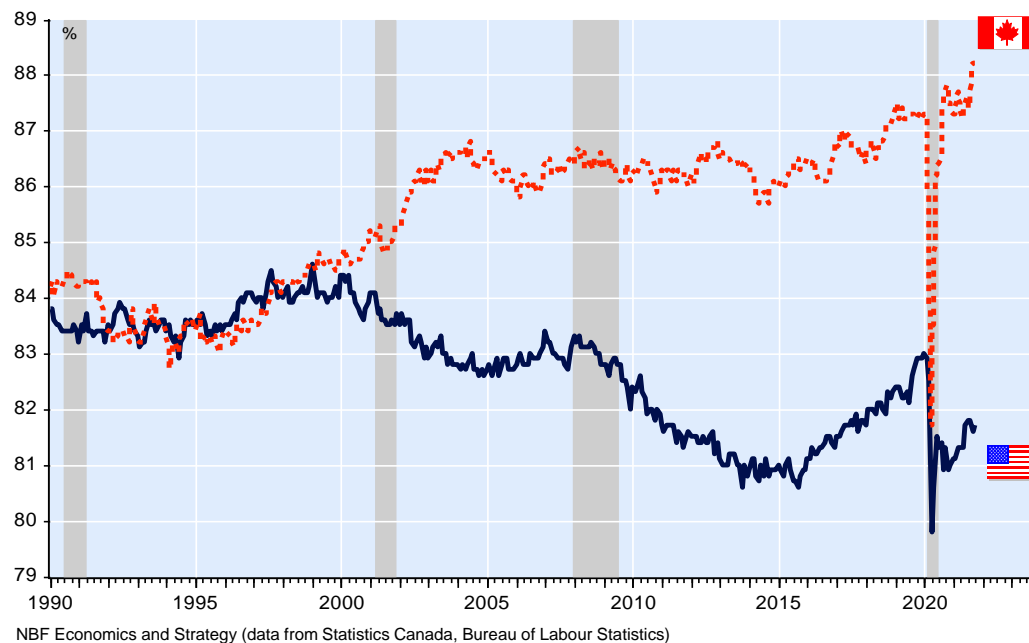
### Conclusion

Attracting private investment and increasing the capital stock are the lifeblood of flexible economies that will successfully adapt to the massive structural changes caused by the pandemic and the fight against climate change. As a small open economy that will remain dependent on its resource sector for the foreseeable future, it is critical that Canada better explain to investors its ESG transition and how it fits into its strategy of integrating a potentially profoundly altered global supply chain. Clearly, we are not doing very well when our own domestic pension funds prefer to invest heavily abroad rather than in Canada. We understand that carbon emissions are now at the heart of investment decisions. At the same time, we cannot ignore the fact that Canada's geographic opportunities, geological makeup, existing infrastructure, collaboration and industry partnerships position our country's energy sector to become a world leader in carbon capture, utilization and storage (CCS/CCUS)<sup>1</sup>. In any event, what we might seem to lack in E, we more than make up for in S or G. An economy that can successfully integrate its large foreign-born population into the workforce as to produce one of the highest participation rates in the OECD should be able to do much better at growing its capital stock<sup>2</sup>.

Against this backdrop, our policymakers must find a solution to solve Canada's investment conundrum before moving forward and further increasing the cost of capital for our domestic businesses by raising corporate taxes. We are already bleeding capital. This is not the time to put ourselves at a further disadvantage.

#### Canada: Participation rate is at a record high

Labour force participation rate of people aged 25-54 (as of October 2021)



<sup>1</sup> See "Carbon Capture in Canada: Boom or bust?", NBCFM Thematic Research, August 3, 2021.

<sup>2</sup> According to the **OECD**, over one-fifth of Canada's population is foreign born vs. 14% in the U.S.

## Economics and Strategy

### Montreal Office

514-879-2529

**Stéfane Marion**

*Chief Economist and Strategist*  
stefane.marion@nbc.ca

**Kyle Dahms**

*Economist*  
kyle.dahms@nbc.ca

**Alexandra Ducharme**

*Economist*  
alexandra.ducharme@nbc.ca

**Matthieu Arseneau**

*Deputy Chief Economist*  
matthieu.arseneau@nbc.ca

**Daren King**

*Economist*  
daren.king@nbc.ca

**Angelo Katsoras**

*Geopolitical Analyst*  
angelo.katsoras@nbc.ca

**Paul-André Pinsonnault**

*Senior Economist*  
paulandre.pinsonnault@nbc.ca

**Jocelyn Paquet**

*Economist*  
jocelyn.paquet@nbc.ca

### Toronto Office

416-869-8598

**Warren Lovely**

*Chief Rates and Public Sector Strategist*  
warren.lovely@nbc.ca

**Taylor Schleich**

*Rates Strategist*  
taylor.schleich@nbc.ca

**Alpa Atha**

*Fixed Income Economist*  
alpa.atha@nbc.ca

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