

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

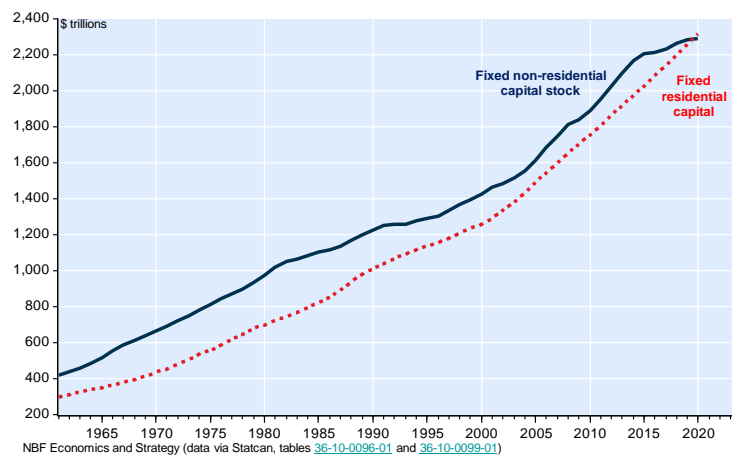
By Stefane Marion

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

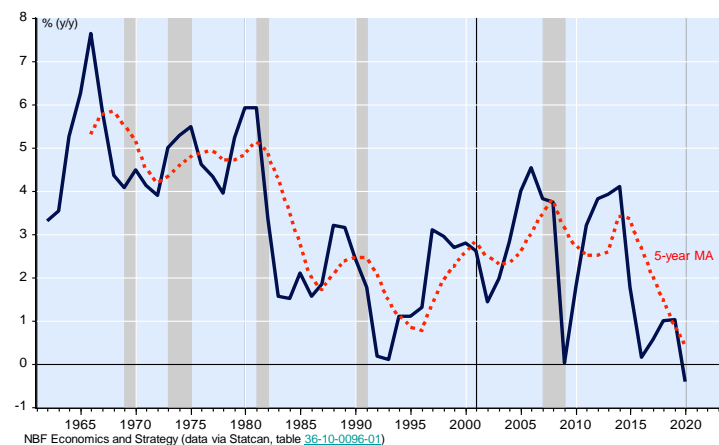
End-year net stock of capital (2012 constant prices)



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

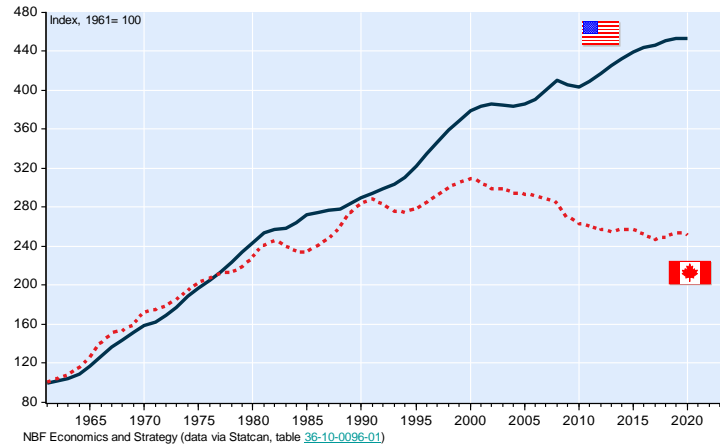
Net stock of fixed private non-residential capital (end-year constant dollars)



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

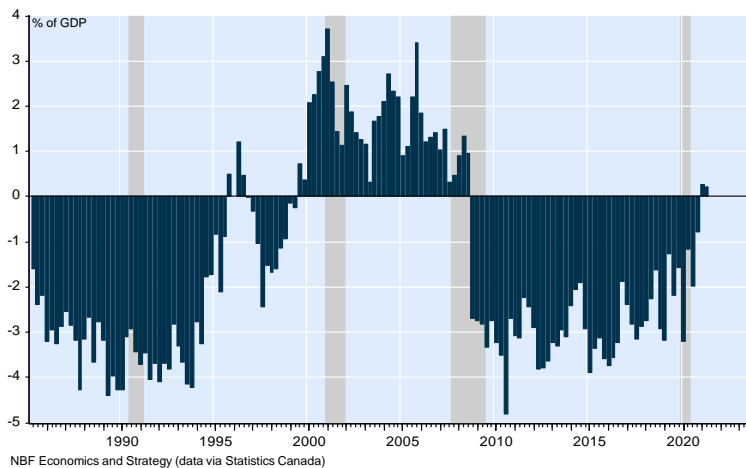
End-year net stock of capital in manufacturing, Canada and the U.S. (chained 2012 dollars)



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

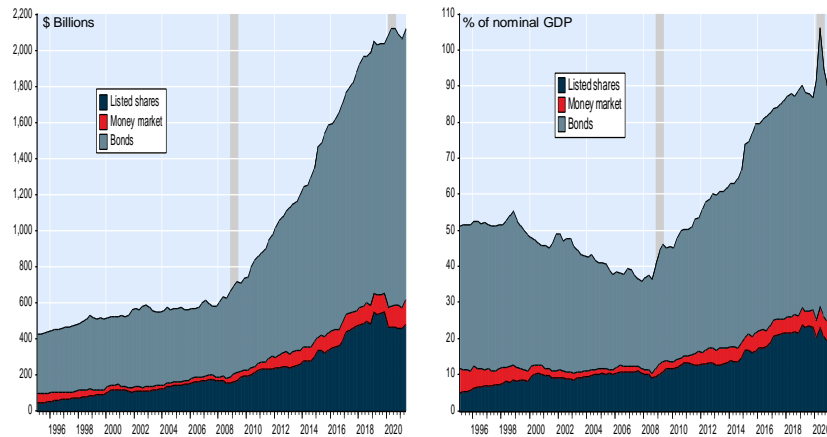
Current account balance (seasonally adjusted)



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

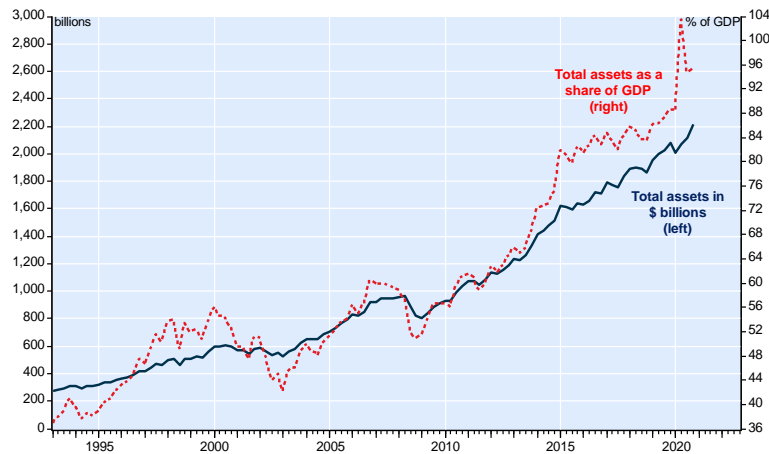


NBF Economics and Strategy (data from Statistics Canada)

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

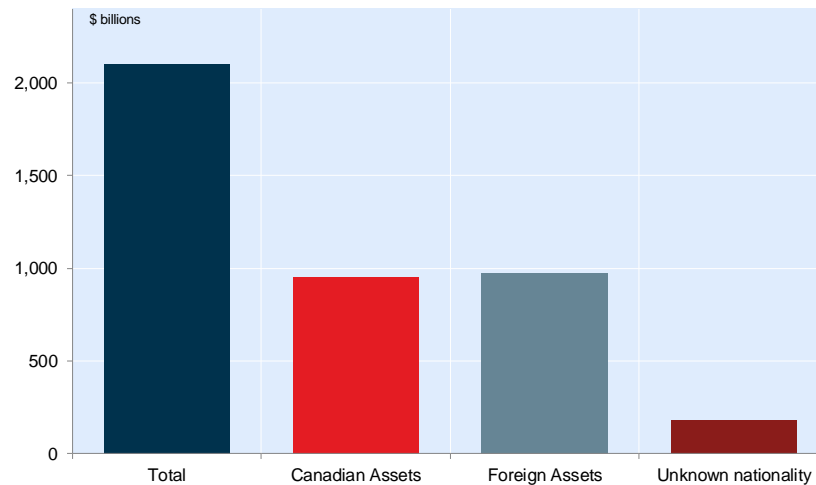


NBF Economics and Strategy (data via Statcan, tables [11-10-0077-01](#))

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)

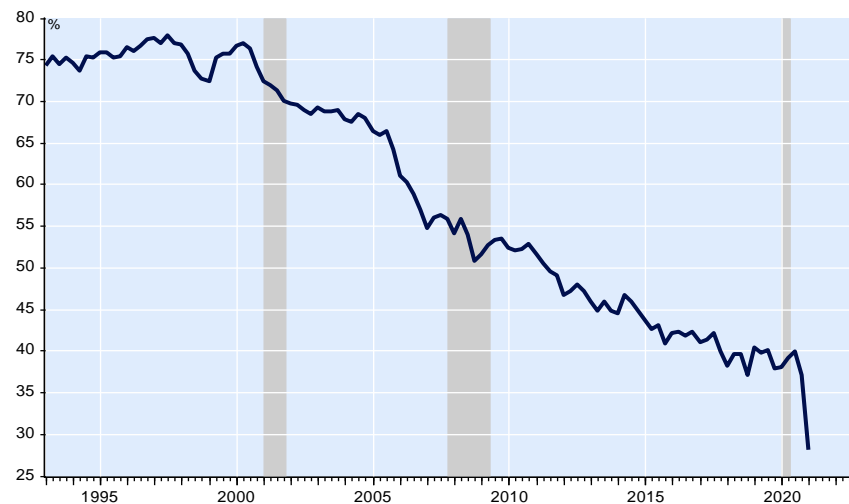


NBF Economics and Strategy (data via Statistics Canada, table [11-10-0085-01](#))

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

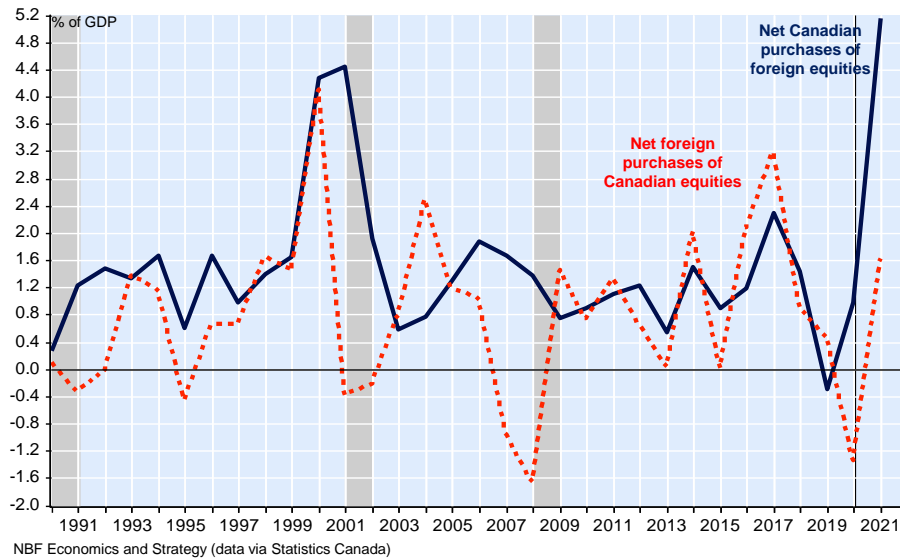


NBF Economics and Strategy (data via Statcan, tables [11-10-0077-01](#) and [11-10-0085-01](#))

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

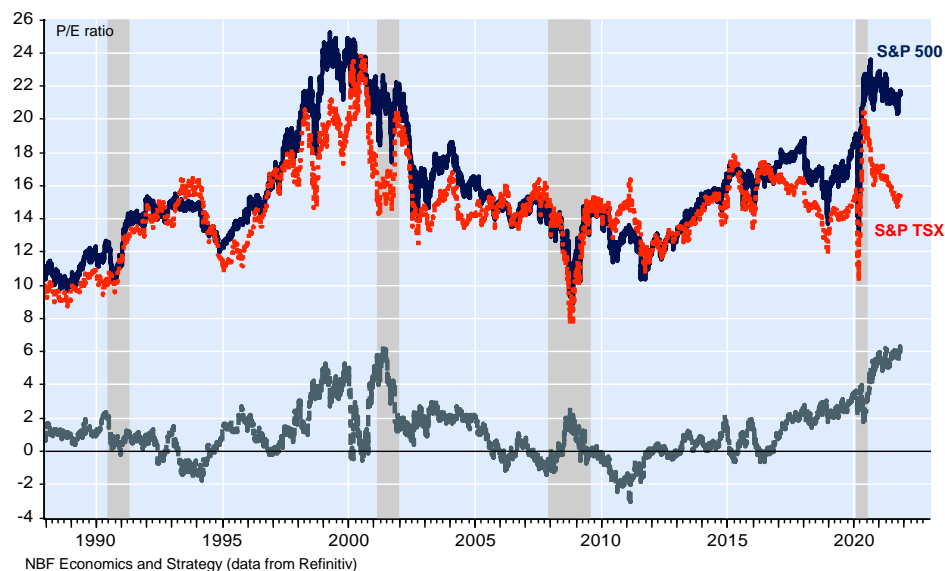
Net purchases of equity and investment fund shares (12-month rolling sum as of September of every year)



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



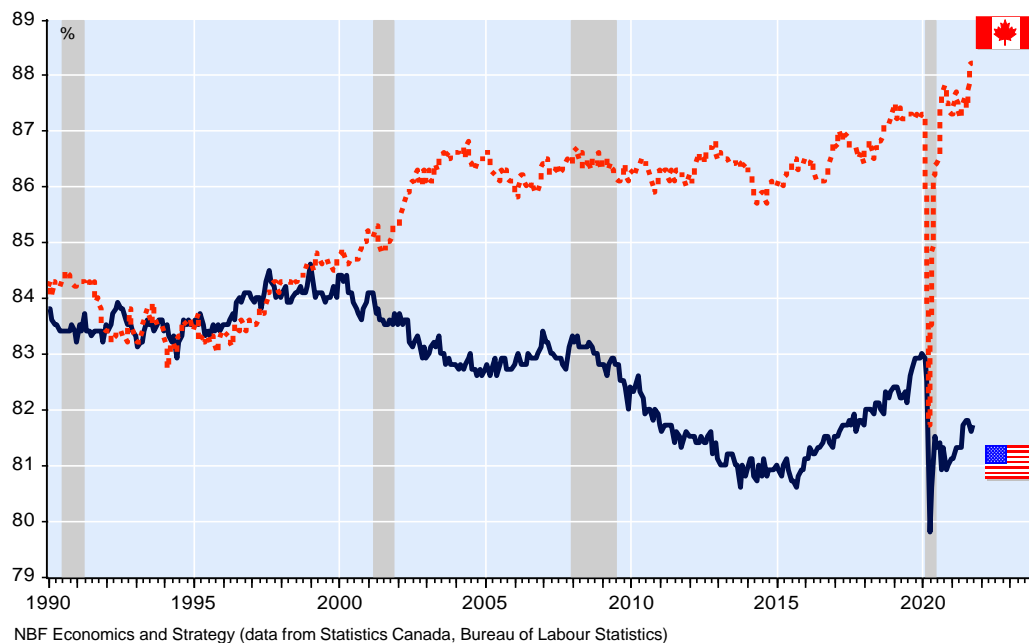
### Conclusion

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

### General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

### Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.



### UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 70 St. Mary Axe, London, EC3A 8BE.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

### U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only.

This report is not subject to U.S. independence and disclosure standards applicable to research reports.

### HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

### Copyright

This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.