"WIDER AND OPEN": THE CANADIAN BOND MARKET AFTER THE REMOVAL OF THE FOREIGN PROPERTY RULE

The proposed federal budget provides for the removal of the Foreign Property Rule (FPR) from the Income Tax Act. This will allow funds which are registered pension and retirement plans to invest unlimited amounts in foreign property compared to the current 30% maximum. We think that the major impact will be felt in the equity markets, as retirement plan sponsors substitute foreign for Canadian equities. We do not expect a major investment in foreign currency bonds by sponsors. We believe that Canadian investors will seek exposure to foreign credit in Canadian dollars. Plan sponsors are unlikely to invest in foreign bonds without hedging the foreign currency and interest rate risk since their fixed rate liabilities are Canadian dollar and interest rate. For the practical and investment policy reasons of liquidity and implementation, we think it is likely that pension plans and their investment managers will invest in the Canadian dollar issues of foreign issuers. The credit spreads of many Canadian bond issuers will move wider as Canadian investors seek higher yields and diversification from foreign issuers. Canadian credit spreads going forward will be more open to influences from foreign markets and will increasingly move with swap spreads and the Canadian dollar.

The Canadian dollar bond universe under the Foreign Property Rule (FPR) was a small and insulated place. Pension and RRSP registered accounts largely used their scarce foreign property availability for foreign equities and limited their bond managers to Canadian issuers. High Canadian real interest rates meant Canadian bond market returns were excellent compared to foreign markets, without the currency volatility. The performance experience of foreign currency mandates and "currency overlays" was good on paper but bad in practice. This kept sponsor mandates close to home in Canadian currency and interest rates.

A Captive Market for A Rated Issuers

Most Canadian plan sponsors limit their managers to investment grade bonds, usually rated A or higher. This meant that Canada was a pretty nice place for higher rated issuers who had a captive market for their bond issues. Provincial, municipal, utility, and especially financial issuers benefited considerably from the FPR. Core bond managers have large weights in bank bonds and capital securities to increase their portfolio yield versus benchmark indices and try to add value with sector rotation, yield curve and modest interest rate anticipation strategies. It is not uncommon for Canadian bond managers to have 5-10% invested in the bonds of each of the five major Canadian banks.

Allocation versus Marketing

This made for easy marketing by the major Canadian investment dealers. Except in terrible credit markets, when nobody issued anyways, the major sales task of Canadian bond originators was dealing with client complaints of insufficient allocations on new issues. Major global investment banks, including Citibank and Goldman Sachs, set up shop on Bay Street in the 1990s to share in the debt bonanza but were shut out by the domestic Canadian dealers. The hammerlock of the major Canadian investment dealers on Canadian debt origination was their superior contacts with Canadian clients through their corporate and investment banking relationships. With the exception of Merrill Lynch, the global dealers have largely closed their Canadian bond desks and now cover their Canadian clients out of New York and London.

The removal of the FPR changes things dramatically. Although they might restrict foreign currency and interest rate exposure, Canadian retirement and pension plan sponsors no longer will require their bond managers to restrict their portfolios to Canadian issuers. This might seem to be relatively benign, but it will inevitably lead to substantially increased Canadian dollar issuance by foreign issuers.

The Canadian Name Game

As we explained above, Canadian plan sponsors have traditionally restricted their managers to investment grade bonds, particularly rated A or higher. As a result, Canadian dollar bond portfolios are very concentrated in several widely held issuers and a few industry sectors, banking and utilities in particular. The 2000 acquisition of the Canadian Bond Rating Service (CBRS) by the Standard and Poors (S&P) credit rating agency of New York exacerbated this problem. S&P "harmonized" the CBRS ratings to its international rating scale. Many "Made in Canada" A rated bonds were eventually downgraded to BBB as a result of the smaller size of Canadian issuers and their cyclical exposures compared to international issuers.

This "name concentration" has had implications for major funds that have reached their internal and legal maximum exposures. New issuers or "new names" have had a higher value than diversification alone would dictate, as large funds have run out of room in their portfolios for large issuers. Large bond investors not restricted by the FPR like insurance companies have "asset swapped" into foreign issuers by purchasing their bonds directly and using currency and interest rate swaps to convert the cash flows to Canadian dollar. Pension funds and their bond managers have not been large players in this market. Anecdotal evidence from traders and sales coverage suggests a "one to three" ratio of clients who can asset swap to those who cannot.

Foreign Stars of the Canadian Credit Universe?

The Canadian marketable bond universe is $546 billion. A rough cut of 75% who cannot presently asset swap suggests $410 billion in possible demand for foreign issuers after removal of the FPR. If bond managers seek to diversify out of their higher credit exposures for only 10% of their portfolios, this equates to over $40 billion of selling of the widely held Canadian bond names and buying of foreign credits. As we discussed above, we expect that Canadian bond managers and their clients will prefer to seek the diversification into foreign credits through investment in Canadian dollar debt issues. While we are confident in the Canadian banking system, the credit risk correlation between Canadian banks is very high. Higher rated and higher yielding foreign banks will offer diversification of financial sector risk into foreign economies and foreign regulatory regimes. Australian, British, Dutch and other foreign banks will offer substantial diversification benefits to Canadian bond portfolios.

The emergence of foreign issuers in Canadian dollars has implications for the credit spreads of Canadian issuers. If Canadian dollar yield spreads on similarly rated credits are higher for foreign issuers than their Canadian peers, Canadian managers will buy these issues. Canadian yield spreads have historically tended to be lower (more expensive) for a given credit risk than in other bond markets. Although current Canadian yield spreads are not exceptionally expensive, given the global credit boom, they are not cheap. The large diversification benefit of adding foreign issuers is still very attractive and suggests a warm welcome for Canadian dollar issues of highly rated foreign issuers.

Wider Canadian Spreads

The obvious long term effect of the removal of the FPR will be a general widening of Canadian spreads as Canadian investors seek to diversify their current portfolio concentrations out of specific names and sectors. We think the provincial, municipal, banking and utility sectors are the most exposed. Widely held corporate names like Bell Canada, TransCanada, Loblaws and the major five banks are subject to potential selling pressure. The Royal Bank of Scotland will be substituted for Royal Bank of Canada and the Republic of Sweden for the Province of Ontario. The A rated Czech Republic could replace the A rated Township of Innisfil.

Open and Volatile Canadian Credit Spreads

Large Canadian issuers running out of room in the Canadian debt markets, provincial and corporate, have historically financed in foreign currencies. This has particularly been the case for issuers rated below investment grade, like Rogers Communications, who have accessed the well developed U.S. high yield or junk bond market. These issuers swapped the financings back to Canadian terms to provide cheaper funding than the Canadian market could provide. These large deals have significantly affected the swap spreads between the Canadian and foreign markets.

Foreigners have typically purchased Canadian dollar debt as a currency play. The Eurobond market is well developed for Canadian dollar issuers selling to foreign investors. This market has a large retail base with the stereotypical "Belgian dentist" as a target buyer. Canadian provinces, municipalities and corporations have outstanding issues in the Eurobond market. Foreign issuers have issued in Canadian currency including national governments like Sweden, international agencies like the World Bank, state governments, corporations and banks. Pricing in the Eurobond market is not driven by domestic Canadian conditions. When the Canadian dollar exposure has been attractive to foreign investors and the swap spreads give cheaper financing, the markets are open.

With the repeal of the FPR, Canadian bond investors will now be using foreign issuers to get better yields and more diversification. If and when the Canadian dollar loses it shine, foreign selling will cause spread widening for Canadian dollar issues. When the Canadian dollar issues of AA foreign banks are widening, the Canadian banks will follow as portfolio managers sell them to buy the better value foreign issues. If foreign issues are expensive in the Canadian market compared to their foreign currency equivalents, arbitrageurs will sell these short on a hedged basis. This will change the demand and supply for Canadian debt issues, adding considerable volatility to Canadian credit spreads. Canadian bond managers will have to be cognizant of foreign comparables and the swap and currency effects of foreign demand and supply.

Ralph’s Higher Return Playing Field

While our outlook might sound grim, we believe there will be substantial value-added opportunities for Canadian bond managers. Canadian credit spreads will be generally wider which will improve long term returns to Canadian bond investors. Credit spreads will also be more volatile. As traders know, this offers more profit opportunities and better long-term performance for Canadian portfolios.

Will Canadians buy foreign credit and will the foreign issuers come to the Canadian debt markets? Dreams told Kevin Costner’s character in the movie The Field of Dreams that: “if you build it they will come.” Kevin built a baseball diamond in his cornfield and the ghost players arrived. Another farmer, Ralph Goodale of Saskatchewan, had a political dream that he could lower the upwards pressure on the Canadian dollar with his budget. His finance department officials told him that he could offset increasing foreign investment inflows to Canada by removing the FPR and increasing Canadian investment outflows into foreign assets. We are not betting against Ralph’s dream: “level the field and they will invest”. While the major Canadian portfolio shifts will be into foreign stocks, we think that Canadian bond investors will decide to play on Ralph’s field. The new Canadian dollar bond playing field will see wider spreads and be much more open to the influences of the global bond markets.