- Industry-level GDP for February is the main event in Canada this week
- The flow-of-funds narrative in Canada is taking a positive turn…
- …and Japanese investors could play a big role going forward

Canada - GDP Ahead

Don't let the light data-calendar this week fool you, it's going to be an important five days for Canadian rates. The main event comes Tuesday with the release of the industry-level GDP report for February, which takes on more rank than usual given the recently revised forecast for Q1-19 growth from the Bank of Canada last week. Recall, the BoC revised Q1 growth down to a paltry 0.3% from a still-low 0.8% prior. This caught the Street wrong-footed given that most of the analytical community - including ourselves - are currently tracking growth north of 1.0% for the reference period.

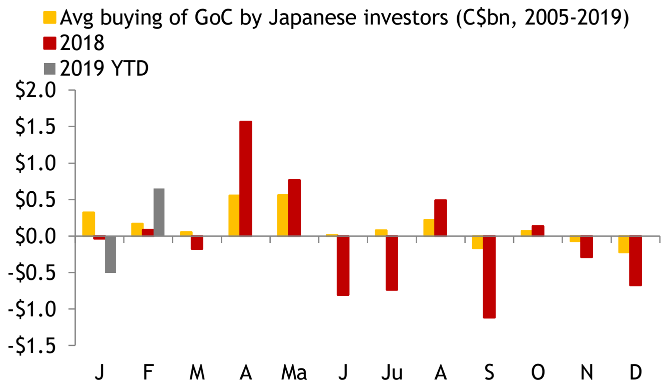
For most of us, we treat the monthly GDP numbers as a de-facto 'nowcast' to track quarterly growth. But remember that the monthly data is based on production, while the quarterly numbers are based on expenditures. This subtle difference means that, at times, monthly growth over/under estimates the quarterly number in the national accounts data. So using the monthly data today would guide you to a resting spot comfortably above the estimate provided by the Bank, but the limited amount of expenditure data we have received - international trade, retail sales - point to a very subdued quarter that is consistent with their estimate.

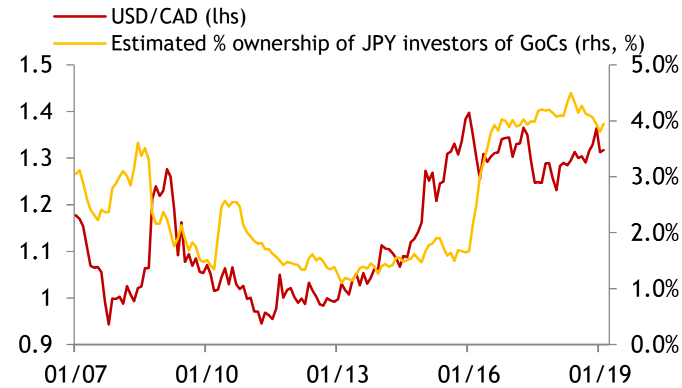
This puts onus on the February data to eke out an improvement, which indeed is our expectation. CIBC Economics expects a small 0.1% gain, as wholesale and retail trade looked good during the reference period. And, with the SEPH data for the same-month showing decent hiring and steady hours-worked, the estimate on paper looks legit. Weather is going to be a problem though, and could undermine select segments of the print. And given the downward revisions to the January retail sales data, it is very important to see whether or not the extremely strong January GDP print is revised down in aggregate. To the degree that the Bank has 'put it out there' but many are still viewing their forecast as too conservative, if the data acknowledges they are likely correct than it could be impactful for the level of domestic rates. Still, we would view the outcome to propel the curve flatter as front-end valuations already look extremely expensive into supply (particularly when you look at 2yr yields versus matched-maturity OIS).

The headline-risk also remains elevated this week as both Governor Poloz and Senior Deputy Governor Wilkins speak to Parliament in their usual post-MPR follow up on Wednesday. Since the MPR, the Governor has made several media appearances that appear to have played-up the temporary nature of the growth detour, effectively backstopping the flattening bias in the curve. We re-entered the CA/US 5s30s box (CAD flatter, US steeper) last Thursday at -14.9bps, and see considerable momentum behind this trade.

The PCE data in the U.S. today is crucial for maintaining the steepening bias in the U.S. 5s30s curve. There was a lot of excitement surrounding the quarterly PCE data on Friday, but the nature of that restricts how much information it actually provides. But the monthly numbers are better poised to paint an accurate picture of inflation trends - if the data misses the expectation (1.7% y/y for core PCE) by a healthy margin than the market is just going to be completely gone. On the flipside, we would think a beat would take-back Friday's price-action and open the gates for issuance, which means rate locking activity could be in fashion (thereby steepening the curve relative to Canada).

Chart of the Day - Japanese investors are an important part of the Canadian bond market





Source: Japan Ministry of Finance, Bloomberg, CIBC Capital Markets

One of the more important themes for the Canadian bond market in 2019 has been the evolving backdrop of fund-flows. Outward investment into our market peaked in late 2017 at around C$150.0bn on a twelve-month trailing total, which over the course of 2018 declined dramatically to just C$25.0bn by the final quarter of the year. And given that every seller must have a buyer, the risk transfer that occurred late last year (from non-residents to domestics) played an important role in dictating broader market positioning early in 2019. The attendant consequence too is the impact these flows have on financing our current account balance, which is one of the largest in the G7 at just under 4.0% of GDP. If foreigners were to abandon their appetite for Canadian debt securities it could, if persistent, cause a balance of payments problem. But the good news is that non-resident flows appear to be improving. Over the first two months of 2019 we have seen foreign investors purchase some C$20.0bn of bonds, concentrated across corporates and governments and to a lesser extent provincials.

And while every investment manager has varying requirements for purchasing foreign debt, what we know is that rising hedging costs have indeed played a role in redirecting global bond fund-flows. After all, it was North America central bankers taking the lead relative to their peers in normalizing administered rates in 2018, and that reduced the attractiveness of both Treasuries and GoCs. Consider that a Japanese investor purchasing a 10yr UST today and hedging the currency-risk would be owning an asset that yields just -45.0bps, some 40.0bps lower than similarly-dated Japanese government bonds (JGBs). So when we think about this within the context of a deteriorating U.S. budgetary balance - and the associated increase in UST issuance - there is a concern that a lack of foreign demand may cause longer-dated yields to offer a concession, thereby steepening the yield curve.

But there is some good news on this front too. Early last week a handful of Japanese life insurance companies - traditionally large purchasers of foreign bonds - said they would be increasing their foreign bond purchases on an unhedged currency basis. The news immediately put a bid into the bond market on the expectation these purchases might begin following the ten-day long Golden Week holiday. We have been receiving a lot of questions from investors about the potential impact to Canada, so in today's note we wanted to shed some light on the historical flows from that region.

Since 2015 Japanese investors have (net) purchased nearly C$20.0bn worth of Canadian bonds. On a calendar basis, most of the purchases in any given year are concentrated around Japanese fiscal year-end, with April and May typically representing the bulk of purchases (see first chart above). Historically we tend to see duration rally in May and it is no coincidence that these flows peak around that time of year. But not every year is the same. In 2018 Japanese investors divested nearly C$1.0bn of Canadian bonds, largely reflecting rising hedging costs and more attractive all-in yields in other markets. Similarly, 2017 saw just C$3.0bn of purchases from Japanese investors while in 2016 the inflow was closer to C$15.0bn. Depending on the composition of tenors, these flows may be understated in either direction given maturity profiles - meaning that purchases/sales can be more impactful than the data suggests. For context, if we assumed every single bond purchased by Japanese investors were GoC securities and, we tallied the cumulative flows from 2005-to-date, the data would say Japanese investors own just under 5.0% of the federal bond market. Considering non-residents own just under 30.0% of the aggregate Canadian market, one region representing nearly 20.0% of the pie is a big deal.

So it remains to be seen when these 'new' flows will begin, but it is safe to say they will be closely watched (data is released weekly from the Japanese MOF, though the more granular data that identifies the geographic location of outward investment is released monthly, on a two month lag). For Canada, we see these flows being an important dictator of near-term curve directionality.

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