

**Quick Hit – Do domestic developments matter not for provi spreads?**

If you're wired, as many good risk managers are, to focus on the scary side of life, then there's seemingly been a raft of negative Canada-centric developments to occupy your time of late. We've plotted many in Chart 1 and offer here a bit of a recap...

Nationally, the economy has shed momentum, as a July GDP stall gave way to an August contraction. Enter the chattering classes and related "the end is nigh" headlines. Housing market psychology has been turned on its head in greater Toronto, where sales activity swooned and prices headed south in response to new provincial rules. Two subsequent BoC rate hikes and a further tightening of the macroprudential screws in the form of OSFI's B-20 guidelines further cloud the outlook for this vital economic driver. Meantime, business confidence has faltered, undone by worries over federal tax reforms (since watered down), a looming minimum wage hike in Ontario (+23% on January 1) and/or NAFTA anxiety. Indeed, the trade file is fairly angst-inducing, as the fourth round of NAFTA talks, by all accounts, went terribly... to say nothing of the punitive (some might say ridiculous) ~300% combined preliminary duty the US has slapped on Bombardier's C-Series aircraft. Fiscally, Ottawa's budget watchdog used its sustainability report to warn about the long-term "fiscal gap" in many provinces. Ontario's *Financial Accountability Office* reached a similar conclusion, also warning about optimistic revenue/debt projections and the prospective jobs fallout linked to the aforementioned minimum wage hike. Not to be left out, Ontario's Auditor General slapped a "qualified opinion" on the public accounts and castigated the government for a complex hydro plan that, in her opinion, will lead to unnecessary interest costs. There's been legal noise in Ontario too, including two trials... one linked to by-election bribery charges (dismissed) and the other tied to a long-standing gas-plant controversy (ongoing).

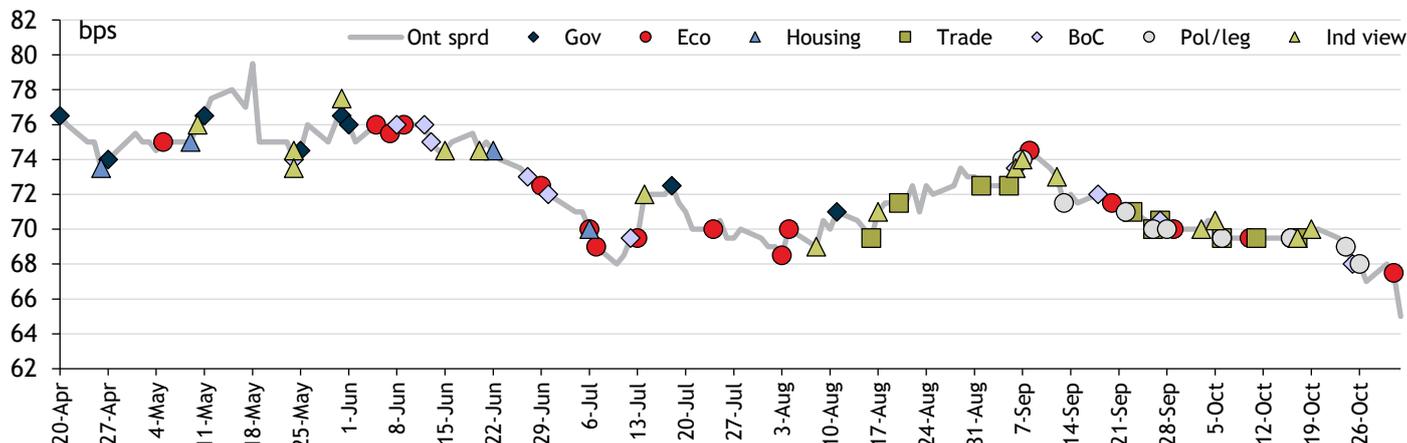
The above recap, which already runs a bit long, is not exhaustive. Nor does it focus on external/geopolitical risk factors, save NAFTA. And yet, as we write this, benchmark provincial credit spreads sit at their tightest level in years, with investors effectively clamouring for product. Is this sheer complacency; a willingness to look past noted domestic shortcomings in an ongoing hunt for yield?

A nuanced approach to provincial valuation analysis finds that domestic considerations do indeed exert long-term influence on spreads. Domestic rates, the C\$, local economic trends, ratings and bond supply (all directly or indirectly influenced by domestic economic/fiscal health) prove to be statistically significant provi spread drivers. Notwithstanding the hue and cry over Canada's recent economic stumble, we maintain a reasonably constructive view of Canada's underlying economic prospects. The attainment of full employment bolsters the consumption/housing market outlook, setting the stage for long-sought wage growth, while loose fiscal policy adds additional support. A near-term GDP rebound (as soon as the September data) could provide a nice set up for Q4 growth, while 2018 could ultimately surprise to the upside. Long-term pressures undoubtedly loom, but Ontario's near-term fiscal outlook is sitting pretty. And bond supply dynamics are more supportive for spreads than at any time in the post-crisis period. The deployment of seasonal cash certainly won't hurt heading into December 1. And what of the material portion of provincial valuations traced to external conditions/global risk sentiment (our preferred proxy being US investment grade credit indices)? Let's just say we expect support from improving global growth and continued equity market traction (with the latter *not* predicated on P/E expansion).

All in all, our view of the world isn't so terrifying for provincial credit. It's part of the reason why we forecast a rally in 10-year Ontario to the 65 bp level. Granted, we got here sooner than anticipated, as the last handful of basis points melted away quickly (something that always gives us pause). Having hit our target, there's an understandable tendency to take profit... particularly when defensive options (e.g., switching into gold-plated CMBs) look so attractive on a chart. We won't begrudge the more defensive-minded for propping such a trade and would hardly rule out a potential near-term correction. However, we won't be surprised if provi spreads display good staying power in the end, seeing important fundamental and technical reasons for a tightening trend.

**Chart 1: Ontario spreads since budget... tighter despite apparent abundance of negative events**

Ontario 10-year C\$ constant-maturity spread vs GoC curve and select developments/events (see appendix on page 2 for event details)



Source: NBF, fed-prov gov'ts, US gov't, BoC, StatCan, OSFI, TREB, Angus Reid, S&P, Moody's, DBRS, Fitch, FAO, PBO, Bloomberg

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## Appendix: List of select developments/events identified in Chart 1

Note: The following list is not meant to be exhaustive, but rather aims to highlight certain domestic developments that might be considered of relevance to Ontario's credit spread; we have deliberately excluded external/geopolitical developments (except for NAFTA)

### Select **government** announcements ("Gov")

20-Apr – Ontario's Fair Housing Plan announced  
27-Apr – Ontario 2017 Budget projects balanced budget  
11-May – Ontario US\$2bn 5Y Global bond offering  
25-May – GoC FinMin Morneau speaks on tax fairness  
31-May – Ontario minimum wage plan announced, including increase to \$14/hr starting Jan-2018; Bill 148 introduced  
1-Jun – GoC small business tax changes released for consultation  
11-Aug – Ontario Q1 finances reiterates balanced budget  
7-Sep – Ontario 2016-17 public accounts confirm better-than-expected result; qualified opinion by Ontario Auditor General  
26-Sep – Ontario US\$2bn 5Y Global bond offering  
16-Oct – GoC adjusts small business tax changes, lowers rate  
24-Oct – GoC fall statement shows smaller deficit, announces new stimulus

### Select **economic** developments ("Eco")

5-May – LFS (Apr); Ontario employment -2K, jobless rate 5.8%  
5-Jun – TREB resale data (May); sales down 20% y/y  
7-Jun – OECD economic outlook upgrades Cdn forecast  
9-Jun – LFS (May); Ontario employment +20K, jobless rate 6.5%  
29-Jun – CFIB Business Barometer reports noted drop in Ontario small business confidence  
6-Jul – TREB resale data (Jun); sales down 37% y/y  
7-Jul – LFS (Jun); Ontario employment -6K, jobless rate 6.4%  
13-Jul – Ontario Q1 GDP shows strong growth  
24-Jul – IMF interim economic outlook upgrades Cdn forecast  
3-Aug – TREB resale data (Jul); sales down 40% y/y  
4-Aug – LFS (Jul); Ontario employment +26K, jobless rate 6.1%  
8-Sep – LFS (Aug); Ontario employment +31K, jobless rate 5.7%  
20-Sep – OECD interim outlook once again upgrades Cdn forecast  
29-Sep – Cdn GDP (Jul) stalls  
6-Oct – LFS (Sep); Ontario employment +35K, jobless rate 5.6%  
10-Oct – IMF economic outlook once again upgrades Cdn forecast  
16-Oct – Ontario Q2 GDP shows continuation of strong growth  
31-Oct – Cdn GDP (Aug) contracts 0.1%

### Select **housing market** developments ("Housing")

26-Apr – Home Capital Group (HCG) announces emergency funding  
9-May – HCG sells \$1.5bn of mortgages  
22-Jun – HCG receives equity injection from Berkshire Hathaway  
6-Jul – OSFI presents B-20 guidelines for consultation  
17-Oct – OSFI finalizes B-20 guidelines, to take effect Jan-2018  
\* Refer to "Gov", "Eco", "BoC" other housing market developments

### Select **NAFTA/trade** developments ("Trade")

16-Aug to 20-Aug – NAFTA round 1 in Washington  
1-Sep to 5-Sep – Round 2 in Mexico City  
23-Sep to 27-Sep – Round 3 in Ottawa  
26-Sep – US announces preliminary CV duty of 220% on Bombardier C-Series  
6-Oct – US announces additional preliminary AD duty of 80%  
11-Oct to 17-Oct – Round 4 in Washington, with Canada decrying US protectionist policies and "winner-take-all mindset", while US "disappointed by the resistance to change from our negotiating partners"  
\* NAFTA round 5 schedule for 17-Nov to 21-Nov (in Mexico City)

### Select **Bank of Canada** developments ("BoC")

24-May – BoC leaves overnight rate at 0.5%

8-Jun – Financial System Review notes elevated level of Canadian household indebtedness, imbalances in housing market  
12-Jun – Wilkins speech on economic strength  
13-Jun – Poloz interview on economic strength (from Winnipeg)  
27-Jun – Poloz interview on economic strength (from Portugal)  
30-Jun – Business Outlook Survey reveals noted improvement in sentiment  
12-Jul – BoC hikes overnight rate to 0.75%  
6-Sep – BoC hikes overnight rate to 1.0%  
18-Sep – Lane speech on international trade  
27-Sep – Poloz speech on economic potential/data dependence  
16-Oct – Business Outlook Survey shows still positive, but declining sentiment  
25-Oct – BoC leaves overnight rate unchanged at 1.0%

### Select **political/legal** developments ("Pol/leg")

7-Sep – Sudbury byelection bribery trial begins  
13-Sep – Ontario Premier Wynne testifies at bribery trial  
22-Sep – Ontario gas plant trial begins  
26-Sep – Latest Angus Reid premier popularity polls put Wynne at 17% approval rating  
8-Oct – "Expert witness" for Crown in gas plant trial ruled out  
6-Oct – Key Ontario cabinet ministers announce they will not stand for re-election in Jun-2018 provincial vote  
16-Oct – Gas plant trial reconvenes  
24-Oct – Sudbury byelection trial dismissed  
26-Oct – Latest public opinion poll, by Forum Research, shows Ontario Liberals (24%) trailing PCs (45%)

### Select **independent analysis** developments ("Ind view")

10-May – Moody's downgrades Canadian banks  
24-May – Ontario Financial Accountability Office (FAO) report on costs related to government's Fair Hydro Plan  
24-May – Ontario Auditor General remarks on planned accounting for Fair Hydro Plan  
31-May – FAO report on Ontario economic/fiscal outlook highlights potential deterioration in budget balance  
15-Jun – S&P affirms Ontario long-term rating at A+ (stable); cuts province's short-term rating to A-1  
20-Jun – Fitch affirms Ontario long-term rating at AA- (stable) and short-term rating at F1+  
14-Jul – DBRS affirms Ontario long-term rating at AA(low) (stable) and short-term rating at R-1(mid)  
8-Aug – Moody's affirms Ontario long-term rating at Aa2 (stable) and short-term rating at P-1  
17-Aug – FAO comments on downside risk to Ontario revenue forecast  
6-Sep – FAO comments on Ontario's optimistic debt reduction assumptions  
7-Sep – AG issues "qualified opinion" on Ontario public accounts  
12-Sep – FAO comments on prospective job losses linked to Ontario proposed minimum wage increase  
3-Oct – IMF Global Financial Stability Report notes risks tied to high debt levels in Canada  
5-Oct – Parliamentary Budget Officer's Fiscal Sustainability Report identifies aggregate "fiscal gap" of 0.9% of GDP for provincial sector; Ontario gap estimated at 0.4%  
17-Oct – AG report on Ontario Fair Hydro Plan identifies up to \$4bn in unnecessary interest costs  
19-Oct – FAO long-term report cites potential for future Ontario deficits and higher provincial debt

## Fixed Income Trading Desk Research

### Public Sector Research

Warren Lovely

+1 416-869-8598 | [Warren.Lovely@nbc.ca](mailto:Warren.Lovely@nbc.ca)

### Corporate Credit

Connor Sedgewick

+1 514-879-3182 | [Connor.Sedgewick@nbc.ca](mailto:Connor.Sedgewick@nbc.ca)

### Relative Value Models

Drew Lloyd

+44 (0)20-7488-9379 | [Drew.Lloyd@nbc.ca](mailto:Drew.Lloyd@nbc.ca)

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