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Quick Hit — Quebec spreads leading the way

Of all the relative relationships in the provincial bond market, Quebec vs Ontario receives the greatest attention… and for good reason. After all, we're talking about the two largest provinces in the land, home to more than 22 million people and jointly accounting for over 70% of all provincial debt.

For the vast majority of our professional life, Quebec's spreads were quoted back of (i.e., above) the relatively tighter Ontario curve. But we've clearly established something of a new era, as Quebec bonds increasingly trade at a premium to Ontario across the term structure in the domestic (C$) market, extending to key international markets as well (e.g., we indicatively put Quebec through Ontario in both the USD and EUR markets).

Let's consider the Quebec/Ontario relationship in the 10-year sector. Domestically, this basis timidly entered negative territory back in June 2015, only to revert back to "normal" in the span of a week. In terms of Cartesian coordinates, the Quebec-Ontario constant maturity credit box oscillated around zero on the X axis over the course of 2016, ranging between -2bps and 3bps; it started the year in slight negative territory and then spent some time both below and above the X axis. However, we more firmly established a relatively tighter 10-year Quebec/Ontario relationship in 2017, standing at an impressive -3bps -the tightest level on record- as the year draws to a close. For reference, the trading range for the past twenty years is -3 to +35bps vs Ontario.

This gradual appreciation of Quebec spreads *vis-à-vis* provincial peers, and most specifically Ontario, reflects a compelling fiscal recovery path. For a number of years now, Quebec has focused on reducing its debt burden, consistent with the tough fiscal standards and long-term debt consolidation objectives set down in the *Act to reduce the debt.* Quebec's *Generations Fund* lies at the very heart of the province's debt reduction strategy. When that fund was established in 2006, the Quebec/Ontario 10-year relationship stood around 10bps. Dedicated deposits of revenues alongside cautious expenditure management have effectively locked-in budget surpluses for a few years now. And the value of the Fund has swollen to a substantial $12.9bln in 2017-18, projected to grow to a hefty $26.1bln by 2021-22. It's little surprise then that this Fund gets prominent play in credit rating reports and that even the remote thought of altering its functioning could impede fiscal progress going forward.

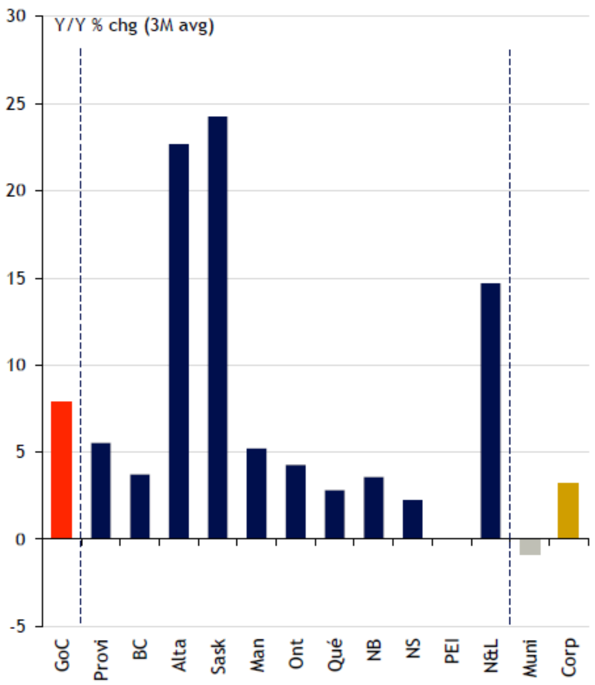
Indeed, Quebec's disciplined approach was applauded by S&P back in June 2017, translating in a one notch upgrade from A+ to AA-, with a new stable outlook. (Note that the upgrade extended to explicitly guaranteed Hydro-Québec). The ratings boost reflected successful cost control, after-capital surpluses, the aforementioned Generations Fund growth and related progress in working down a large debt burden. Note that at the time of the upgrade, 10-year constant maturity Quebec spreads were trading at 2bps through Ontario's, and they appreciated further to 3bps through within a few weeks' time. This was somewhat to be expected given that this upgrade, which was the province's first one in a decade, boosted *la belle province* into the "double-A" camp according to three of the four agencies rating its debt and leaving it to S&P's vantage point the third highest-rated province, now boasting a superior rating to Ontario, Alberta and all four Atlantic Provinces.

In addition to solid economic growth, immigration-related population growth and an enviable fiscal position, Quebec's debt management has lent further support to its credit spreads. Like Ontario, Quebec is committed to establishing and growing benchmark issues. In Quebec's case, that means benchmark bonds consistently hover around $6bln outstanding in 10s and closer to $10bln in longs. So there's good established liquidity, but with little in the way of net new funding to do. An analysis of outstanding C$ provincial bonds shows Québec has become relatively less abundant, but still very liquid (Chart 1). Simply put, relative supply differentials are supportive of tighter spreads on a relative value basis.

Could the province's spreads ultimately be influenced by the global uncertainties currently entrenched in the economy? Of course, but probably no more than for other provincial names and even perhaps to some lesser extent in our opinion. Quebec is not immune to NAFTA uncertainty, but a diverse economy and a little less export dependence on the US could make the province slightly less vulnerable than others. As per housing market anxiety, we view the province -and most specifically Montreal- as well insulated, having eschewed the sharp erosion in affordability witnessed in some other markets and having less direct leverage to foreign buyers. Moreover, meaningful personal income tax relief offered up in the November 2017 Economic Update should bolster the consumer spending/housing market outlook, all without eroding the underlying fiscal balance the province has fought so hard to establish.

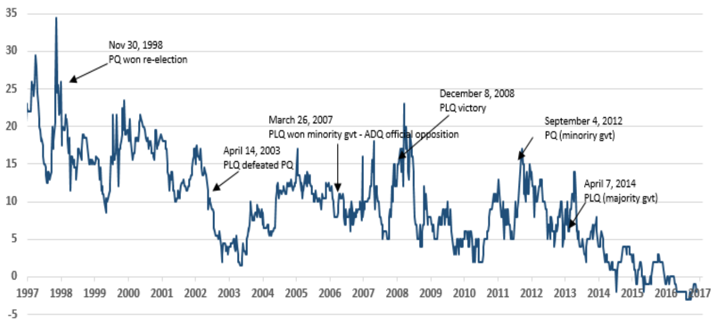
Of course, an upcoming October 2018 election in Quebec could very well influence the trajectory of the highly monitored Quebec-Ontario trading relationship—it certainly has in the past (Chart 2). But we remain optimistic that Quebec could well remain on a favourable credit spread trajectory measured against a basket of bonds issued by its provincial peers.

Chart 1: Growth in outstanding C$ bond stock



Source: NBF, Statistics Canada

Chart 2: Quebec/Ontario relationship (10-year)



Source: NBF

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