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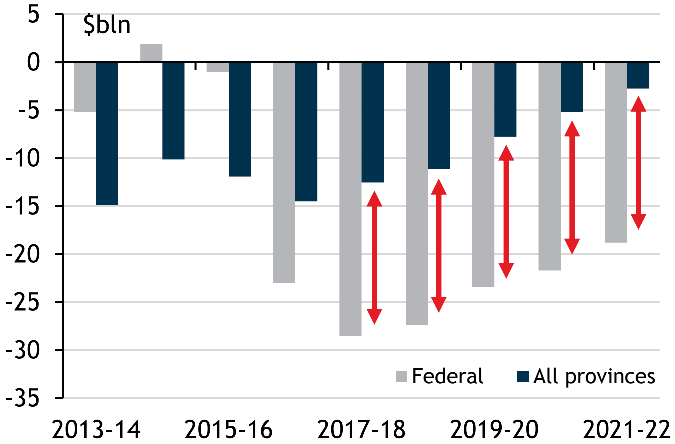
Quick Hit — Trading places: Federal-provincial bond supply upended

With two provincial budgets still to come—Nova Scotia and Ontario—the broad fiscal strokes at the federal and provincial levels of government are visible enough. At $28 billion, the federal deficit telegraphed for 2017-18 isn't monumental (<1½% of GDP), but our sovereign is opting for a go-slow approach to deficit reduction. You'll find a couple of provinces likewise moving gradually to slay deficits, but the broader provincial storyline is one of fiscal healing (in some cases from a weakened base). This year's combined provincial deficit target, at $12.5 billion, is less than half that being eyed in Ottawa (Chart 1). But with more than $10 billion of that red ink traced to Alberta, the "aggregate" provincial balance understates the budgetary edge enjoyed by a growing number of provinces. Indeed, five of the ten provinces, accounting for more than 80% of C$ provincial bonds outstanding, expect to be in the black this year. It's been a decade since such a large share of the provincial bond universe rested on balanced fiscal ground. Now budget balances are one thing, debt is another. And the provincial sector hasn't exactly been shy to lever up. The stock of domestic provincials bonds has vaulted $225 billion higher since spring 2011, long ago displacing the federal government as the single largest source of unmatured bonds in Canada. More rapid provincial debt accumulation—provis outstripped the GoC in terms of net supply 2.3:1 during the past half-decade—contributed, in some cases, to weaker provincial credit ratings and wider spreads. For six straight years then, the stock of domestic provincial bonds has grown faster than outstanding Canadas. But that streak ends in 2017-18. We'd put gross provincial funding needs at ~$80 billion for 2017-18, after building in expected pre-funding. Assuming about one quarter of that amount gets placed internationally (a somewhat smaller share than last year), then we're looking at roughly $60 billion of C$ provincial issuance through March 2018. Strip out maturities and net domestic bond issuance would be $33 billion—slower than the prior fiscal year and below what Ottawa has planned. As with the budget balance, this aggregate provincial bond picture is heavily influenced by Alberta. So train your focus on provinces like Ontario, Québec and British Columbia, where net requirements are fairly limited. Again, a brief history lesson: despite an economic weight of <40%, Ontario expanded its domestic debt stock every bit as much as the federal government over the past half-decade. Over the coming two years, however, Ontario's net bond issuance is poised to downshift, representing a mere fraction of what's due to come federally (Chart 2). The relative increase in Québec's outstanding C$ bond stock will likely be tinier still. A caution: high-level supply trends are hardly the be all and end all when it comes to driving valuations, often taking a back seat to more statistically significant and/or consistent spread drivers (including underlying risk sentiment, the rates complex, regulatory developments, etc.) Critically, where debt gets placed on the curve is a vital consideration. Down the curve, in 2s to 5s, supply from the sovereign is blowing away provincial issuance 10:1. In contrast, provincial issuance in longer tenors should be at least twice as plentiful as what we get from the GoC this fiscal year. Ontario alone comes close to supplying as much 10- and 30-year paper as Ottawa. So yes, the ongoing scarcity of 10- and 30-year Canadas could limit performance potential for longer-dated provi spreads that have staged a nice run of late. A post-budget surge in supply is another near-term factor, and one reason why provincial spreads have tended to struggle in the April to June quarter. Looking past these short-term seasonal effects, however, we see a skew to net bond issuance that, *ceteris paribus*, is supportive for provincial spreads, while contributing to credit curve steepness. We've passed a critical inflection point in our bond market, whereby Canada's marginal bond supply is coming more and more from the sovereign and less and less from the large provinces. It's a case of trading places and a trend that could be with us for some time.

Chart 1: Fiscal outlook: Advantage provinces

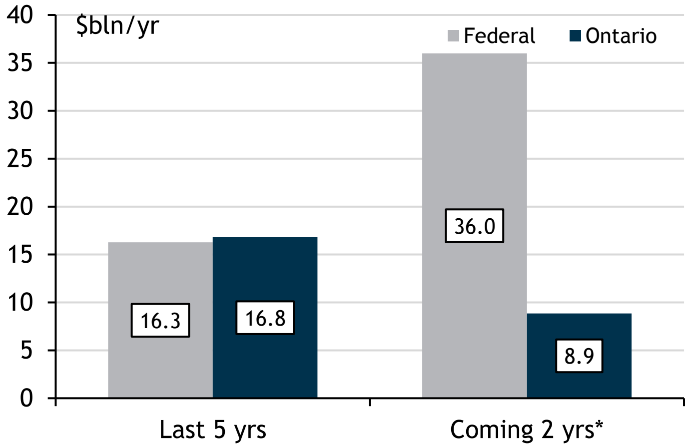
*Federal and aggregate provincial budget balances**



*Source: NBF, fed-prov govt's | * Includes some NBF estimates for future years*

Chart 2: Ontario net supply slows, feds speed up

Average annual change in C$ bonds outstanding: Federal vs Ontario



*Source: NBF, fed-prov govt's | * Coming 2 yrs reflects NBF forecasts*

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