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Quick Hit — Putting provincial valuations in perspective

Don't look now, but provincial credit spreads are in some cases sitting at the tight end of the range observed over the past half-decade. Take our preferred measure—Ontario's 10-year constant maturity spread vs the GoC curve—which at ~72bps has rallied roughly a dozen basis points in three months and sits a striking 40+bps inside of the post-crisis wides established about a year ago. Setting aside the fact it can take almost twice as long to recover ground as it does to cede it, this spread rally has been impressive. It begs the question: how sustainable are today's tighter valuations? Notwithstanding noted uncertainties (can you say 'border adjustment tax'), we view today's financial conditions, economic backdrop and fiscal/financing profile as fundamentally more supportive than the last time provincial spreads traded down here. To illustrate the point, we'd draw your attention to the table at bottom—apologies for the size—which compares current levels with those prevailing during the first half of 2015. Ontario 10s may be a snick tighter than the 74bps averaged during Feb-Jun 2015, but shorter- and longer-dated Ontario spreads are, if anything, a bit cheaper. Moreover, given the compression in Canadian swap spreads, provincial credit looks even more enticing vs BAs than in the first half of 2015. Underlying yields are notably higher, consistent with a firming in global economic conditions and a wholesale re-pricing of Fed expectations (even if the BoC appears in no rush to hike). US investment-grade and high-yield credit indices are tighter, as are domestic dep notes, energy and infrastructure names. (Hydro One is one of the few Canadian credits to widen vs 2015:H1, but a partial privatization has altered credit fundamentals.) The Canadian dollar is notably weaker vs Feb-Jun 2015 (good news for a manufacturing- and export-levered Ontario economy), while equities have notched impressive gains (with earnings growth improving). Meantime, volatility has moved lower. Housing risks linger, but Ontario's economic performance has turned heads, including solid job growth and a noted pick-up in our own proprietary measure of economic momentum. There's been important fiscal progress too, with a balanced budget in the offing and the debt burden edging lower (from a high level mind you). Finally, Ontario's funding needs are stepping lower, with domestic demand sturdy and international markets receptive and competitively priced to boot. All in all, you might not label provincial spreads overwhelmingly 'cheap', but assuming we sidestep the worst of our geopolitical fears, there's greater staying power to today's spreads than you might think.

Warren Lovely

Chart: Provincial credit spreads rally

Ontario 10-year constant maturity spread vs GoC curve

Source: NBF

Table: A host of key spread determinants look better today than in early 2015

Ontario constant maturity spreads & select financial market, economic, fiscal indicators — Current vs Feb-Jun 2015 average

	Ont vs GoC:			GoC 10Y	Cdn 5Y	US 5Y	Cdn 5Y	Cdn 30Y	Cdn	Equities:		Vol	Cdn eco	Ont	Ont	Ontario finances:		Ont lt
	5Y	10Y	30Y	yield	swap sprd	IG CDX	RY DN	H.One	dollar	S&P TSX	DJIA	VIX	surprise	u-rate	IPEM	bud bal	net debt	rating
	bps	*bps*	*bps*	*%*	*bps*	*bps*	*bps*	*bps*	*C$/US$*	*Index*	*Index*	*Index*	*Index*	*%*	*3M % chg*	*$bln*	*% of GDP*	*Avg*
Feb-Jun 2015	46.8	74.0	84.1	1.51	42.0	63.8	92.8	138.3	1.241	15,110	2,101	14.1	-3	6.6	0.0	-10.3	39.1	AA-
Current	54.0	72.5	85.0	1.77	32.0	60.1	80.0	140.0	1.341	15,617	2,378	11.1	63	6.1	0.9	-1.9	38.3	AA-
Change	***7.2***	***-1.5***	***0.9***	***0.26***	***-10.0***	***-3.8***	***-12.8***	***1.7***	***0.100***	***3.4%***	***13.2%***	***-3.0***	***66***	***-0.5***	***0.9***	***8.4***	***-0.8***	***-***

Source: NBF, Bloomberg, StatCan, S&P, Moody's, DBRS | Note: Green shading denotes a variable where the change vs Feb-Jun 2015 would typically be expected to lead to tighter provincial credit spreads, all else equal

Government Credit

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