November 9, 2020 - (Vol. IV, No. 63)

Market View – What can be inferred from Ontario's budget? Plenty

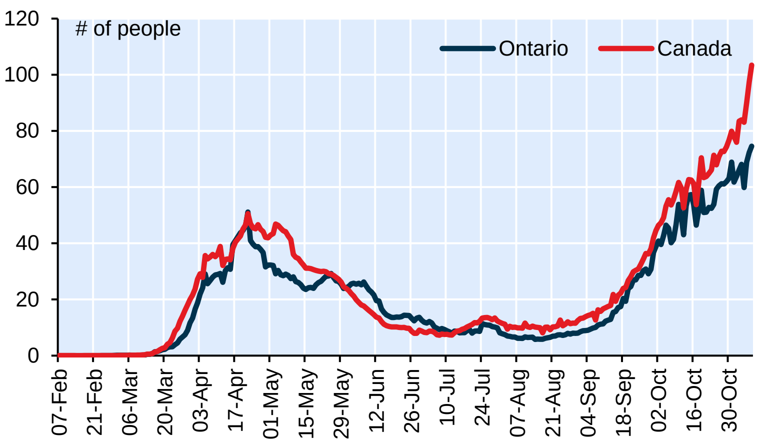
By Warren Lovely

Seven-plus months into the 2020-21 fiscal year, Ontario has treated us to a multi-year budget. The delay was understandable; the world was about as topsy-turvy as it gets during the traditional springtime budget season. The outlook remains plenty fluid, riven with uncertainty over the trajectory for the coronavirus against encouraging news on a vaccine. But we now have an initial sense as to where Ontario sees itself headed in the coming years. Just what can be inferred from Ontario's budget, as it relates to other provinces or more broadly? A fair bit, as it turns out.

Virus containment is obviously the most vital assumption – There are countless assumptions embedded in a budget. Bread-and-butter indicators like GDP and employment are always in focus. But whether formally spelled out or not, the most vital planning assumption for any government right now (in Ontario or elsewhere) is virus evolution. Despite rising case counts (Chart 1) and ongoing restrictions, Ontario is banking on a less-disruptive second wave. Here's hoping for effective containment and eventual eradication of the virus, with fresh headlines on a vaccine clearly encouraging.

Chart 1: Assessing the second wave

New COVID-19 cases in Ontario & Canada, 7-day moving average



Source: NBF, Johns Hopkins CSSE

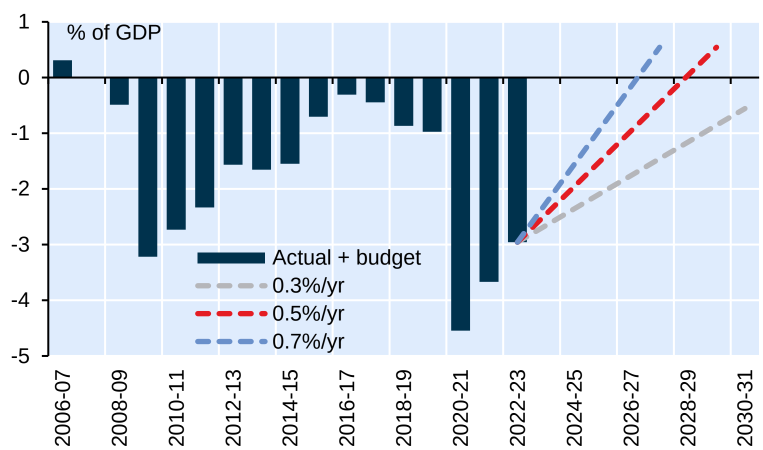
More support offered – The initial response to the virus saw governments rush out temporary or "time-limited" measures to build a quick bridge to recovery. Notwithstanding progress towards a vaccine, economies remain too vulnerable to seriously (or quickly) step-down supports. Ontario outlined additional measures in last week's budget, driving the cost of what is now a three-year action plan to $45 billion. It's a similar story in Ottawa, where a minority Liberal government has offered more help to shore up a vulnerable economy. The federal outlook (sans fiscal anchors we're told) will be freshened up later this month, providing needed visibility given monumental sums earmarked to fight the virus. Now, more than ever, fiscal transparency must be demanded. Whether the Prime Minister likes it or, it's entirely appropriate for opposition parties to hold his government to account. It's their job.

Output gap? How about a revenue gap – Fresh LFS data saw the national labour market take another step on the road to recovery. Canada has now regained ~80% of the jobs shed when the virus came ashore. Even if we're able to sustain job creation and growth, it will take time to close the non-trivial gap that has opened up in the level of own-source revenue vs. the pre-virus trend. In Ontario's case, new figures suggest that gap will exceed 8% (or >$11 billion) in 2021-22 relative to the prior forecast, even after factoring in a positive base effect. Think of this as the fiscal equivalent of the virus-related "scarring" you're hearing about. Other governments will be coming to terms with revenue gaps as they extend their own fiscal thinking.

A swift & savage fiscal hit, followed by a gradual recovery – Sticky anti-virus spending and revenue gaps imply a drawn-out period of fiscal consolidation. For Ontario, the current year's shortfall is a record $38.5 billion or 4.5% of GDP. That's exceeds the peak deficit of 3.2% left in the wake of the Global Financial Crisis, which took seven years to redress. (Ontario never officially got back to balance, but the deficit was a relatively skinny 0.3% of GDP by 2016-17.) Ontario expects to trim the deficit to $28 billion by 2022-23, which would still be equivalent to 3% of GDP. Where to from there? A definitive timeline for deficit reduction has not been offered up, that comes next year. But informed by past deficit reduction episodes, let's assume Ontario chips ~0.5%-pts from its deficit per year. In such a scenario, it might take until 2028 (or thereabouts) to get back to balance (Chart 2). Looked at more generally, while it took Canada's provinces only 1-2 quarters to fall into COVID's deep fiscal hole, many jurisdictions will need 20-30 quarters to recoup the fiscal ground lost. That's a pretty striking damage-to-recovery ratio and one that assumes the economy remains on an uninterrupted growth path from here.

Chart 2: How much time needed to address COVID deficits?

Ontario budget balance: Official projections + scenarios



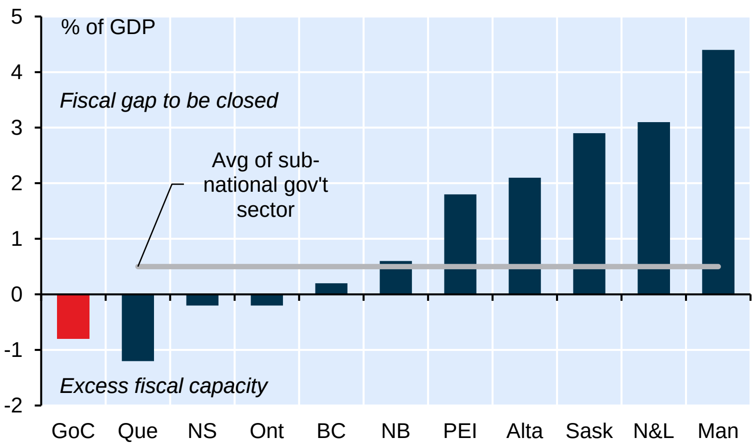
Source: NBF, Ontario | Note: Figures for 2020-21 to 2022-23 from Ontario budget; dotted lines are illustrative, based on assumed deficit reduction pace

Super-sized prudence appropriate – Even if you've a sunny disposition by nature, the current murky outlook makes a strong case for prudent budgeting. This is something Ontario has long embraced, and prudence was once more on full display in last week's budget via reserves and dedicated contingencies. For finance ministers sensitive to hitting fiscal targets—presumably most are—embedding prudence is a sensible strategy. Although let's be realistic, such padding might not be enough should health authorities lose control of the virus before an effective vaccine is widely deployed. And here's a humble request: make a firm, public and consistent commitment to flow unused reserves/forecast allowances/contingencies to the budget balance (and thus the debt). Seems reasonable.

Fiscal sustainability fears dog the provincial sector – The evidence of scarring Ontario's budget implicitly acknowledges won't soothe fiscal sustainability worries at the provincial level. Mind you, the non-partisan Parliamentary Budget Officer offered an updated *Fiscal Sustainability Report* in the immediate aftermath of Ontario's budget. Assuming full expiry of pandemic measures, Ontario was characterized as fiscally sustainable (Chart 3). Ditto for Quebec and Nova Scotia, while British Columbia was all but there. The picture was less rosy elsewhere. Aggregating Canada's subnational governments, the PBO identifies a fiscal sustainability gap. Nothing new there. If anything, the situation has deteriorated since COVID arrived. Note that fiscal sustainability is about the *slope* of the debt burden, not the *level*. While we may eventually succeed in tilting debt ratio sideways, they will be running at higher levels, which could limit capacity to fight the next downturn (when it arrives).

Chart 3: Sustainability a worry for provi sector as a whole

PBO's updated estimates of fiscal sustainability gap by sector/province



Source: NBF, PBO Fiscal Sustainability Report 2020: Update | Note: Negative figures indicate excess fiscal room; for detailed assumptions refer to PBO report here

Heavy debt loads manageable as long as rates stay low – Let's zero-in on debt loads for a moment. Ontario's net debt-to-GDP ratio, having shot up this fiscal year, is seen approaching 50% by 2022-23. This debt ratio may not peak for five years, even allowing for meaningful deficit reduction and steady nominal GDP growth. The saving grace: lower interest rates, which have been pulling the effective cost of debt down for a quarter century now. Consider: while Ontario's net debt has more than doubled since the GFC, the interest bite has eased and doesn't look at all scary (holding below 9% of revenue through 2022-23). When it comes to fiscal anchors, it must be tempting to embrace debt affordability metrics like the interest bite over a debt ratio or budget balance… if a government is bothering with a fiscal anchor at all, that is.

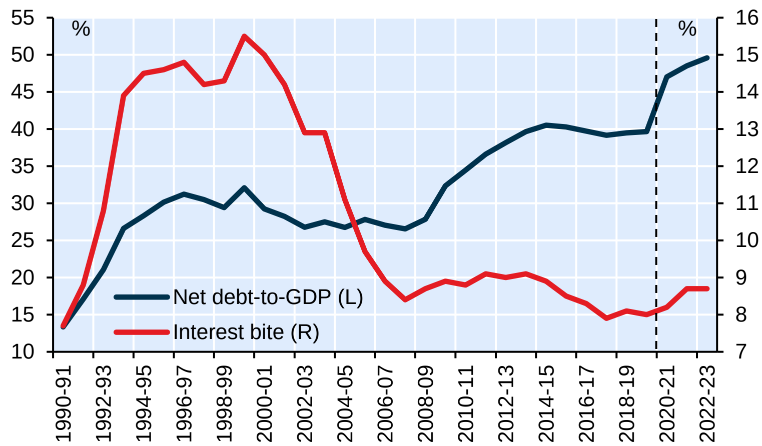
Rating agency assumptions need further re-calibration – Non-trivial fiscal rewrites, like the one Ontario just authored, can force credit rating agencies to re-calibrate their thinking. Many assumed virus damage would be contained and more-or-less transitory, allowing provinces (and governments more generally) to undertake important fiscal repair starting in 2021. Notwithstanding welcome news on a vaccine, acknowledgements of longer-lasting fallout could make it hard for rating agencies to remain impassive. Moody's loosely conceded the point in their "comment" on Ontario's budget, which is not to be confused with a formal rating action:

"The material size of these deficits and the associated increase in debt are credit negative. Moreover, although the government indicated it will announce next March details of its plans to return to a balanced budget, the material size of the deficit in 2022/23 suggests this will take an extended length of time which will put further upward pressure on the debt level of the province. However, the continued low interest rate environment and our expectation that Ontario will retain very strong access to capital markets mitigates some of the credit effects of this rise in debt." – Moody's on Ontario, 6-Nov-2020

Fiscal pressures and rating risks are hardly unique to Ontario. Shots have already been fired over the bow of Canada's oil-levered provinces via negative outlooks if not outright downgrades. All this to say, a decade-long deterioration in weighted average provincial credit quality isn't over. There's likely more shakeout to come.

Chart 4: Two perspectives on debt: burden & interest bite

Ontario net debt burden & corresponding interest bite



Source: NBF, Ontario | Note: Interest bite = interest on debt-to-revenue ratio

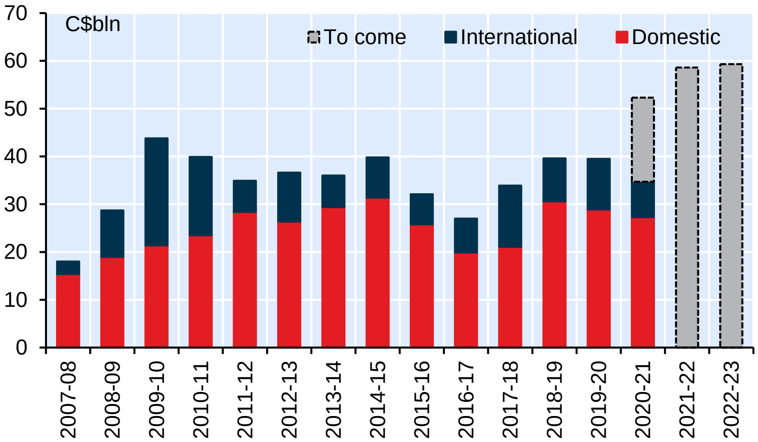
Regime shift in gross provincial borrowing? Again – Budget targets and debt ratios are all well and good, but for bond investors, the borrowing requirement is where the rubber hits the road. Just how many bonds are they being asked to swallow? The answer: record amounts, with perhaps no let up in sight. At least that was the message from Ontario. We're tempted to label this a genuine regime shift. To us, there was a pre-2008 regime, when Ontario's long-term needs were in/around $20 billion/year. Then the Global Finance Crisis hit, leaving requirements generally running between $30-40 billion/year. Enter the pandemic. Ontario has $52 billion of term funding to secure in 2020-21, and that's after pre-funding/cash draws and a larger pull from short-term markets. The province sees bigger term debt programs coming in 2021-22 and 2022-23, around $59 billion/year—some 60% above the pre-virus trend. Even under a so-called "faster growth scenario", Ontario's long-term funding needs don't decline. Depending on what you assume for Ontario's share of total provincial issuance, we could see $140-170 billion of gross provincial bond issuance in 2021-22. For reference, the current pace is ~$150 billion, while the pre-COVID trend was more like $80 billion/year. More bonds for everyone then, in domestic and international markets, and across the yield curve. It hints at more frequent and larger benchmark securities. If you liked provincial bond liquidity *before* COVID, then you're going to love this.

Large capacity to absorb bonds in today's QE/CE world – Importantly, investors have gobbled up provi bonds like candy. The

Bank of Canada (alongside other central banks) injected much-needed confidence in the spring by implementing special purchase programs. Specifically, the BoC's Provincial Money Market Purchase Program (PMMP) provided vital liquidity. As for the supplementary Provincial Bond Purchase Program (PBPP)—a form of credit easing—the scale of purchases hasn't necessarily been overwhelming. To date, some $11 billion of provincial bonds have been bought via this program, a six-month pace running well shy of the $50 billion 12-month program cap (by May 2021). So there's a lot of room to accelerate purchases if markets wobble. Given another slug of outsized issuance in 2021-22, an extension of this program may be worth considering—to serve as a safety valve/backstop if nothing else. Then there's the Bank's QE program, which is really the granddaddy when it comes to absorbing domestic bond supply. Look past the recent step-down in the weekly purchase pace. BoC QE is still jumbo-sized anyway you slice it, clearing material room for sub-sovereign governments and corporate issuers alike. After all, with policy rates at the Effective Lower Bound and QE keeping a lid on GoC yields out the curve, where else is an investor to find yield?

Chart 5: Evolution of Ontario's long-term funding

Ontario long-term borrowing: Domestic vs. international + forecasted req'ts



Source: NBF, Ontario | Note: For 2020-21, "to come" portion as at 5-Nov; figures for 2021-22 & 2022-23 represent total borrowing requirement to be sourced from all markets

Lastly, does anyone care? – In today's QE/CE world, you might think economic, fiscal and/or rating damage to our provinces has little to no impact on valuations. We'd note that immediate market reaction to Ontario's budget was relatively muted. As one trading colleague put it: "Ontario is getting swept up in this great chase for yield", in both CAD and USD markets. Somewhat perversely, in a low rate/tight spread environment, it's the relatively wider credits that might have the greatest scope to tighten… or so the thinking goes. At the extreme, this implies little regard for deteriorating credit fundamentals. Investors simply scoop up the juiciest coupons they can find. There's no denying the overwhelming quantity of liquidity made available through central bank balance sheet engorgement… money that needs to find a home. But is there not at least a bit of evidence of credit differentiation in bond markets? Perhaps, at least judging from what are still non-trivial spreads observed *across* provincial bond markets (i.e., from one name to another). Moreover, the gradual but undeniable tightening of some other public sector entities vs. the provinces may be partly a function of fundamentally divergent risk profiles. Of course, just two trading days removed from Ontario's budget, encouraging vaccine headlines fueled the appetite for risk, propelling stocks to new highs and pulling credit spreads (including provincials) in nicely. Which brings us full circle: the degree of virus containment is clearly one of the most vital assumptions any portfolio manager needs to make right now. So determine the level you care at, because vaccine or not, there are more provincial bonds to be had than ever before.

Next up: Quebec tables a fiscal update on Thursday, November 12th, which coincides with a fresh CEO's Corner from Ontario Financing Authority chief Gadi Mayman. Other provincial governments will be trotting out fiscal updates over the course of the fall. As for the feds, Chrystia Freeland will deliver her first fiscal update later this month, although the Prime Minister has already cautioned that it will not include guidance on Ottawa's preferred fiscal anchor(s).

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Paul-André Pinsonnault
Senior Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rate Strategist, Economics and Strategy
warren.lovely@nbc.ca

Taylor Schleich
Associate, Rates Strategist, Economics and Strategy
taylor.Schleich@nbc.ca

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only.

This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA")which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.