Market View
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2021 budget takeaways: Where to begin…

By Warren Lovely/Taylor Schleich

Canada's budget season has essentially wrapped, the federal government and nine of the ten provinces having presented detailed fiscal blueprints for the 2021-22 fiscal year. Note: Given a provincial election, Newfoundland and Labrador is not scheduled to release its 2021 budget until June.

Here we outline a variety of takeaways, numbered for ease of reference and arranged across four broad categories: economic outlook; budgetary balance; debt & interest burden; borrowing requirement & strategy. We've included select charts to further illustrate key points, embedding links to related reports as appropriate. As a reminder, detailed analysis of individual budgets can be sourced from our Economics and Strategy website.

Economic outlook: Still uncertain but apparent near-term upside

(1) **An economic recovery is everywhere underway.** Nominal GDP (the best proxy for government own-source revenue) should mostly recoup lost ground before the year is out (i.e., a one-year recovery rate). Real GDP looks to take two years tops to regain 2020's setback. But it could take 3-7 years for unemployment rates to return to pre-COVID levels, with evidence of inequality in labour markets—youth, women and low-wage workers having generally suffered more.

(2) Economic assumptions are informed by the private sector consensus. Unlike last year, when growth assumptions were trashed as the virus hit, **this year's revisions have in no small measure been to the upside**. Notwithstanding ongoing uncertainty and a variant threat, honest economists will admit to being pleasantly surprised by the economy's resilience. For its part, the Bank of Canada just ushered in a massive upgrade to its thinking on 2021.

(3) At this point, **nominal GDP growth could top provincial budget assumptions by more than 3%-pts in 2021** (on a weighted average basis). That's *a lot* of extra income and spending that will be subject to various government taxes.

(4) Loosely speaking, **the scope for surprise is related to the age of the budget** (older budget = more upside) **and/or to the degree of commodity exposure** (higher resource prices = positive terms of trade adjustment = heady nominal growth = extra revenue). National Bank's latest provincial growth outlook foresees double-digit nominal GDP growth for four provinces, Alberta looking to be out in front. [Thanks to our colleague Daren King for his work on the provincial forecast.]

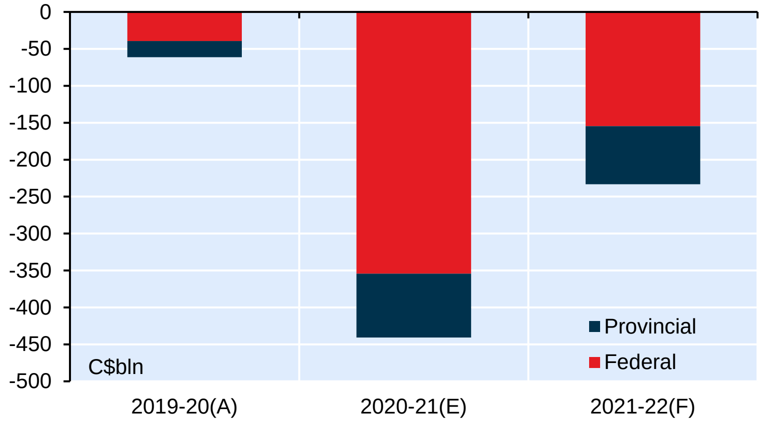
(5) **More realistic/current economic forecasts imply >C$10 billion of above-plan revenue for the provinces in 2021-22.** There's much less upside at the federal level, Ottawa's budget having been drafted much later and thus incorporating a more buoyant/current outlook.

(6) **Positive economic surprises should allow for the release of billions of dollars in reserves, forecast allowances and contingencies.** Assuming it's not spent, bonus revenue plus unused prudence leaves many governments positioned to beat budget targets in 2021-22 and could accelerate deficit reduction goals. Caution: bondholder-friendly fiscal consolidation may not necessarily be priority number one, particularly when/where elections could be in the offing (federally for instance).

Budgetary balance: Starting the *long* road back

(7) Regardless of revenue upside and embedded prudence, **the feds and every single province are set to run deficits in 2021-22.** In most cases, there will be less red ink than in 2020-21. Three provinces—British Columbia, New Brunswick and Saskatchewan—have planned for a larger deficit this fiscal year. Mind you, revenue and spending has been so distorted by temporary factors that year-over-year comparisons are tricky (borderline useless). A truer comparison is to 2019-20 and that's where COVID's ongoing fiscal fallout is more apparent (Chart A).

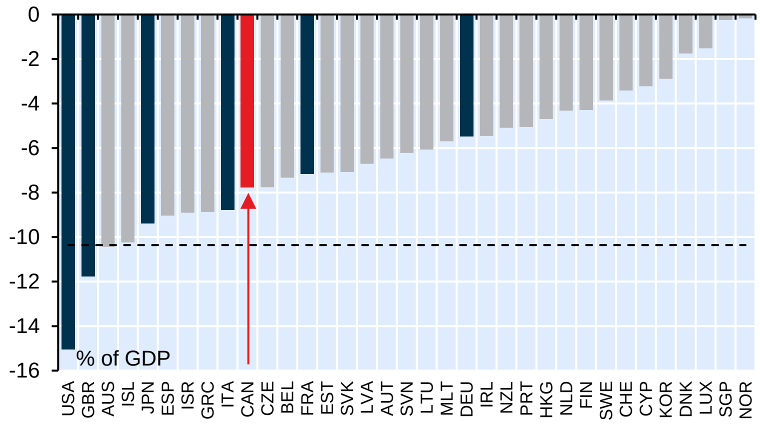
Chart A: Smaller but by no means small deficits for 2021-22
Federal & provincial budget balance: 2019-20 to 2021-22



Source: NBF, fed-prov gov'ts | Note: Provincial total excludes N&L

(8) **When it comes to budgetary red ink, Canada is hardly alone/unique.** All 35 of the major advanced nations on the IMF's radar are expected to run a general government deficit in 2021 (Chart B). If anything, the IMF assumes Canada cleans up its red ink reasonably fast(er), showing the country's general government deficit all but erased by 2024. But as we've previously argued, the IMF may be giving Canada's fiscal authorities too much credit.

Chart B: Budget deficits everywhere you look
2021 general government budget balance: Advanced economies



Source: NBF, IMF | Note: Dashed line = advanced economy average; blue bars = other G7

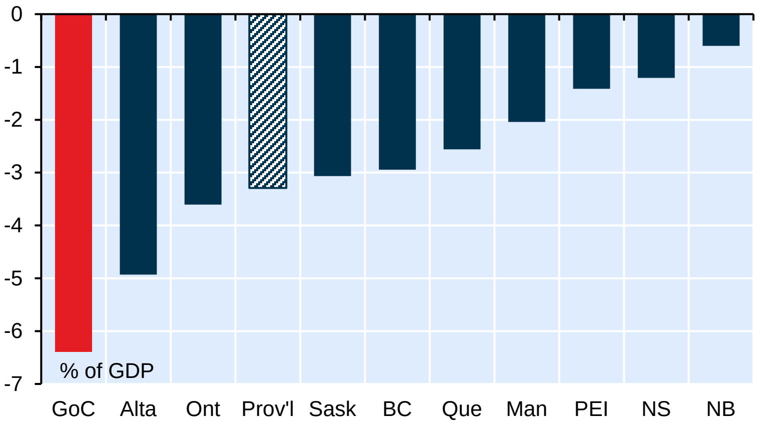
(9) **If you're a fiscal hawk, you'll need considerable patience with federal and provincial governments.** The federal government hasn't been in surplus since the Global Financial Crisis hit and still sees a

deficit of C$30 billion by 2025-26 (1.1% of GDP). Only a few provinces have planned for balance in the next few years; Nova Scotia expects to get there first (by 2024-25). For some, deficit reduction could take most (all?) of this decade to complete, if governments get there at all.

(10) **Take long-term fiscal guidance with a grain of a salt.** Faster and slower growth scenarios—a helpful addition to some budgets—show fiscal trajectories subject to considerable variation.

(11) **The feds will once again own the largest relative shortfall in 2021-22** at 6.4% of GDP, almost double the weighted average provincial deficit (3.3%). Provincially, Alberta has projected the largest deficit relative to GDP (~5%), whereas New Brunswick gets the medal for tiniest planned shortfall relative to GDP (less than 1%) (Chart C).

Chart C: Feds own largest shortfall, provi landscape varied
Federal & provincial budget balance: 2021-22



Source: NBF, fed-prov gov'ts | Note: Official budget projections applied to NBF forecasts for nominal GDP; provincial weighted average excludes N&L

(12) **Whether fully needed or not, additional stimulus is being offered up federally and provincially.** There are two main thrusts to this effort: (i) shorter-term protections to bolster health systems and aid the vulnerable; (ii) longer-term, structural policies (infrastructure investment and the federal move on national childcare being obvious examples). The largest spender? That's easy. It's still Ottawa.

(13) **Fiscal investments slow near-term progress on the deficit but bolster confidence in the recovery.** The feds, for instance, see their fresh package (fully C$100 billion over three years) adding 1½-2%-pts to annual real GDP growth, spurring meaningful job creation. Even more striking are the fiscal plans outlined by President Biden—that's shock and awe fiscal stimulus if we ever saw it.

(14) By speeding closure of output gaps, **a still-strong fiscal impulse argues for/permits the removal of extreme monetary policy accommodation.** The process is already underway in Canada and could commence soon enough stateside. We've more conviction in this call, not less, having brought forward our timing for the first BoC rate hike to October 2022.

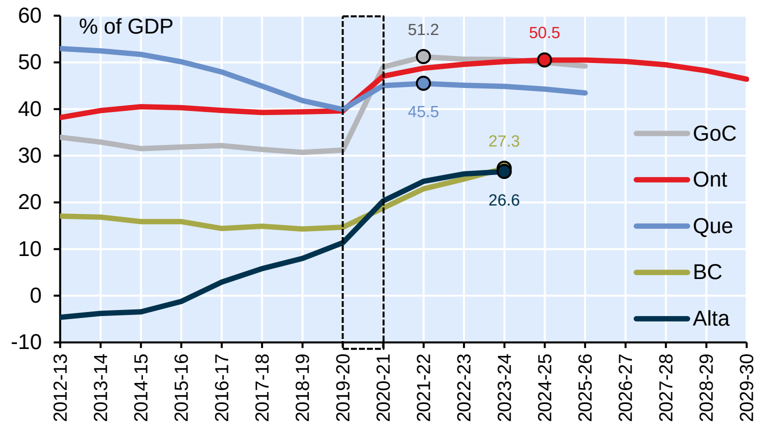
(15) While the feds have financed the lion's share of virus supports, **the provinces are still looking for *a lot* more from Ottawa.** Priority one remains a hefty and permanent increase in health transfers, far beyond March's one-time top. Provinces have also sought to have the cap on fiscal stabilization payments removed retroactively, a particularly hot button issue for resource-sensitive regions. So even as Chrystia Freeland pushed fresh stimulus to the top of the planned range, including funding for national childcare, provinces expressed deep disappointment with the 2021 federal budget.

Debt & interest burden: One is a bit ugly, the other not so much

(16) **Canada's general government debt shot higher in 2020-21.** Net debt surged C$363 billion federally and was up more than C$100 billion across the provincial sector. This extra leverage added almost 25%-pts to the combined fed-prov net debt-to-GDP ratio in 2021-22.

(17) **Balance sheet damage, in many ways, appears permanent.** Debt won't be repaid anytime soon (if ever). Think of this as a regime shift. For now, the goal is to slow the accumulation of *new* liabilities, allowing nominal GDP growth to flatten debt-to-GDP curves (Chart D). Have we mortgaged our future to fight the pandemic? In a sense, yes. Public sector balance sheets will almost certainly be in a relatively weaker position when the next recession hits.

Chart D: Regime shift in federal-provincial debt ratios
Net debt-to-GDP ratio

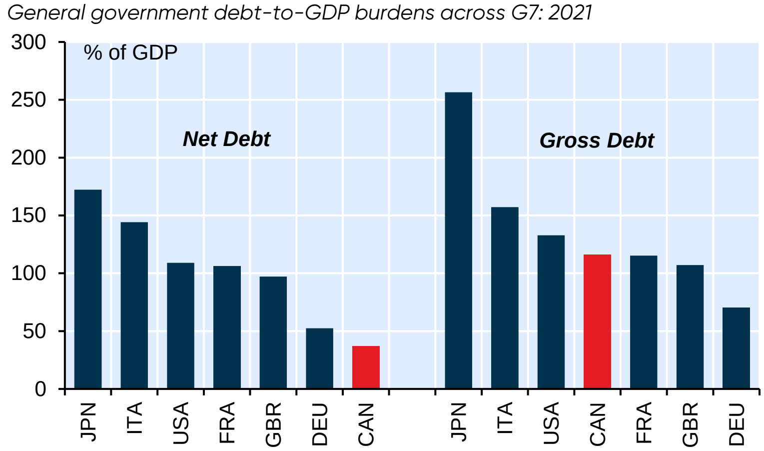


Source: NBF, fed-prov gov'ts | Note: Official projections as far into future as possible

(18) **The debt burden is now clearly heavier at the federal level, which if you're going to choose, is the level of government better equipped to carry marginal liabilities.** The feds, after all, possessed excess fiscal capacity and have theoretically less to worry about as populations age. Ottawa can likewise borrow larger (limitless?) amounts at cheaper rates from a broader array of investors. And it's GoC bonds, not provi paper, that Canada's monetary authority is still gobbling up via large scale Quantitative Easing.

(19) As we're forever reminded, **Canada's general government *net* debt burden remains at the low end of the spectrum vs. our G7 peers** (Chart E). This long-standing bragging right survives COVID.

Chart E: Canada has edge on *net* debt… less so on *gross*
General government debt-to-GDP burdens across G7: 2021



Source: NBF, IMF

(20) **Canada's edge on general government *gross* debt**, which in some cases is the debt metric rating agencies focus on, **isn't nearly as striking**. Debt burdens remain something of an Achilles heel when it comes to stand-alone credit profiles in Canada's public sector, in more than a few cases the scorecard element flashing red.

(21) **Governments are placing greater emphasis on the interest bite rather than the debt burden**. Example: "public debt charges as a per cent of GDP are expected to stay near their lowest level in over a century over the forecast horizon" *[Federal budget]* | "Despite increases in forecasted deficits and borrowing requirements caused by the COVID-19 pandemic, IOD-to-revenue over the medium term continues to remain lower than forecasted in the pre-pandemic 2019 Budget." *[Ontario budget]* | "Despite a substantial increase in debt, the proportion of revenue devoted to debt service will remain at a historic low due to the very low interest rates." *[Quebec budget]* The focus on debt affordability is both understandable and defensible.

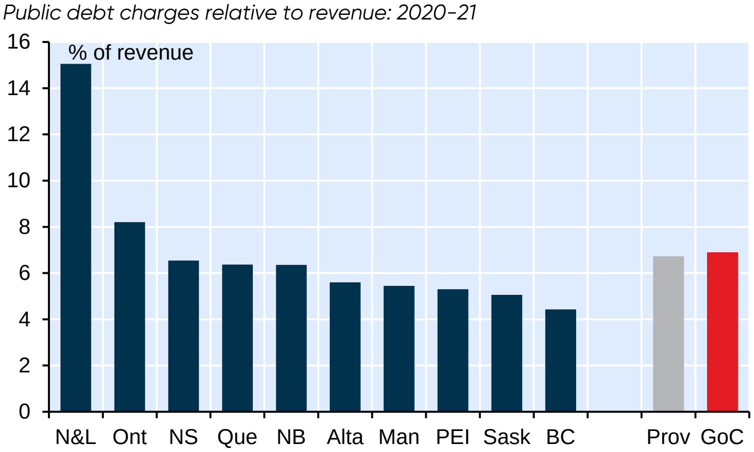
(22) **Even credit rating agencies are willing to concede that low interest rates make today's extra debt affordable.** Although interest rates have backed up (vs. last year), that partly reflects greater confidence in the global recovery. That in turn signifies more revenue to service debt. Interest charges will nonetheless be one of the fastest growing expenditure items for years to come, something of a deadweight loss fiscally speaking and arguing for fiscal repair.

(23) **If you're wondering which level of government is most exposed to interest rate reset risk, it's the feds more than the provinces.** Provinces have less short-term debt outstanding and their bond stock is of a longer weighted average term (i.e., it rolls slower). There are more legacy high-coupon securities outstanding provincially, where re-couponing is net favourable. We explored a host of related issues in an earlier note that put the interest bite in the spotlight.

(24) **Fiscal sensitivities highlight the compounding nature of interest rate surprises.** Federally, a 1%-pt jump in interest rates adds $1 billion to the interest bill in year one, growing to $4.6 billion by year five.

(25) If province-by-province comparisons are your thing, then **British Columbia gets a gold star for its lower interest bite**. Newfoundland and Labrador is at the other end of the spectrum (Chart F).

Chart F: How big an interest bite? Very much depends
Public debt charges relative to revenue: 2020-21



Source: NBF, fed-prov gov'ts | Note: Based on 2021 budgets or latest available estimate

(26) Despite the larger deficit and more rapid debt accumulation at the federal level, **the sovereign rating has been and likely will remain less at risk than in some provinces**. Note: After downgrading Canada last year, Fitch still looks to have more of an itch to scratch when it comes to Canada's sovereign rating. Moody's and S&P have been less alarmed with Ottawa's fiscal trajectory, the latter affirming Canada at AAA with a 'stable' outlook on April 26th.

(27) **Rating agency comments on provincial budgets have tended to emphasize credit negative elements.** That's not particularly surprising. There remain a number of negative outlooks (9 in total) to be resolved provincially. To us, ratings possess a degree of predictive power over relative credit spreads, so the upcoming rating report parade could be informative from a RV perspective.

Borrowing requirement & strategy: Less BoC absorption, more competition out the curve

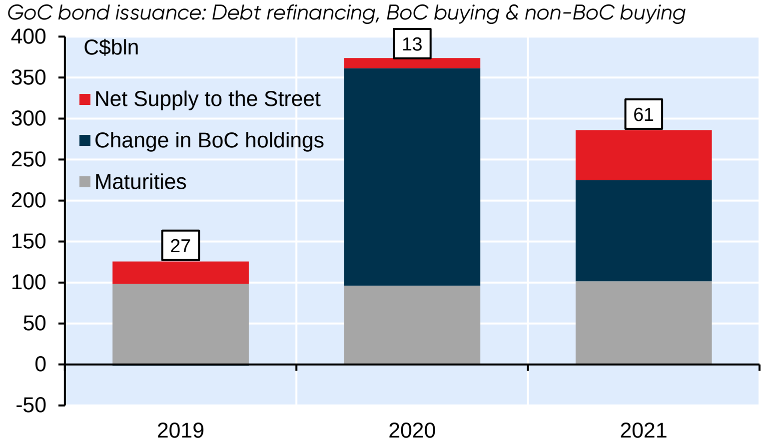
(28) Deficits + capital spending + other non-budgetary needs = **no shortage of high-grade Canadian government debt in 2021-22**. All told, federal-provincial long-term borrowing requirements stand at ~C$430 billion this fiscal year. Additionally, we'll get C$40 billion in gross CMB supply and C$6.0-6.5 billion in marketable muni bonds.

(29) Federally, we're due to get C$286 billion in gross bond issuance, down from the monumental lift undertaken last fiscal year but still more than double the pre-virus run rate. Refer to our earlier deep dive on the *Debt Management Strategy*. There's plenty of noise in economic/fiscal/financing assumptions, but **short-term markets can/will serve as something of shock absorber, adding predictability to the GoC bond program**.

(30) **The federal government's term-out strategy has been thrown into overdrive.** Markets will see more longer-term issuance despite a smaller overall GoC bond program for 2021-22. The average term of new GoC supply could reach 9 years, up from what had been closer to 5 years pre-virus. By advanced economy standards, IMF analysis suggests Canada's central government has a relatively short(er) debt portfolio, which could help explain the ongoing fixation with terming out (even when faced with a much steeper yield curve).

(31) Netting off retirements and BoC purchases, net GoC bond supply to the Street looks to be about C$60 billion in 2021-22—a notable pick-up relative to last fiscal year (when QE sopped up most everything) or the pre-COVID trend. **The BoC, while still a major player, simply won't be vacuuming up as much paper in 2021-22.** Nor will the Bank be offsetting a portion of net provincial supply as they did last fiscal year via C$17 billion in direct provi bond buying.

Chart G: Fewer GoCs auctioned, but supply to investors up
GoC bond issuance: Debt refinancing, BoC buying & non-BoC buying



Source: NBF, BoC, fed budget | Note: Total bar = gross issuance; year refers to fiscal year (e.g. 2021 = 2021-22); assumes C$125 of gross QE in 2021-22 fiscal year

(32) Provincially, gross bond requirements (all markets) are provisionally set at C$144 billion (Table). That's down somewhat from the ~C$160 billion completed in 2020-21 but would far surpass the amount routinely printed pre-COVID. On one hand, conservative assumptions and built-in prudence could mean smaller-than-planned deficits and less to borrow. Conversely, still-elevated requirements beyond 2021-22 and an expectation of higher interest rates down the road offer an incentive to pre-fund. On balance, **we'll be looking for ~C$150 billion of gross provincial bond issuance in fiscal 2021-22**. Assuming the domestic market receives about 70%, then the equivalent of C$45bln (or thereabouts) could be steered internationally. For reference, international issuance had tended to average ~C$20 billion a year post-GFC/pre-COVID.

Table: Taking stock of provincial bond programs
Provincial gross long-term borrowing requirements: 2021-22

Province / Agency	Required[a] C$bln 2021-22	Required[a] C$/per capita 2021-22
British Columbia	19.25	3,735
Alberta	22.49	5,069
Saskatchewan	4.10	3,478
Manitoba	4.90	3,549
Ontario[c]	53.90	3,653
Québec[d]	28.46	3,727
Hydro-Québec[e,f]	3.50	
New Brunswick[g]	1.85	2,365
Nova Scotia	2.21	2,256
Prince Edward Island	0.20	1,251
Newfoundland & Labrador[h]	3.00	5,764
TOTAL	**143.9**	**3,794**

Source: NBF, prov budgets, StatCan | Notes: (a) Long-term gross funding requirement; where available, funding requirement based on official sources; excludes pre-funding for coming fiscal year; (c) includes certain hydro-related financing under province's banner; (d) includes financing for Financement-Québec; (e) funds in own name with explicit provincial guarantee; (f) fiscal year is Jan-Dec; (g) includes requirements for NB Municipal Finance Corp; (h) NBF estimate as 2021 budget not yet presented, includes funding for N&L Hydro; per capita requirements are based on 2021:Q1 population projections

(33) **In the Maritimes,** where the virus has been bettered contained and fiscal fallout is far less pronounced, **per capita borrowing needs are decidedly below average.** For example, New Brunswick's per capita bond program (including needs for MFC) is more than 40% below the weighted average. It's a similar story in Nova Scotia. Technically no province has a smaller per capita bond program than PEI. Per capita requirements generally jive with Chart C (page 2).

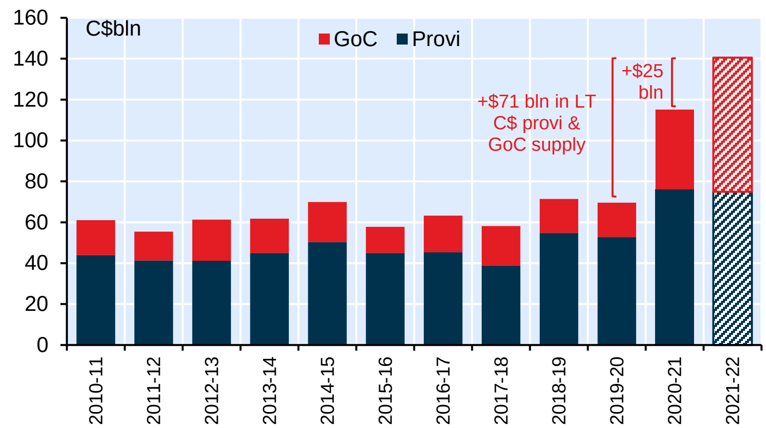
(34) Roughly C$50 billion provincial bonds will mature in fiscal 2021-22. Thus, **net provincial bond supply could be closer to C$100 billion across all markets, no small nut to crack** and a potential headwind for spreads (given less active BoC bond buying).

(35) As expected, provincial credit spreads have survived the announced termination of the BoC's Provincial Bond Purchase Program. That's not to say there's been no re-pricing of provi credit lately. **Ten-year provincials, having earlier underperformed on the curve, are regaining some traction; meanwhile peripheral names have enjoyed quite a run vs. Ontario**. Is this latter phenomenon overdone? Not necessarily. There are cyclical, fundamental and/or technical reasons supporting certain of these peripheral basis spreads.

(36) In keeping with well-established seasonal patterns, **provincial funding activity got off to a fast start in April**. Ontario and Quebec, for example, have needed very little time to knock off 15% of their full-year programs. (This fiscal year is 7% elapsed.) Activity can be expected to remain brisk in the coming weeks/months, issuing windows being fully utilized and investor demand/strength regularly met with new supply. Calendar Q2 (i.e. April-June) tends to be the busiest quarter of the year for the provinces; it's been tops in terms of quarterly bond supply in 8 of the past 11 years.

(37) This month's activity has highlighted an ongoing receptivity for provincial risk in longer tenors, an encouraging development to be sure. If anything, federal-provincial issuance in the 10- and 30-year sectors looks to expand, particularly once you control for reduced BoC bond purchases (Chart H). We don't foresee a massive crowding out effect, but **provinces could (if necessary) slide some supply down the curve and/or into foreign currency markets**.

Chart H: More competition for investor dollars in longer end
Long-term domestic GoC/provi bond supply (8Y+) less BoC purchases



Source: NBF, BoC, fed-prov gov'ts | Note: Domestic issuance only; long-term refers to issuance & purchase of 8-year & longer bonds; dashed bars are NBF projections; assumes same BoC QE purchase composition as current YTD; PBPP 8-year and longer purchases (from May-20 to May-21) estimated at 25% of program total

(38) Notwithstanding a desire to divert supply to deep international markets, **provinces remain sensitive to the cost of accessing foreign markets**. USD funding arbs have moved a bit offside of late, with market depth remaining inversely related to tenor and 10-year demand having more recently been sated by SSAs. It only takes a trade or two to reprice international markets. Finally, with yields higher in the U.S. and less certainty as to achievable term, provinces could turn their attention to Europe.

(39) **The green bond space will be even more active.** Provinces like Ontario have been leading the way in Canada, but the feds will throw their hat in the ring soon enough via C$5 billion of planned issuance in a yet-to-be-announced tenor. Think of this as a tangible example of a growing ESG focus—a tectonic shift that is increasingly influencing behavior, policy development, portfolio management and credit risk assessment. Overlook ESG risks at your peril.

(40) Finally, if you put any stock in longer-term projections, it looks like elevated bond issuance will be with us for a while. Yes, Ottawa and the provinces expect to make progress on deficits in 2022-23 and beyond. But **we'll start to see maturities accumulate, holding up gross levels of supply even as economies distance themselves from COVID-19**.

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