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Deuces are wild [a comparison of Canada-US fiscal sustainability]

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The US and Canada: Two countries, with two independent budget watchdogs, releasing two long-term budgetary assessments, on two consecutive days, the latter keying on two levels of government, revealing (or rather confirming) two fundamentally different fiscal trajectories.

The first report (US): Congressional Budget Office (CBO) – The 2022 Long-Term Budget Outlook (July 27th)

Based on current tax and spending policies, the US federal deficit is expected to grow over the coming decade(s). That's not the most shocking finding. Still, the compounding of budget shortfall on budget shortfall, combined with higher interest rates, paints a sobering fiscal picture. Based on the CBO's latest projections, an average deficit of 7.3% of GDP from 2022 to 2052 would be more than 2X the long-term average, a growing share of that fiscal gap comprised of interest charges. Debt is no longer free and there will be no shortage of it, even as the Fed maneuvers to lighten up its Treasury holdings. US publicly held debt is currently hovering around 100% of GDP, held back for the moment by sturdy nominal growth. But the debt burden is likely to reach a new high in less than 10 years (2031), taking aim at 185% of GDP by 2052 (barring corrective policy action and based on a reasonable economic forecast).

As per the CBO report: *"Debt that is high and rising as a percentage of GDP could slow economic growth, push up interest payments to foreign holders of U.S. debt, heighten the risk of a fiscal crisis, elevate the likelihood of less abrupt adverse effects, make the U.S. fiscal position more vulnerable to an increase in interest rates, and cause lawmakers to feel more constrained in their policy choices."* Doesn't sound like the healthiest fiscal path for a sovereign nation. Of course, as the world's foremost safe haven, the US can run relatively irresponsible budgetary policies for some time without alienating investors too badly. We've seen this time and again. Still, if the CBO's figures are on the mark, there's going to be no shortage of net UST issuance and an ever-growing glut of debt to roll for as long as you care to dream.

The second report (Canada): Office of the Parliamentary Budget Officer (PBO) – Fiscal Sustainability Report 2022 (July 28th)

Like the CBO's long-term analysis, the PBO's report projects current policies forward in an attempt to assess how (un)sustainable a fiscal path Canadian governments may be walking. The added twist here is that projections extend to subnational governments and to the nation's public pension plans. In this way, the PBO paints a more comprehensive picture of Canada's general government sector.

Contrasting with the US outlook, Canada's sovereign remains on a sustainable fiscal path, characterized by a declining debt burden over time. The PBO sees Ottawa with excess fiscal room equivalent to 1.8% of GDP or C$45 billion in current dollars. There's been a material improvement relative to the prior assessment, as revenue moved onto a firmer glidepath while an improved demographic/economic outlook eased related outlays. Perhaps we needn't worry *too* much about the pandemic-era shortfalls that were rung up or the residual red ink still being spilled by a minority Liberal government. Rather, it seems the feds have excess wiggle room to cut taxes, increase direct spending and/or boost transfers without putting debt on a rising trajectory. Any number of competing sovereigns are presumably green with envy.

There was encouraging news for the provinces too. Collectively, the provincial sector was deemed fiscally sustainable (or very close to it). Technically, the PBO identified a relatively tiny fiscal gap of 0.1% of GDP. But given the uncertainty and assumptions embedded in this type of analysis, you could treat this as zero. It implies little to no collective action is needed to keep the average debt burden (currently ~25% of GDP) from rising over time. Like the feds, the provincial outlook has improved nicely from the last report, when the combined gap stood at 0.8% of GDP. As per the PBO report: *"Based on recent budget plans, the medium-term outlook for provincial and territorial government own-source revenues has been revised up significantly in most provinces and, consistent with our methodology, we assume that the revision carries through to the long term. The upward revision to subnational own-source revenues is only partially offset by upward revisions to program spending."*

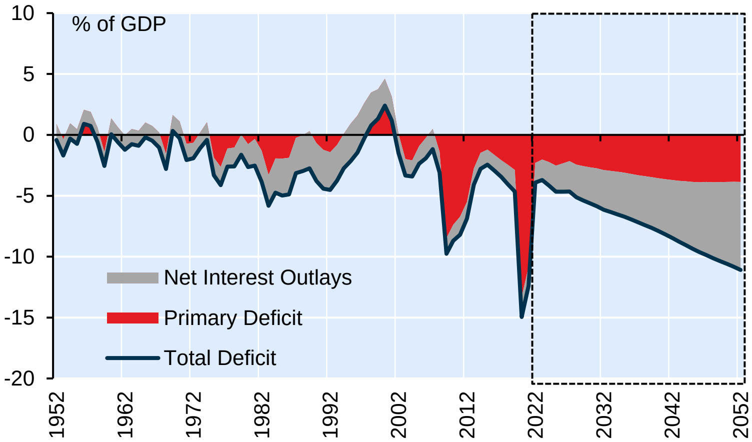
So provincial revenue is flowing in the door faster than expected. Notwithstanding new commitments, budget balances are much improved, the resulting debt burdens materially recast to the better. We've been arguing for over a year now that the provincial sector has entered into an immensely constructive budgetary window, arresting a decade-long erosion in average credit quality. At the margin, the PBO report reinforces this narrative. Importantly, fiscal repair has translated into appreciably lower borrowing requirements, making the Bank of Canada's ongoing balance sheet run-off less of a worry, directly for the feds and indirectly for the provinces.

That's not to say that all is hunky-dory in provi land. The geopolitical backdrop is unsettled; the virus (and related supply chain worries) have yet to be vanquished; inflation is far too high, keying a belated but dramatic monetary policy tightening exercise. The US may not be in an "official" recession, but the loss of momentum in Canada's largest trading partner is doubtless concerning. Canada's economy is feeling the effects of abrupt policy normalization, with housing markets rolling over and consumers less enthusiastic. It's not the most sanguine economic outlook one could conjure up for a finance minister. Moreover, Canada's provinces remain a diverse group in terms of economic make-up and fiscal pressure points. That was once again evident in the PBO's estimates of province-by-province fiscal capacity.

Four provinces are deemed fiscally sustainable. Quebec and Nova Scotia have been here before, but Alberta and Saskatchewan have seen their fortunes rise empathetically. That leaves six provinces (plus the territories) in less sustainable territory, although we hasten to add that the estimated fiscal gaps in Ontario (0.2% of GDP), New Brunswick (0.6%) and British Columbia (0.9%) aren't all that large. There's some work to be done in some corners. Thankfully, the province with the largest fiscal gap—Newfoundland and Labrador—is enjoying a cyclical recovery.

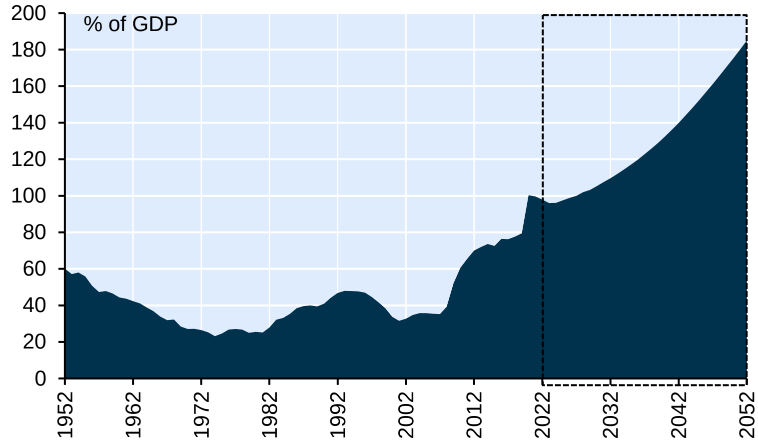
Infrequent fiscal sustainability reports aren't your standard catalysts for re-pricing, but to us, they reinforce the following bias (ceteris paribus): Support for longer-dated Canadas, consistent with a flatter curve (5s-30s, 10s-30s) and lower cross-market yields out the curve, while the front-end is clearly more influenced by the evolving policy rate outlook; fundamental and technical support for provincial spreads, with premium Quebec yields well founded and our existing long-Alberta and long-Saskatchewan recommendations finding marginal support here.

Chart 1: Above-average US deficits may become the norm
US federal budget balance, incl. CBO long-term outlook



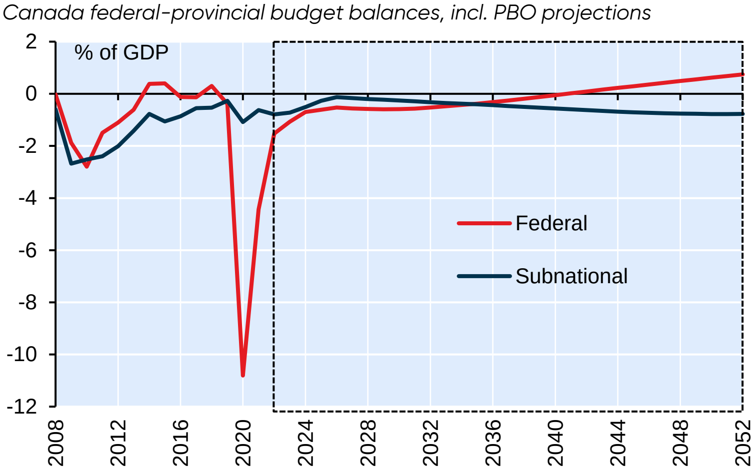
Source: NBF, CBO | Note: Projections starting from 2022

Chart 2: US debt burden up, up and away?!
US federal publicly held debt outlook, incl. CBO long-term outlook



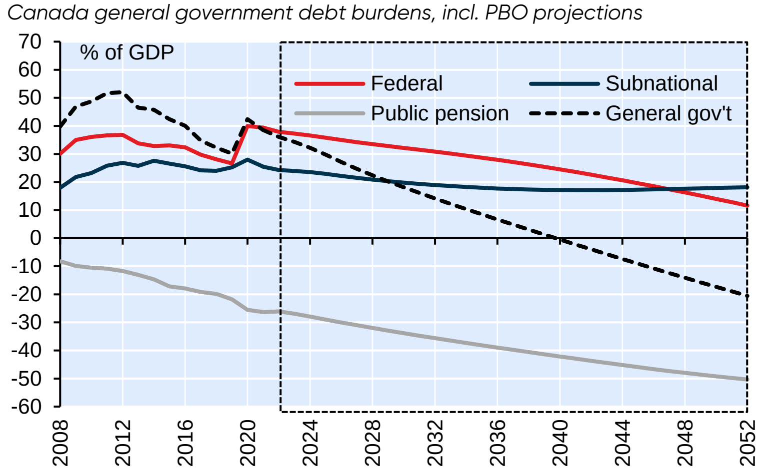
Source: NBF, CBO | Note: Projections starting from 2022

Chart 3: Much less red ink in Canada (federally and provincially)
Canada federal-provincial budget balances, incl. PBO projections



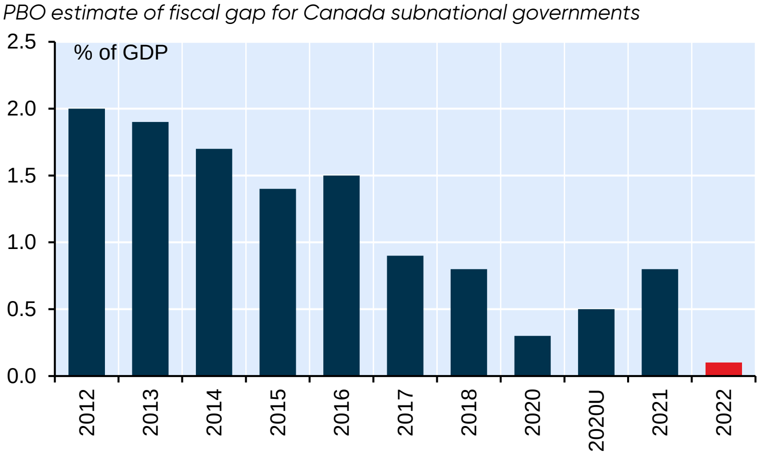
Source: NBF, PBO

Chart 4: Detailing the general government debt outlook
Canada general government debt burdens, incl. PBO projections



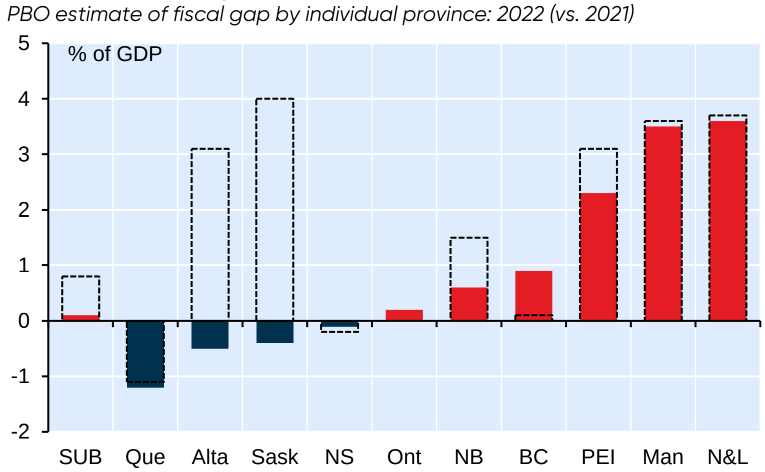
Source: NBF, PBO | Note: Projections starting from 2022

Chart 5: Provinces have made important fiscal progress
PBO estimate of fiscal gap for Canada subnational governments



Source: NBF, PBO | Note: No FSR in 2019, with two projections made in 2020

Chart 6: Assessing fiscal sustainability across provinces
PBO estimate of fiscal gap by individual province: 2022 (vs. 2021)



Source: NBF, PBO | Note: -ve figures imply excess fiscal capacity; dotted bars reflect PBO's assessment of provincial fiscal gaps from 2021

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