November 4, 2021

Ontario on distinctly firmer path as 2022 election comes into focus

By Warren Lovely

Highlights

Can you recall an Ontario mid-year update making such an overwhelmingly positive adjustment to the fiscal trajectory? Didn't think so. This was a striking one, even if we saw it coming after the public accounts. A resilient/robust economy and the massively positive prior-year handoff sees the 2021-22 deficit cut $11.6 billion to $21.5 billion (2.3% of GDP). Future year deficits were likewise marked down significantly, Ontario's red ink getting absorbed more quickly than previously telegraphed. There's no official word on the return to balance—that will come in next year's budget—but the road ahead is undeniably friendlier than what was envisioned back in March. While not to be confused with a budget, Ontario's FES made some new policy announcements, largely in the vein of supporting business, enhancing infrastructure, strengthening the labour market, promoting skills/training. Factoring in the good news from the 2020-21 public accounts, net debt will end the year substantially lower than planned. And considering red-hot nominal output growth, Ontario's relatively high debt-to-GDP ratio was placed on a lower/shallower trajectory (that key metric is now estimated at 43.4% for 2021-22 vs. 48.8% in budget). Meanwhile, a 7.7% interest bite signifies an affordable debt load. There's roughly $40 billion less to borrow over three years, the 2021-22 long-term requirement cut to $42 billion (from $54.7 billion). Being 69% funded, Ontario is well advanced against its new, lower program, with at least $6 billion of pre-funding expected towards 2022-23. There should be little difficulty funding the balance of this year's program, with apparent fiscal upside and evident investor demand suggesting a larger amount of pre-funding might ultimately materialize. While the public accounts had set us up for a significant fiscal enhancement, it's nonetheless encouraging to see the skinnier deficits, relatively lower debt burden and lighter borrowing program extended (quasi-permanently) into future years. Overall, Ontario's mid-year is both fundamentally and technically supportive of spreads, even if a lot of fiscal/financing good news had already been discounted.

- Economic outlook — A significant recovery has economic growth on a firmer footing than what was assumed in March's budget. Ontario's forecast for 2021 real GDP growth has been nudged up from 4.0% to 4.3%, this improved pace standing three ticks shy of the private sector consensus. Economic momentum is expected to carry over to next year, where real growth of 4.5% is now anticipated. Here again, the planning assumption has been set a bit below consensus. Nominal growth, the better proxy for own-source revenue, has bounded higher in Ontario and across much of the country. The province now plans for 9% nominal GDP this year, the average private sector forecast currently expressed in double digits (10.1%). There's some uncertainty on nominal growth to be sure. But as with real GDP, another above-trend tally is expected in 2022, nominal output expanding by a projected 6.6%. The finer details of Ontario's current-year outlook reveal noted upgrades to many other forecast elements: job growth, employee compensation, household consumption, housing starts/resales, home prices and corporate profits. Forecast revisions speak to the resilience of Ontario's large domestic economy. Of note, a recent hiring spree has pushed employment above the pre-pandemic level, even if labour force growth has left 2021's jobless rate forecast unchanged. The external backdrop is likewise brighter, U.S. growth proving more forceful than what was assumed in the spring. As implied from the nominal GDP adjustment, inflation is running much hotter-than-expected, Ontario's full-year all-items CPI inflation rate now estimated at 3.1% for 2021 (vs. 1.7% in Budget). Overall, this is a buoyant economic outlook, one clearly supportive of revenue growth and conducive to fiscal consolidation.

Summary of Ontario's Economic Outlook

(Per Cent)

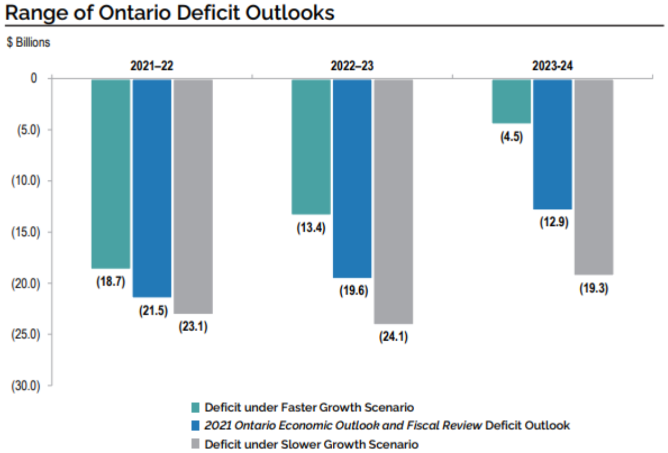
	2020	2021p	2022p	2023p	2024p
Real GDP Growth	(5.1)	4.3	4.5	2.6	2.0
Nominal GDP Growth	(4.6)	9.0	6.6	4.6	4.1
Employment Growth	(4.8)	4.3	3.3	2.0	1.5
CPI Inflation	0.7	3.1	2.6	2.1	1.9

p = Ontario Ministry of Finance planning projection based on external sources.
Sources: Statistics Canada and Ontario Ministry of Finance.

- Revised 2021-22 budgetary outlook — Today's robust economy, combined with a much stronger handoff from the prior fiscal year (confirmed in the 2020-21 public accounts), allows for a material improvement in Ontario's finances. The 2021-22 deficit has been marked down to $21.5 billion (2.3% of GDP), a net improvement of $11.6 billion vs. March. Notwithstanding this significant budgetary upgrade, we view the revised deficit figure as somewhat conservative (i.e., beatable). The full $1 billion reserve established with the budget remains intact, on top of $1.4 billion in unused standard contingencies. A net $2.2 billion remains in a separate time-limited COVID contingency fund should additional pandemic pressures materialize. Residual padding, combined with the prudent economic assumptions outlined above, hint at additional fiscal flexibility as the 2022 budget approaches. That could translate into an even smaller deficit that what was telegraphed today. Alternatively, marginal fiscal room could be used to finance new budget initiatives (e.g., tax relief and/or new spending) ahead of a scheduled June 2022 provincial general election.

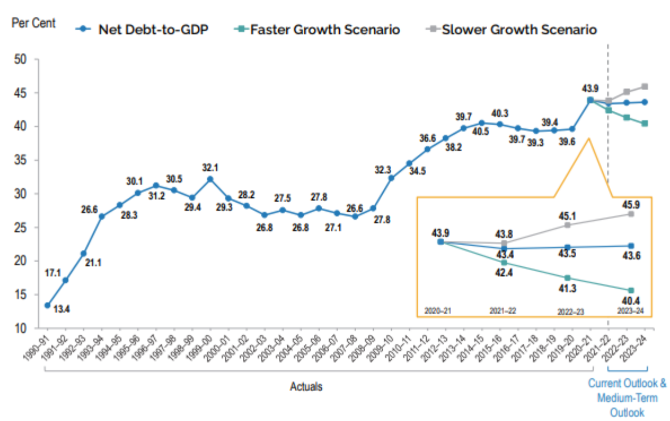
- **Current year revenue outlook** – Recall that Ontario's Q1 update acknowledged some initial improvement to the revenue outlook. Today's mid-year kicked that upgrade into high gear, leaving revenue $14.6 billion or 9.5% above the original budget plan. Any number of own-source revenue streams have firmed, and the associated narratives ring true to us: compensation growth and stronger prior-year returns have spurred personal income tax revenue; sales tax revenue has been bolstered by solid consumer spending and housing completions; elevated home resales have propelled land transfer tax revenue; corporate profitability has improved smartly. There's more money from the feds too, although a lot of that had been captured in the Q1 fiscal update.
- **Current year spending outlook** – Compared to the $14.6 billion improvement in revenue, total spending is up less than $3 billion (~1½%) relative to budget. Today's mid-year added less than $800 million in net spending, as a drawdown of contingencies partially offset the cost of some measures. Interest on debt (IOD) is coming in below budget. That's been a long-standing theme, with more colour on the evolving IOD outlook provided below. All this is not to suggest a particularly lean expenditure profile. Base program spending will expand by more than 10% this fiscal year, downshifting to an average annual rate of 3% in the final years of three-year planning horizon.
- **New initiatives** – More than a mere fiscal updating, Ontario used its mid-year statement to initiate or enhance certain policies. Provincial businesses will benefit from a variety of cost saving initiatives, the majority geared to small enterprises. There was marginal infrastructure money designed to spur key projects (including vital transportation and information networks). The province will invest more in skills/training. An increase in the general minimum wage, to $15/hour starting in 2022, had been confirmed in the lead up to this statement. A new, temporary "Staycation Tax Credit" will be offered in 2022, meant to encourage in-province tourism. There were other items, which collectively might be thought of as a warm-up act for Budget 2022.
- **Medium-term fiscal plan** – After the astonishing budget beat in 2020-21 and the new-and-improved (yet still-beatable) deficit tally for 2021-22, what lies in store for future fiscal years? Today's statement signals a deficit of $19.6 billion in 2022-23, followed by a $12.9 billion shortfall in 2023-24. Ontario outlined a probable deficit range based on faster/slower growth scenarios, illustrated below. As with the current fiscal year, there's prudence in the medium term in the form of reserves and contingencies. Unlike a budget, there's no requirement to present/update the longer-term fiscal recovery plan, so we'll need to wait for Budget 2022 to see what the government really has in mind there. It would seem, however, that the fiscal road ahead is considerably friendlier, budgetary balance to be achieved more easily and/or more quickly than previously telegraphed. By way of illustration, the new baseline for the 2023-24 deficit stands inside of Budget 2021's most optimistic scenario, which at that time implied deficit elimination by 2027-28. In addition to economic uncertainty, the medium-term budgetary trajectory could be impacted by future policy announcements, with some additional pledges likely before Ontarians head to the polls in June 2022.

Range of Ontario Deficit Outlooks



Source: Ontario Ministry of Finance.

Net Debt-to-GDP

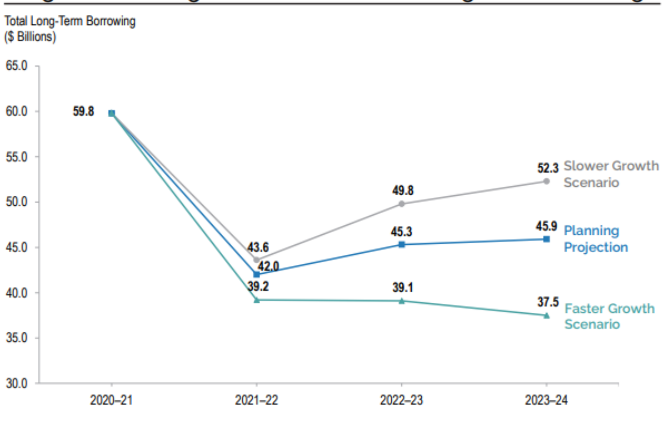


Sources: Statistics Canada and Ontario Ministry of Finance.

- **Debt burden & interest bite** – Ontario's debt has been dramatically recast relative to budget, the prior fiscal year ending on a much stronger footing and the current fiscal year's deficit likewise marked down in no small way. As it stands, Ontario expects net debt to end 2021-22 at $402 billion, erasing $38 billion in net liabilities relative to March's forecast. Layer in buoyant nominal GDP and the resulting debt-to-GDP ratio has been placed on lower/shallower path. For 2021-22, the debt burden is equivalent to 43.4% of GDP, down 0.5%-pts vs. the prior year and standing approximately 5½%-pts south of the original budget forecast (48.8%). Under baseline economic assumptions, debt-to-GDP would hold relatively steady through 2023-24. Ontario emphasizes two other debt metrics. Based on the net debt-to-revenue ratio, leverage would climb to new heights: 239% in 2021-22, rising to 253% by 2023-24. Turning to the interest bite—a measure we put a lot of stock in—debt appears genuinely affordable. Interest charges are set to consume 7.7 cents of the revenue dollar in 2021-22, lower than originally forecast and comfortably below the prior 10-year average (8.4%). Ontario has allowed for a steady increase in its borrowing rates, from an average of 1.9% in 2021-22 to 3.2% by 2023-24. Even still, the relative interest bite doesn't look to increase much over the coming two years. Look for interest rate assumptions to be closely scrutinized here and elsewhere now that the Bank of Canada is closer to policy rate hikes. But having successfully and consistently locked-in so much of its debt longer term, refinancing risk is relatively limited. Testifying to defensive risk management, Ontario's net interest rate resetting exposure of 9.9% remains far below the policy limit of 35%. The average term of current year funding is a relatively long 14.5 years, the term of the entire debt stock now 10.9 years. It hasn't been higher/longer since the GFC hit. Meanwhile, official sensitivities suggest a 1%-point 'surprise' in interest rates would amount to roughly $700 million in marginal interest charges in year one. Put another way, embedded budgetary prudence appears sufficient to offset a faster-than-expected jump in interest rates should the BoC opt for aggressive rate normalization.

- **Long-term borrowing requirement (2021-22 & beyond)** — It should follow from the substantial reduction in net debt that Ontario's borrowing needs have moved decisively lower in 2021-22. Officially, the long-term public borrowing requirement has been cut $12.7 billion to $42 billion. This year's program could have been lowered even more (given the extra cash from 2020-21 and smaller shortfall for 2021-22), but Ontario signaled a desire to pre-fund at least $6 billion of next year's requirement early. That's a sensible strategy in our opinion, given evident market capacity and an expectation of rising interest rates ahead. Short-term outstandings will also increase by a smaller-than-projected amount. Of this year's $42 billion bond program, $28.8 billion has been completed, the funded ratio currently a snick under 70%. Just over three quarters of completed financings have been steered to the domestic market, the full-year target maintained at 65-80%. Canadian dollar funding includes the largest-ever Ontario green bond: $2.75 billion. That was Ontario's tenth green bond, with the financing strategy reiterating a desire to issue 'multiple' green bonds per fiscal year, at least one other green trade therefore coming before March 2022. Consistent with the stronger budgetary picture, medium-term bond requirements have moved onto a lower plane vs. budget. Looking at the full three-year period covering 2021-22 to 2023-24, there's roughly $40 billion less borrowing to do—a technical plus for provincial debt markets in general and this issuer in particular. As with the key fiscal elements, Ontario presents alternative paths for long-term borrowing under faster and slower growth scenarios. These are illustrated below. Notwithstanding consistent/demonstrated access to debt capital markets, liquid reserves continue to build, likely ending the fiscal year near $50 billion and thus providing a significant liquidity buffer in the event of extreme financial market duress. Ontario likewise has meaningful undrawn capacity in the short-term markets, equivalent to $38 billion currently.

Range of Borrowing Outlook Scenarios for Long-Term Borrowing



Sources: Ontario Financing Authority and Ontario Ministry of Finance.

- **Current long-term credit ratings** — S&P: A+, Stable | Moody's: Aa3, Stable | DBRS: AA(Low), Stable | Fitch: AA-, Stable
  [Refer to our Provincial Ratings Snapshot for additional colour on specific credit rating drivers/considerations]

Fiscal Summary

($ Billions)

	Actual	Current Outlook	Medium-Term Outlook	
	2020–21	2021–22	2022–23	2023–24
Revenue	**164.9**	**168.6**	**171.5**	**178.0**
Expense				
Programs	169.0	176.1	176.4	175.6
Interest on Debt	12.3	13.0	13.1	13.8
Total Expense	**181.3**	**189.1**	**189.6**	**189.5**
Surplus/(Deficit) Before Reserve	**(16.4)**	**(20.5)**	**(18.1)**	**(11.4)**
Reserve	–	1.0	1.5	1.5
Surplus/(Deficit)	**(16.4)**	**(21.5)**	**(19.6)**	**(12.9)**
Net Debt as a Per Cent of GDP	43.9%	43.4%	43.5%	43.6%
Net Debt as a Per Cent of Revenue	226.5%	238.7%	251.0%	253.3%
Interest on Debt as Per Cent of Revenue	7.4%	7.7%	7.7%	7.8%

Note: Numbers may not add due to rounding.
Sources: Ontario Treasury Board Secretariat and Ontario Ministry of Finance.

2021–22 Borrowing Program and Medium-Term Outlook

($ Billions)

	2021 Budget	In-Year Change	Current Outlook	Medium-Term Outlook	
			2021–22	2022–23	2023–24
Deficit/(Surplus)	33.1	(11.6)	21.5	19.6	12.9
Investment in Capital Assets	11.8	0.1	11.9	12.7	12.2
Non-Cash Adjustments	(9.5)	–	(9.5)	(9.5)	(9.5)
Loans to Infrastructure Ontario	0.2	(0.0)	0.2	(0.1)	(0.0)
Other Net Loans/Investments	1.3	(0.3)	1.0	0.3	(1.0)
Debt Maturities/Redemptions	25.0	(0.0)	25.0	30.5	31.2
Total Funding Requirement	**61.9**	**(11.8)**	**50.1**	**53.3**	**45.9**
Decrease/(Increase) in Short-Term Borrowing	(6.0)	4.0	(2.0)	(2.0)	–
Increase/(Decrease) in Cash and Cash Equivalents	4.0	–	4.0	–	–
Pre-borrowing in 2020–21 for 2021–22	(5.2)	(10.9)	(16.2)	–	–
Pre-borrowing for 2022–23	–	6.0	6.0	(6.0)	–
Total Long-Term Public Borrowing	**54.7**	**(12.7)**	**42.0**	**45.3**	**45.9**

Note: Numbers may not add due to rounding.
Source: Ontario Financing Authority.

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