Market View
Economics and Strategy

November 6, 2023 - (Vol. VII, No. 82)

Ontario: Back in the saddle, riding hard & fast

By Warren Lovely

Giddy up! That might have been the unofficial/working title of the Ontario Financing Authority's freshly released suite of IR material, which includes a handy 4-page brief, a comprehensive presentation and another useful episode of CEO's Corner (with Gadi Mayman).

Canada's largest province now looks to get back in the saddle. We expect this province to be riding hard and fast, accessing debt capital markets at home and abroad… frequently and/or in size.

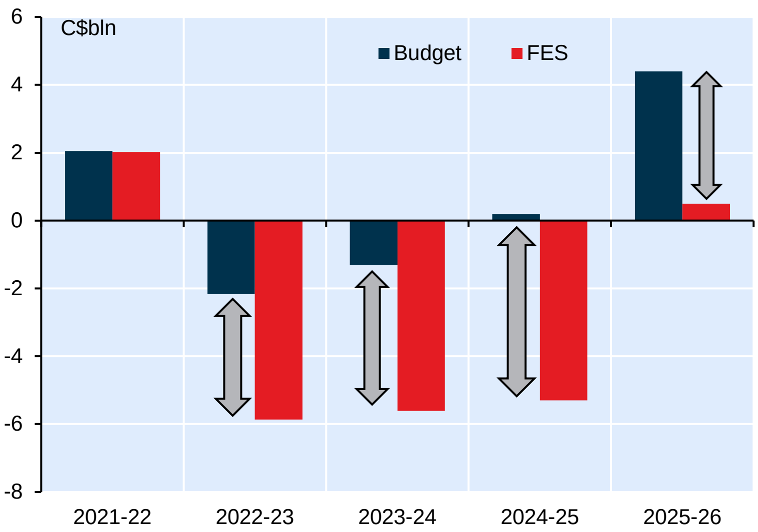
In case you missed it, Ontario's November 2nd Fall Economic Statement (FES for short) ushered in a whole set of revised figures/estimates/forecasts for the economy and the budget. Our detailed write-up is here. In the simplest and narrowest of terms, the story goes something like this: growth is slower, the deficit is bigger and there's more borrowing to do.

It's the last of these concepts—borrowing—that we wish to focus on here. In particular, we have structured this *Market View* to provide colour and context as it relates to Ontario's revised borrowing needs:

- We explore the rather direct connection between the updated budget balance trajectory (weaker) and revised borrowing needs (larger);
- We put Ontario's long-term borrowing requirement into context, comparing the latest adjustments to recent years and reflecting on what might have been considered 'normal' borrowing conditions pre-COVID;
- We highlight the still-uncertain nature of the underlying fiscal backdrop and cite other factors, like pre-funding, that could see actual borrowing deviate from the official requirement;
- We assess where things stand in terms of funded status and just how much Ontario's borrowing tempo needs to pick up;
- We illustrate how this high-frequency issuer may approach the market, with the province having clearly identified core foreign currency markets as a place to secure marginal borrowing;
- We reflect on the relative cost of foreign currency funding, while simultaneously eying some convenient holes in Ontario's foreign currency bond maturity profile;
- We provide some context on the province's strategic green bond program, where investors should be prepared for two offerings before the end of fiscal 2023-24, including one in short order;
- We highlight how much success Ontario (and other provinces) have had securing long-term funding, which creates scope to move down the yield curve to less risky tenors if absolutely necessary;
- And we give a sense of where provincial spreads are trading.

Yes, it's a lot, but we're talking about a very important Canadian bond issuers… one that can really set the tone for the broader public sector credit market. And this is hardly an academic exercise, with plenty of fresh product headed our way. Giddy up indeed!

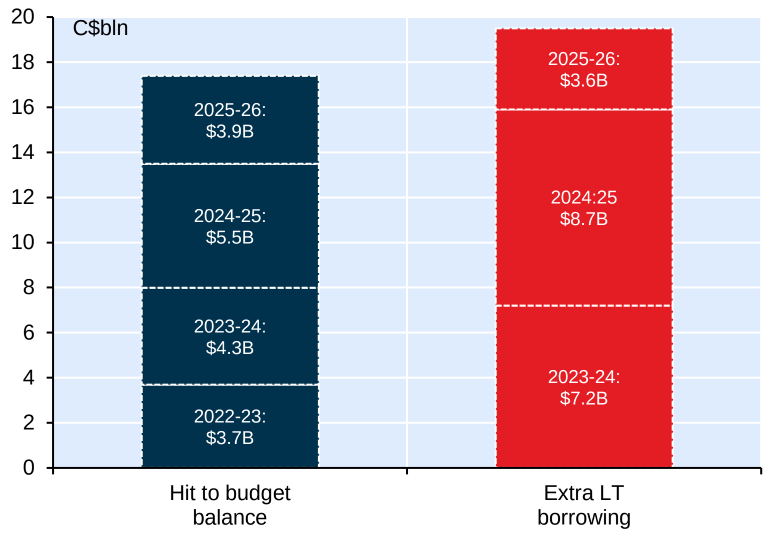
Chart 1: Budget balance comes under some pressure…
Ontario budget balance



Source: NBF, Ontario

Well, you could see this coming: Ontario's budgetary position has deteriorated vs. March's budget. There's a poor hand-off, earlier confirmed via public accounts. Add in a weaker growth profile and some extra spending pressures and voila, the $1.3 billion budgeted deficit for 2023-24 has transformed into a $5.6 billion shortfall. That's equivalent to ~0.5% of GDP, which isn't exactly enormous.

Chart 2: … resulting in extra borrowing needs
Cumulative change in Ontario budget & long-term borrowing requirement

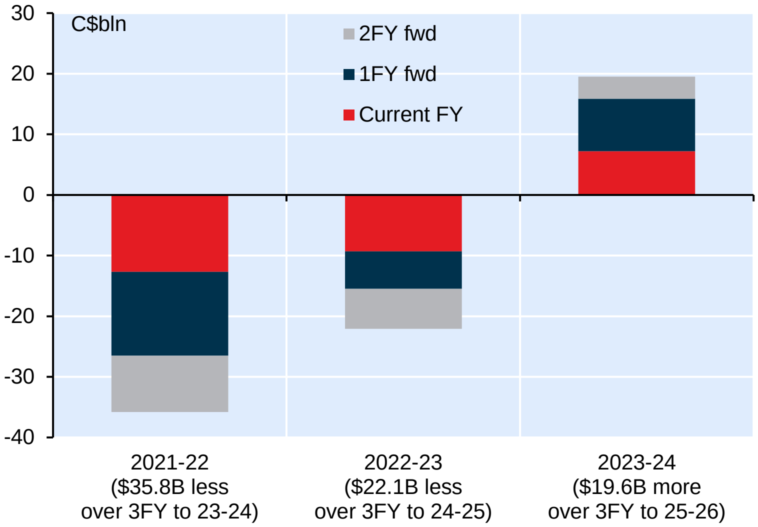


Source: NBF, Ontario | Note: Represents chg from Budget 2023 to FES

Regardless of the scale of Ontario's deficit—relatively modest in our opinion—the extra budgetary red ink in the FES, spanning the entire 2022-23 to 2025-26 window, means incremental cash requirements. In aggregate, Ontario has added $19.6 billion to its cumulative long-term borrowing requirement vs. budget, the current fiscal year's need now standing $7.2 billion higher than prior guidance.

Chart 3: This year's FES a departure from past two versions

Cumulative change in Ontario's 3-year long-term borrowing requirement

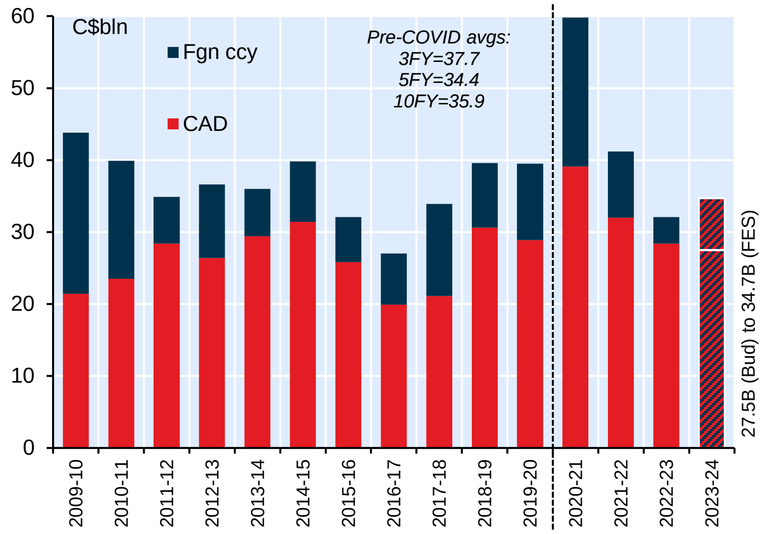


Source: NBF, Ontario | Note: Represents chg from budget to FES for each year

An extra $19.6 billion in new borrowing over three fiscal years stands in contrast to the 'good news' bond investors received in the two prior FES releases. Last fall's update cut some $22 billion from total borrowing over an equivalent three-year period. Meanwhile, back in 2021's FES, a strengthening recovery saw more than $35 billion erased from long-term borrowing requirements over three years.

Chart 4: $34.7bln in LT borrowing isn't that outsized after all

Ontario long-term borrowing, incl. revised requirement for 2023-24

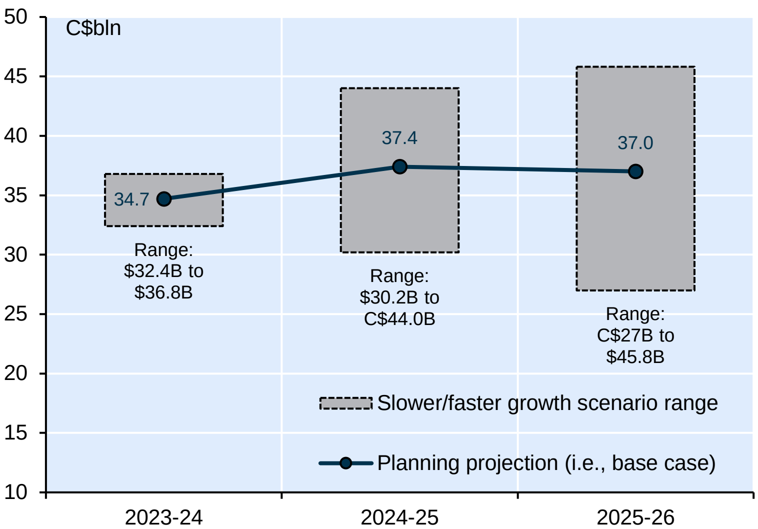


Source: NBF, Ontario

The revised (and enlarged) long-term borrowing requirement for 2023-24 is $34.7 billion. That's up from budget, but still less than what was previously forecast for this fiscal year back in 2022 and 2021. It's also less gross bond supply than what was averaged in the immediate lead up to the pandemic. Really, the $27.5 billion figure from Budget 2023 might have been the real anomaly.

Chart 5: Slow growth could add borrowing (the opposite is true)

Ontario long-term borrowing requirement under alternative scenarios

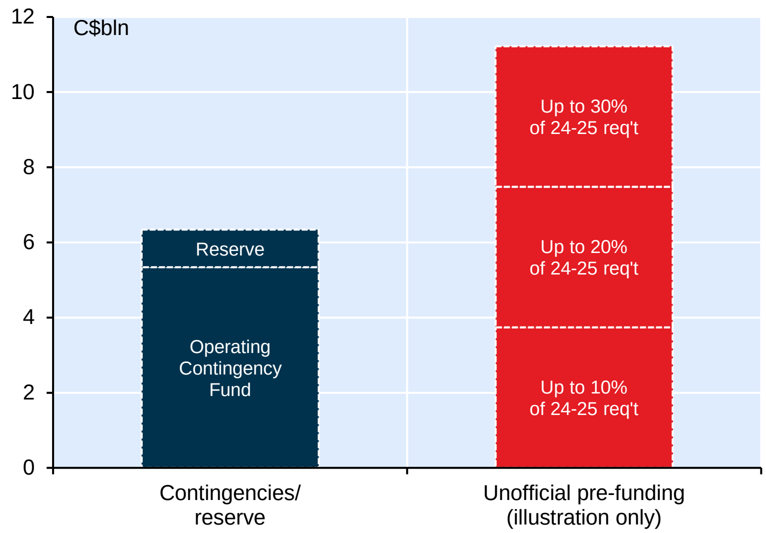


Source: NBF, Ontario

Don't let the decimal point on the revised borrowing requirement fool you, there's still considerable uncertainty as it relates to the economic, fiscal and financial outlook for Ontario (and others). Credit the province for outlining alternative scenarios, not just for the budget balance but for bond supply too. A slow(er) growth scenario would see more bonds issued. The corollary is also true.

Chart 6: Push & pull... budget prudence vs. pre-funding?

Ontario 2023-24 budget prudence vs. NBF pre-funding illustration

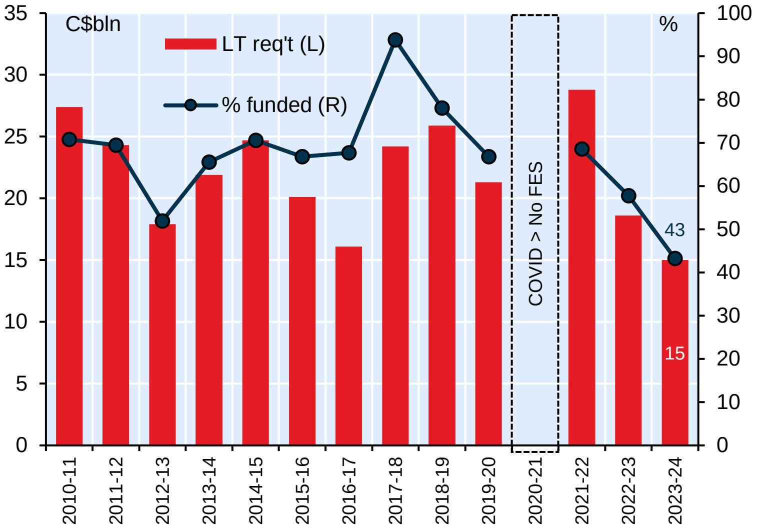


Source: NBF, Ontario | Note: Pre-funding relates to $37.4bln requirement for 2024-25

The budget balance is ground zero for the borrowing program. There are risks to the fiscal outlook to be sure. But sizeable contingency funds are set aside, plus an additional reserve. On the flip side, the 2023-24 borrowing figure DOES NOT include pre-funding. Borrowing rates are higher, but we still assume that the province will want to get a partial jump start on 2024-25 if possible.

Note: The province is launching the Ontario Infrastructure Bank (OIB), "a new, arms-length agency to leverage investments by public-sector pension plans and other trusted Canadian institutional investors to help fund large-scale infrastructure projects across the province". As initial funding for the OIB ($3 billion) is being sourced from cash reserves, there's no impact on the 2023-24 borrowing program. Backgrounder

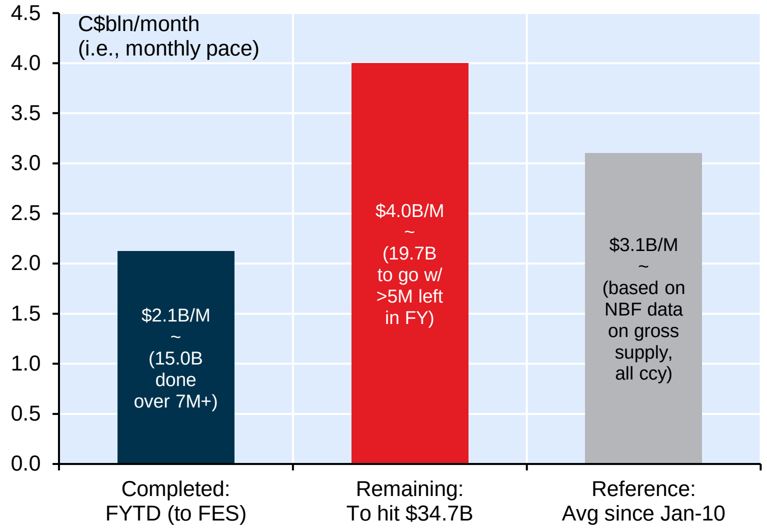
Chart 7: Technically, borrowing program a bit behind
Ontario long-term borrowing completed & funded status as at time of FES



Source: NBF, Ontario | Note: Funded status is vs. official requirement at time of FES

Without being unkind, Ontario has some work to do. At this point, $15 billion has been funded against the official $34.7 billion requirement. That's a funded ratio of 43% at what is technically the 59% mark of the fiscal year. Ontario is typically much further along by the time the FES drops, routinely two-thirds (or more) funded against the expected full-year requirement.

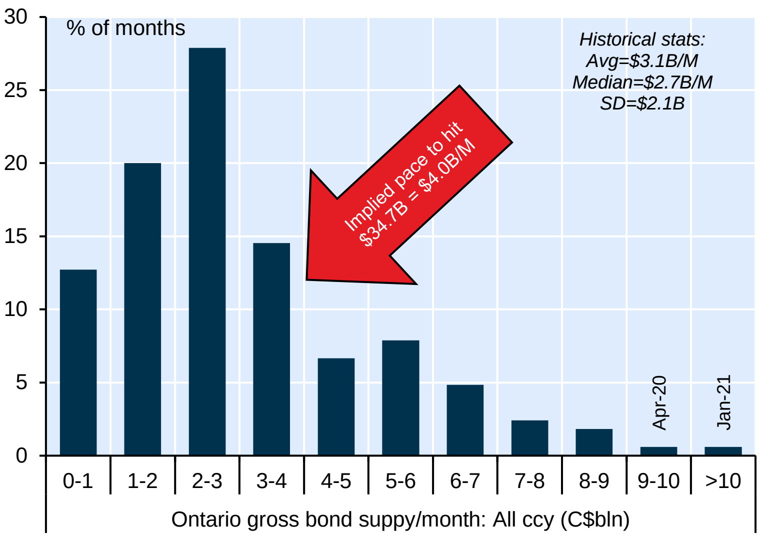
Chart 8: Ontario needs to pick up the (issuance) pace
Implied pace of Ontario 2023-24 long-term borrowing: Completed & required



Source: NBF, Ontario, BBG | Note: Completed as at 2-Nov-23

Taking the new borrowing figure at face value, and assuming no pre-funding, the borrowing math looks like this: securing $19.7 billion over the remained of fiscal 2023-24 implies an average run-rate of $4 billion/month in gross bond supply. So Ontario has to up its tempo, relative to what it had been doing earlier in the fiscal year and also vs. the province's longer-term average issuance pace.

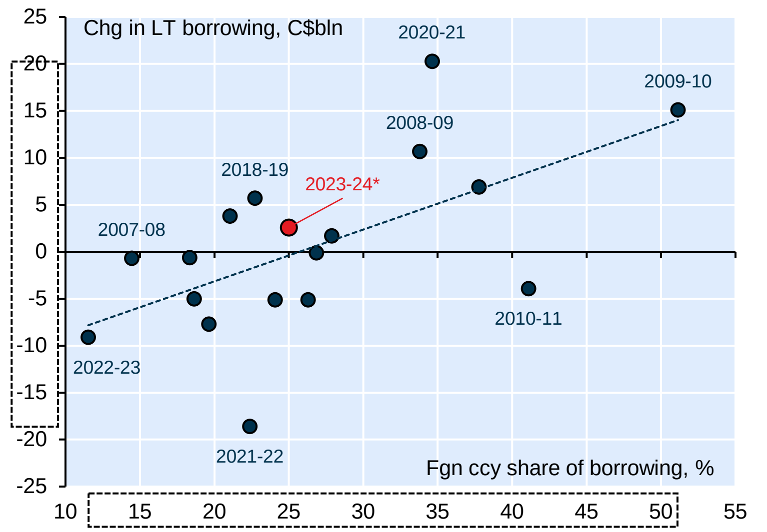
Chart 9: $4bln/month perhaps not much of a stretch
Distribution of Ontario monthly gross bond supply: 2010-23



Source: NBF, BBG

It would be foolish to underestimate Ontario's ability to get money in the door… in size and in a hurry. Time and again, this province has demonstrated its exceptional access to global debt capital markets. Even with the time to be lost over the holiday season and the upcoming budget black out (in March 2024), a hyper-efficient treasury operation can be counted on to secure necessary funding.

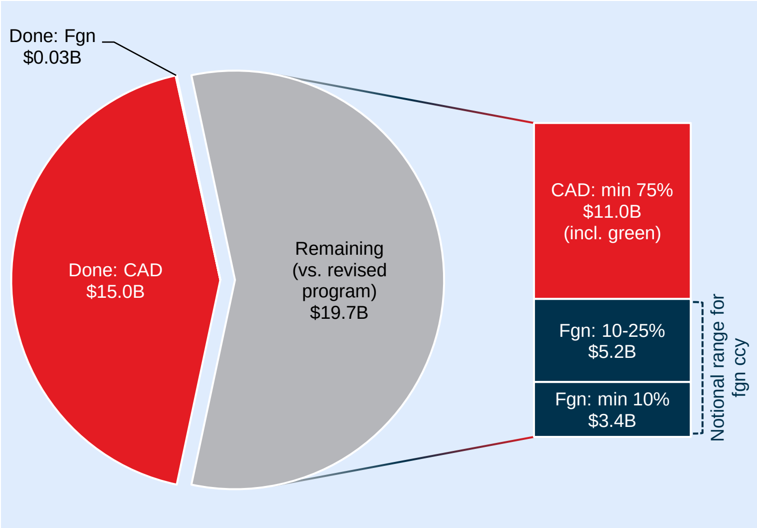
Chart 10: Foreign markets called on to clear extra borrowing
Chg in Ontario long-term borrowing vs. foreign currency share of borrowing



Source: NBF, Ontario | Note: FY results from 2006-07; 2023-24 assumes 25% fgn share

Mind you, borrowing more aggressively (as the borrowing program and funded status requires) is likely to mean greater utilization of foreign currency markets. The province has said as much. And this jibes with past practice. Generally speaking, when there's more funding to be done, foreign currency markets tend to get leaned on. This is an entirely sensible strategy in our opinion.

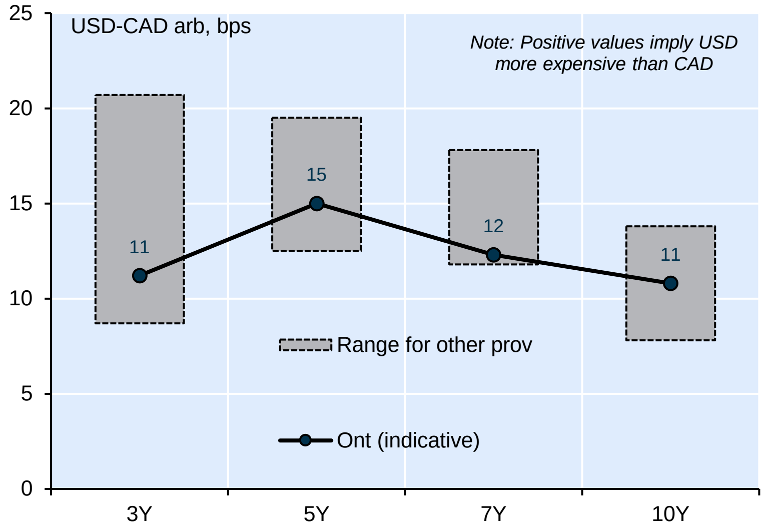
Chart 11: A look at what's still to come
Ontario 2023-24 long-term borrowing: Completed & remaining (w/ illustration)



Source: NBF, Ontario | Note: Done as of FES; remaining borrowing split is NBF illustration

So what might future Ontario issuance look like? Again, the province has provided welcome direction, including via the latest OFA CEO's Corner. As it stands, there's nearly $20 billion to borrow (before adjustments/pre-funding). Using an international funding share of 10-25%, that would imply $3½-9 billion (roughly) in foreign currency issuance, the core USD and EUR markets a stated focus.

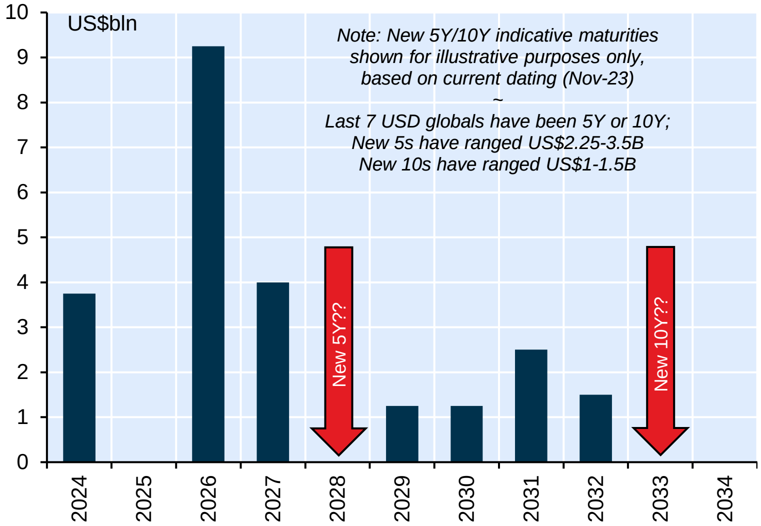
Chart 12: USD arbs notionally offside, but may still make sense
NBF indicative USD-CAD long-term funding arbs (all-in cost): 2-Nov-23



Source: NBF | Note: Indicative funding levels as at 2-Nov-23

Ontario may need to pay up somewhat to tap the deep pools of liquidity south of the border or across the pond. Keying on the USD market, we'd currently put Ontario's all-in cost of funding some 10 bps (or so) above the comparable NI levels available in the domestic (CAD) market. Too much? Perhaps not if you're really keen to advance a borrowing program quickly. Note: Arbs are volatile.

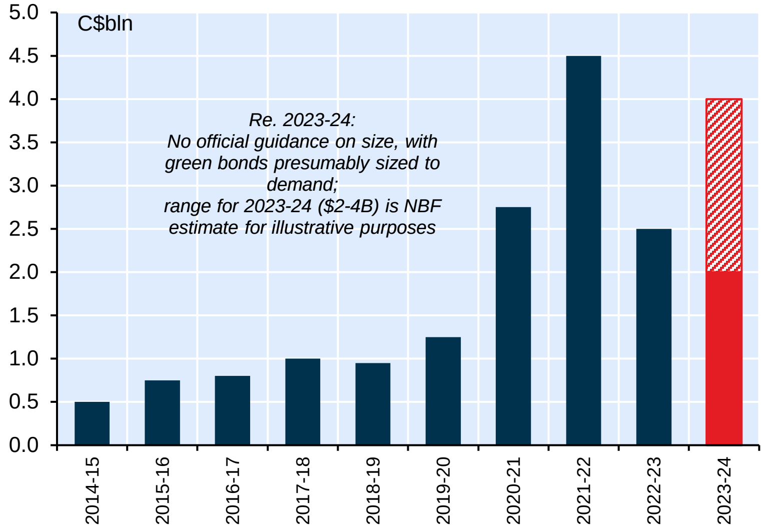
Chart 13: Some nice holes in Ontario USD maturity profile
Profile of Ontario USD bonds outstanding



Source: NBF, BBG | Note: Maturity profile as at 3-Nov-23

Sticking with the hypothetical USD trade(s) that could be coming down the pike, we spy some convenient holes in Ontario's maturity profile. There's nothing maturing in either calendar 2028 (i.e., new 5Y dating) or calendar 2033-34 (i.e., new 10Y). Ontario could consider other tenors of course, although 5s/10s have clearly been the most common/dominant terms for this issuer in years' past.

Chart 14: Greens still a go, with 2X per fiscal year the plan
Ontario green bond issuance, incl. NBF illustration for 2023-24 (unofficial)



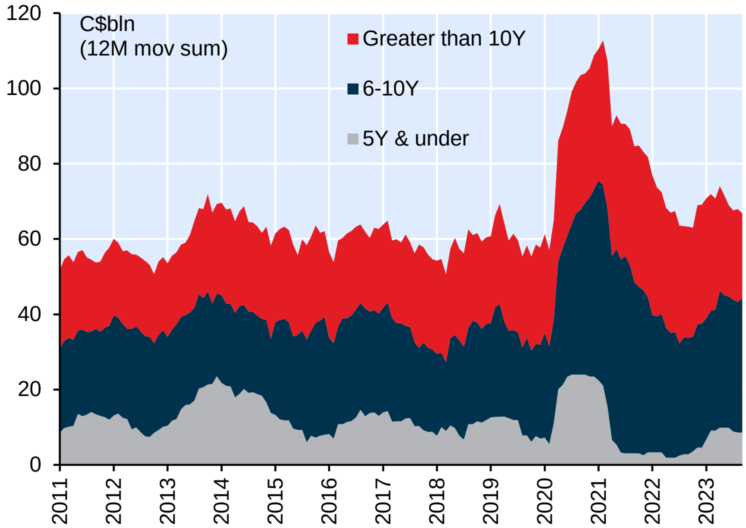
Source: NBF, Ontario

Green bonds, meanwhile, remain strategically important. Ontario's FES reiterated a plan to issue multiple greens per fiscal year (including in 2023-24). That suggests (at least) two greens between now and March 2024, trades that we'd expect to be sized to underlying investor demand. Ontario has driven the development of Canada's green bond market and should retain its dominance.

NATIONAL BANK OF CANADA FINANCIAL MARKETS

Chart 15: Ontario (& other provinces) have termed out plenty…

Provincial gov't gross bond supply by bucket: CAD issues only

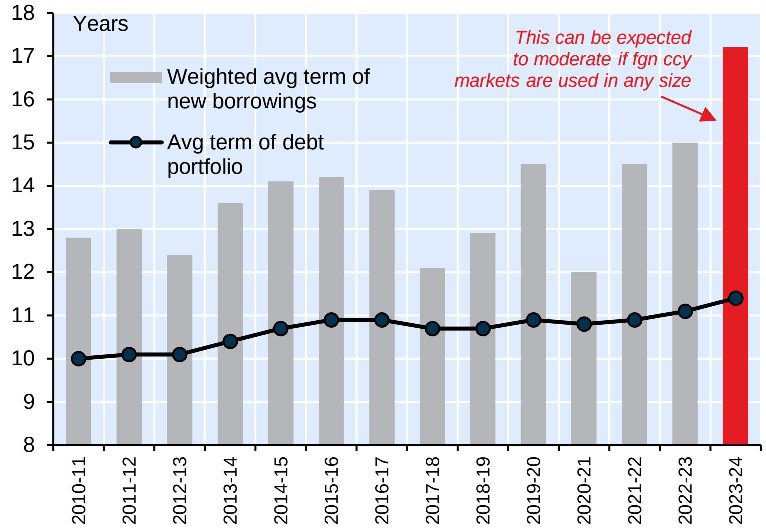


Source: NBF, BBG | Note: Based on NBF database of marketable bond offerings

From a debt management strategy perspective, Ontario (and most provinces for that matter) have generally favoured 'terming out'. This approach aligns nicely with what a good amount of net financing is geared towards: long-lasting capital assets. In the past three years, over 90% of domestic provi supply has been steered to 10s and longs, generally meeting with firm demand.

Chart 16: … providing room to move down curve if necessary

Ontario weighted average term of new bond supply & total debt portfolio

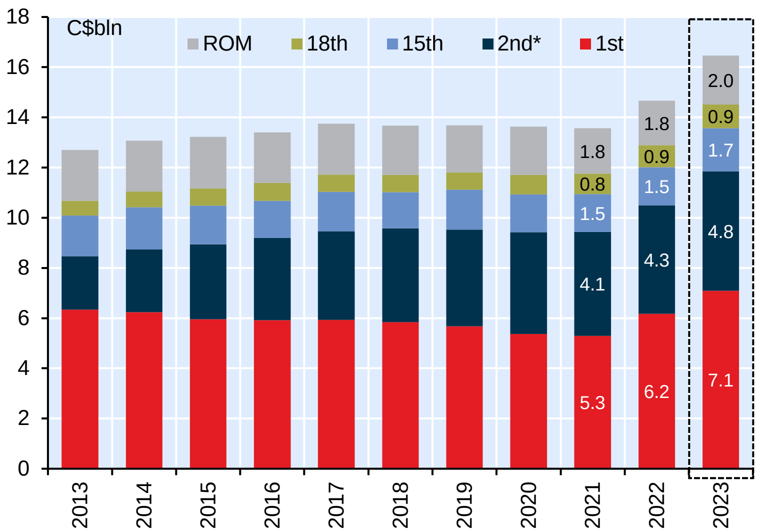


Source: NBF, Ontario | Note: 2023-24 borrowing as at FES, portfolio as at 30-Sep

The provincial penchant for terming out has inoculated the sector against severe near-term interest cost pressure, even if borrowing rates have moved higher. If you've not noticed, Ottawa has opted for a different model. Ontario's past success terming out creates scope to move down the curve, if the long end got crowded and/or investor demand for duration risk structurally thinned out.

Chart 17: As reminder, there's seasonal cash to issue into

Projected FTSE Canada Universe Bond Index cash flows: Dec-23 vs. prior 10Y

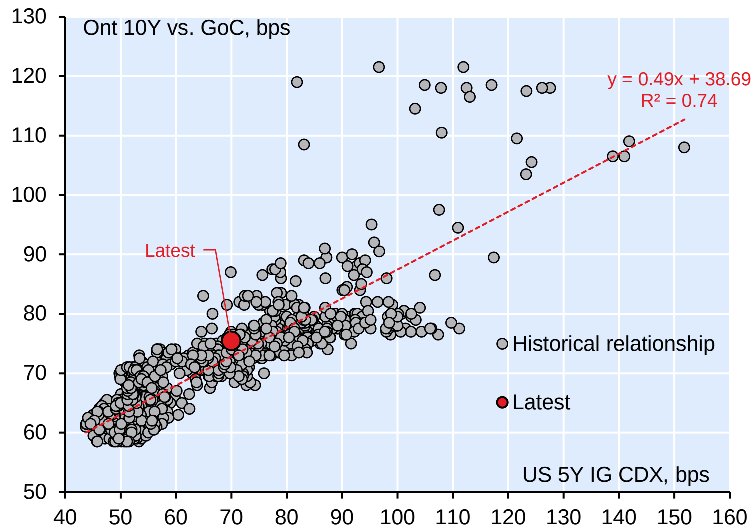


Source: NBF, FTSE Russell | Note: Dec 2nd falls on weekend in 2023

Notwithstanding the ability to tap international markets (soon to be demonstrated in our opinion) and the flexibility to move down the curve (if necessary), Ontario appears well positioned to leverage super-sized coupon payments coming into focus this December. Related index adjustment can put a bid to duration, all else equal. So it's not uncommon to see provinces steering fresh supply to well-endowed and duration-hungry investors in/around this uber-lumpy cash. For additional context, refer to this [Market View](#) report. Additional analysis on December's outsized cash flows and what they might mean for rates and credit markets will follow.

Chart 18: Spreads attractive, all else equal (famous last words)

Ontario 10Y constant maturity CAD spread vs. US 5Y IG CDX (risk proxy)



Source: NBF, BBG | Note: Based on latest 1000 trading days; latest refers to 3-Nov-23

From the looks of things, investors took Ontario's larger deficit and extra borrowing requirement in stride. Domestic spreads were, if anything, a touch firmer the morning after the FES. We always caution that provincial credit takes considerable direction from the broader sentiment towards risk. You can proxy risk any number of ways but based on one preferred gauge—US IG CDX—we might label Ontario on the cheap(ish) side of things (relatively speaking). Investors can and will judge for themselves. Given the amount of funding Ontario looks to bring, there should be plenty of opportunity to express a view on this provincial bellwether.

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

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King, CFA
Economist
daren.king@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich
Rates Strategist
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 70 St. Mary Axe, London, EC3A 8BE.

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

US 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 US Institutional Investors only.

This report is not subject to US 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.