

Canadian Provincial Outlook

Provincial outlook: New year bringing new challenges

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So far this year, a lot of things have gone right for provincial finances. Upwards revisions to tax revenues and nominal GDP through the pandemic period are improving debt metrics, while borrowing in the current fiscal year is running well ahead of Budget plans. Provincial spreads relative to Government of Canada bonds have tightened as a result. The recent decline in interest rates, and expected acceleration in growth as a result, have added to enthusiasm.

However, the New Year does bring new challenges which could see spreads widen again. While efforts to reduce population growth shouldn't have a negative impact on growth within the Canadian economy as a whole until existing labour market slack has been absorbed, that is not the case for every province. Moreover, the threat of tariffs from the new Trump administration could result in softness in business investment and volatility in markets, while provincial spending is likely to be upped at budget time ahead of upcoming elections.

Good things come to those who wait

Recently revised data from Statistics Canada show generally stronger performances among provinces during the pandemic and post-pandemic period. Relative to prior estimates, Alberta and Quebec saw the largest cumulative upward revision to GDP, although BC and PEI remained leaders in terms of real growth rates since 2019 (Chart 1). Only Saskatchewan and Newfoundland & Labrador failed to see upwards revisions.

This revised data has helped to improve fiscal metrics in a couple of ways. Firstly, the revisions were partly based on new tax revenue data, which for Ontario meant a higher prior year tax base at the time of its mid-year update which enabled downward revisions to future deficit projections. This could be mirrored in other provincial updates over the coming months. Secondly, the higher nominal GDP figure raises the denominator in debt-to-GDP calculations, leaving this crucial metric at a lower level than expected at budget time (Chart 2).

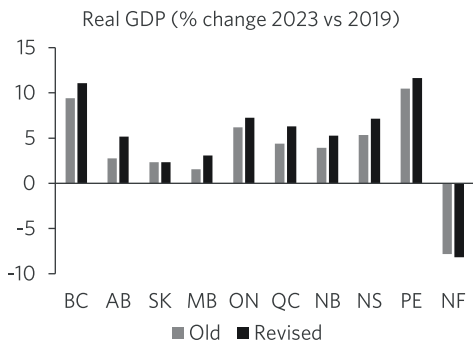
Challenges and opportunities

However, this positive trend in debt-to-GDP may not carry forward into the 2025/26 fiscal year. For a start, we can't rely on consistent upward revisions to prior years' tax revenue and GDP. But more crucially, plenty of incentives remain for provinces to raise spending.

Contracts for government workers continue to come up for renewal with wages needing to be reset at higher levels, while more capital spending is required to catch infrastructure up with the needs caused by prior population growth. The two largest provinces have election dates set for 2026, while one is rumoured in the media for an early election call next year. Regardless of when the elections are held, the incumbent governments could use their upcoming budgets as an election platform.

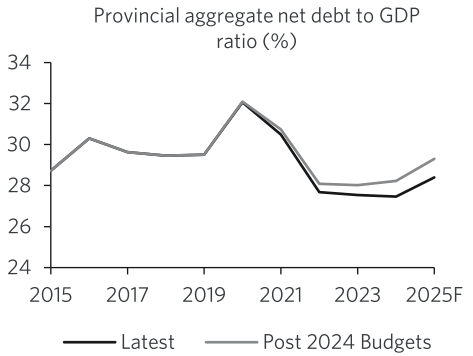
While GDP growth is expected to accelerate in the year ahead thanks to lower interest rates, which will help provincial revenues, there is greater uncertainty around that projection following the US election result. Even if Canada avoids a worst-case scenario of blanket tariffs, we saw during Trump's first term that just the uncertainty over trade can negatively impact business investment, particularly

Chart 1: Most provinces have seen upward revisions to GDP figures



Source: Statistics Canada, CIBC.

Chart 2: Aggregate debt-to-GDP ratio has improved



Source: Provincial budgets, CIBC.

in the non-energy space. Provinces with the highest trade exposure with the US, excluding energy exports, are New Brunswick, Ontario and PEI (Chart 3). While we continue to forecast that Ontario will see the largest acceleration in GDP growth thanks to lower interest rates (Table 1), risks around that forecast have risen since the US election result.

Table 1: Real GDP forecasts (Y/Y % change)

Region	2022A	2023A	2024F	2025F	2026F
BC	4.0	2.4	0.8	1.7	2.4
AB	6.0	2.3	2.2	2.5	2.7
SK	7.2	2.3	2.0	1.8	2.2
MB	4.2	1.7	1.3	1.6	1.9
ON	4.1	1.7	1.0	1.5	2.7
QC	3.4	0.6	0.8	1.9	2.3
NB	2.0	1.6	1.5	1.7	1.9
NS	3.5	2.0	1.7	1.8	2.0
PE	4.4	2.2	2.5	2.1	2.5
NF	-1.9	-2.6	3.5	2.1	2.5

Source: Statistics Canada, CIBC.

A key reason for expecting Ontario growth to accelerate more than others is the slack that has emerged within the province's labour market, relative not just to 2022 but also compared to pre-pandemic norms (Chart 4). This creates plenty of room for job growth, labour income and by extension consumer spending to accelerate ahead, even as population growth decelerates due to new Federal permanent and non-permanent immigration.

However, that is not the case in every province. Those in Atlantic Canada, which have a higher proportion of retirees, have found it easier to absorb the influx of new workers who have contributed to stronger GDP growth relative to pre-pandemic norms. A slowdown in population, and by extension labour market growth, would limit the ability for economic activity in these provinces to accelerate even as interest rates move lower.

Provincial borrowing to remain elevated

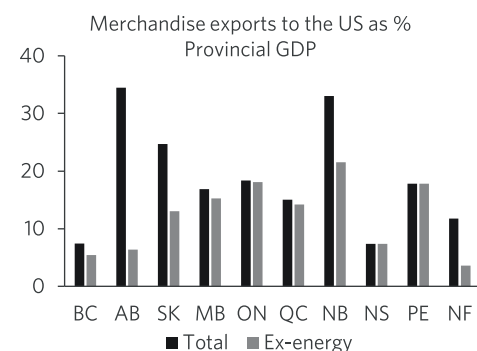
For the current fiscal year, provincial borrowing appears well ahead of plans. Indeed, on aggregate 85% of planned borrowing has been completed, compared to 60% at the same point last year and only 50% two years ago. That only leaves an estimated \$20bn of provincial issuance between now and the fiscal year-end in March.

While some provinces may select to pre-fund for next year's program, such activity may be lower than in previous years due to the opportunity cost. As opposed to the past couple years, short-end rates have fallen to a level where it now costs provinces more to issue than they would otherwise make in return on short-term investments. With that said, we expect a reduced volume of provincial issuance in the first quarter of next year, under the assumption that we do not get significant revisions in the remaining mid-year updates.

One of the main reasons provincial issuance was elevated in fiscal 2024/25 was large bond maturities, as shorter-dated deals conducted during the pandemic needed to be refinanced. That will also be the case for the upcoming 2025/26 fiscal year, as there are just under \$80bn worth of bonds coming due. Coupled with the increased expenditure plans announced in recent provincial elections, and assuming very little pre-funding this outgoing fiscal year, projected borrowing for the 2025/26 fiscal year should be around the same level as this year. Current projections place this year at around \$135bn, while next year's should be only marginally below that at around \$130-135bn (Chart 5). And that forecast doesn't

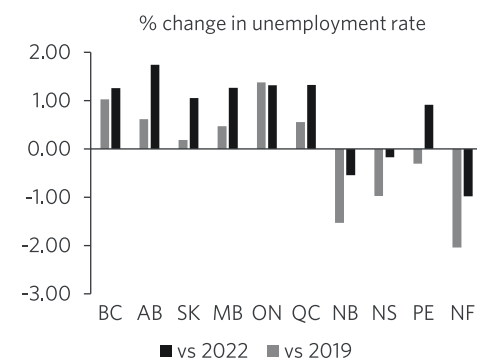
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Chart 3: Export exposure to US has large provincial variance



Source: Statistics Canada, CIBC.

Chart 4: Atlantic Canada has least labour market slack



Source: Statistics Canada, CIBC.

include any extra spending that could be announced at budget time ahead of upcoming elections in the two largest provinces, which may result in larger deficits.

Foreign deals expected to continue

One of the dominate themes playing out this year is the return of international provincial issuance. As a result of lower overall funding needs in the previous two years, coupled with substantially more domestic demand due to HQLA obligations, the percentage of foreign deals was much lower than normal in fiscal 2022/23 and 2023/24. However, with almost a 35% jump in borrowing needs this year, provinces had to expand their funding avenues and return to international markets (Chart 6).

With projected funding needs for next year forecasted to remain at elevated levels, and with CAD rates being rich compared to other jurisdictions, international investors could continue to prefer the safety of Canadian provinces but in non-Canadian denominated currencies. That notion materialized to be another key theme observed so far this year. Therefore, we believe international issuance will continue to play a key function in funding programs going forward.

Despite potentially costing provinces a few extra basis points compared to a similar domestic transaction, the ability to execute larger transaction sizes while expanding the investor base should more than offset that added expense. Also, some provinces set targets for international issuance, so that in times of need they will already be active in that market and have already built benchmarks as well as curves.

Spreads potentially on a higher path

With borrowing for the remainder of the fiscal year projected to be light due to the provinces' advanced funding status, provincial spreads could tighten further, especially heading into the December 1 index extension. Spreads are already sitting at the tightest levels since early 2022, just before we had a significant risk-off move due to expectations for interest rate increases as well as fears emanating from the emerging Omicron virus (Chart 7).

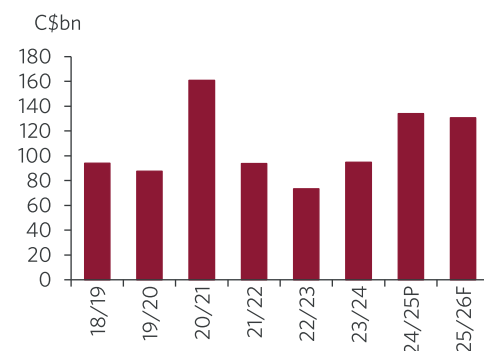
For the upcoming year, we believe a re-widening is more likely than a continued grind tighter. In fact, looking back to the start of the financial crisis in 2008, benchmark 10s have had a floor of 60bps and only broke through momentarily a handful of times before returning back above. And with current levels sitting around 65bps, it does not leave much room to the downside on a historical basis. At the same time, benchmark longs do have some room to tighten as historically they have traded in the high 60s a couple of times since 2008 (in 2010 and 2018). However, we do not believe they will venture back to that territory this time around.

The prospect of increased spending during upcoming budgets, with large provinces heading closer to elections, could add to the already high level of issuance needed in fiscal 2025/26. Meanwhile, there is greater uncertainty over economic (and by extension revenue) forecasts following the US election result, with the risk of increased protectionism. Even if Canada avoided a worst-case scenario of blanket tariffs, trade uncertainty would weigh on business investment and sector-specific tariffs could be introduced.

One such example that could be extended to other industries is the softwood lumber dispute that has been ongoing for years. In fact, the US is now poised to surpass Canada's dominance over the North American lumber industry as decades of trade restrictions and duties have taken their toll. This year alone, there have been numerous announcements of either suspended or shuttered western Canadian mills as a result.

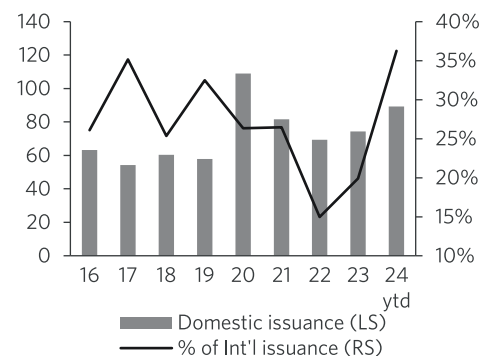
Overall, the high degree of fiscal uncertainty stemming from elections both north and south of the border should push spreads wider in the coming year.

Chart 5: Aggregate provincial borrowing programs



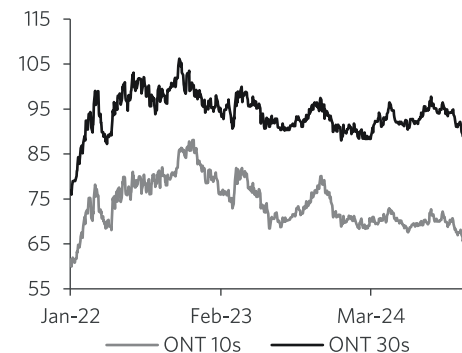
Source: Provincial budgets and updates, CIBC Capital Markets.

Chart 6: Provincial issuance by calendar year (C\$bn) and international issuance (%)



Source: CIBC Capital Markets.

Chart 7: Benchmark (Ontario) spreads are at multi-year tight (CMT, bps)



Source: CIBC Capital Markets.