

# Canadian Provincial Outlook

## Bigger isn't always better

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For provincial economies over the next year, bigger will not mean better in terms of both GDP growth and fiscal performance. Households in large provinces such as Ontario and British Columbia have the greatest sensitivity to higher interest rates, which will restrain consumer spending. Meanwhile Ontario and Quebec have high levels of government debt and are already running budget deficits, which could restrict the ability to further stimulate their economies through a slowdown. Provinces in the Prairies and Atlantic Canada generally appear better placed to navigate the economic turbulence ahead.

## A temporary boost set to fade

At face value, Ontario's economic performance since interest rates started to rise could be classed as unexpectedly resilient. Growth appears to have at least matched and potentially exceeded the national average in 2023, despite the widely acknowledged elevated level of household debt. However, a closer look reveals some cracks. Even more so than the national average, growth in 2023 has been driven by exports, and in particular a normalization of auto exports following the chips shortages of 2021.

In contrast, domestic demand in Ontario has been quite weak, and the unemployment rate has risen more than the Canadian average. Looking ahead Ontario, alongside British Columbia, will also likely see a bigger drag to household spending as more homeowners refinance at higher interest rates. While debt levels rose across the country during the pandemic, fuelled by ultra low interest rates, Ontario and BC were two of the few provinces to see debt levels rise by more than household incomes — adding to an already challenging situation (Chart 1).

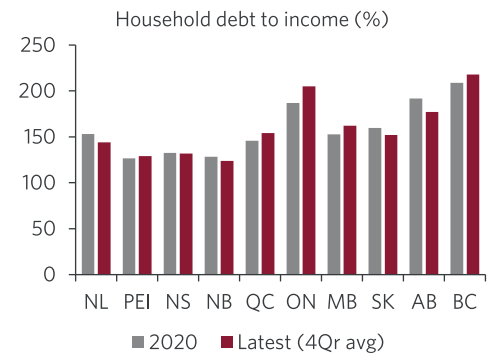
## Population boom

Something that has been prominent across all provinces this year has been the rapid immigration-led growth in the population. Even Newfoundland & Labrador, whose population was trending lower prior to the pandemic, is now seeing an increase in not just the population but also the available workforce. The pace of population growth has been highest, and further above its pre-pandemic trend, in most of Atlantic Canada, as well as Alberta (Chart 2). Quebec, which has lower targets for new immigrants, has seen a smaller acceleration relative to 2019.

Population growth has, of course, brought challenges as well as opportunities. Increased demand for housing has added inflationary pressure, but a fast growing labour market has also helped to fill job vacancies and keep wage pressures lower than they otherwise would have been. How this trade off plays out overall depends on how well newcomers into a province are assimilating into the labour market, and here there have been some key differences.

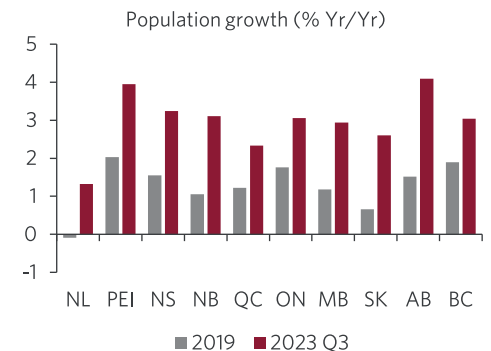
Atlantic Canada, and in particular Nova Scotia and New Brunswick, has remained much better at finding jobs for new arrivals into the province even as interest rates have slowed demand (Chart 3). Given an even older population than in the rest of Canada, these provinces were in need of a large influx of potential workers to grow their economies as others retired. In contrast, Alberta and Saskatchewan are not benefitting as much as they maybe could be from such strong population growth, with unemployment rates among newcomers back in line or above levels seen prior to the pandemic.

**Chart 1: Household debt-to-income levels increased further in Ontario and BC since 2020**



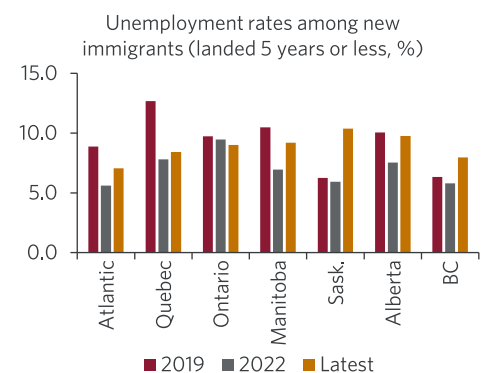
Source: Statistics Canada, CIBC.

**Chart 2: Populations surging across the country**



Source: Statistics Canada, CIBC.

**Chart 3: Some provinces finding it easier to match newcomers with jobs**



Source: Statistics Canada, CIBC.

## Room to maneuver?

Where provinces such as Alberta and Saskatchewan have a distinct advantage in the coming year is the room they have to support the economy through fiscal policy — more so today than in 2019. While debt levels rose modestly during the pandemic, both provinces have recently been running budget surpluses. In Atlantic Canada, New Brunswick has seen the biggest improvement in its fiscal position since 2019, in terms of both debt and deficit levels. In contrast the largest provinces of Ontario and Quebec appear modestly less well prepared to deal with an economic slowdown than they were before the pandemic, with the latter already using up quite a bit of fiscal room in recent budgets (Chart 4).

Indeed, recent mid-year updates from the two largest provinces point towards fiscal deterioration for both the current and future years, while we expect similar results from British Columbia in their upcoming fall update. As has been the case for most provinces, the use of contingency funds has helped absorb unexpected outcomes. The problem is though that some have already accounted for a large portions of this year's 'safety nets', with only half the fiscal year having elapsed thus far.

Meanwhile, revisions are still calling for growth in 2024 real GDP, whereas the possibility of a recession looms on the horizon. And if we do experience a more pronounced slowdown than forecasted, revenues would be further pressured at the same time as contingency funds are exhausted. That scenario does not provide much wiggle room, leading us to believe that potential fiscal shortcomings will require funding and tilt borrowing requirements to the upside.

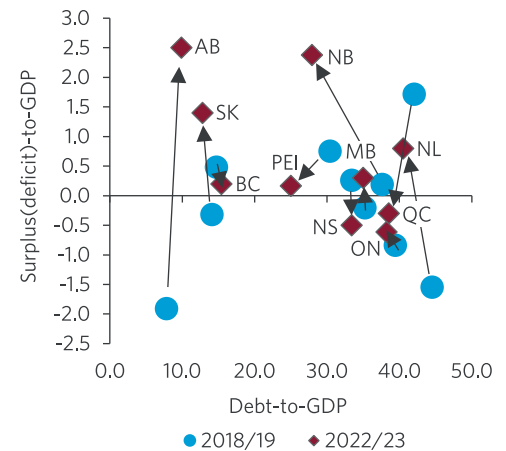
## Provincial borrowing requirements are rising

Even without accounting for this prospective increase in funding, borrowing requirements have grown year-over-year. In fact, we are fast approaching last year's levels at the same time that only 60% of the aggregate estimated programs have been funded fiscal year-to-date. Moreover, that's before accounting for any pre-funding that usually takes place, other than Manitoba's \$2.7bn built into their plans.

One of the main reasons for this growth in borrowing requirements is provinces are no longer getting unexpected revenue gains from higher commodities and/or inflated nominal GDP bolstering their tax base. Those windfall gains significantly reduced funding needs last year, while the opposite seems to be playing out this year and next. Another attributing factor to higher funding needs is debt maturities, which are increasing for both 24/25 and 25/26 as the shorter debt issued during the pandemic needs to be refinanced. For example, in 24/25 there are about \$63bn in debt maturing, while the following fiscal year sees that grow to \$78bn. For context, this out going year of 23/24 was just under \$60bn.

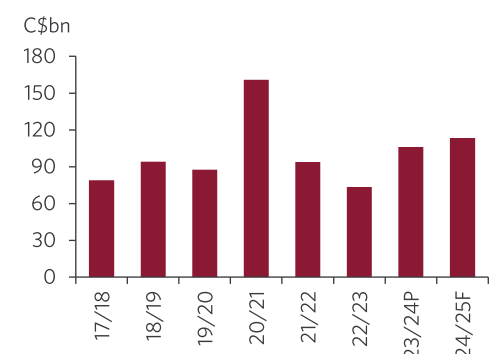
When combining all these factors including pre-funding, we project borrowing should finish in the area of \$105-110bn for this year (fiscal 23/24). That is up some 45% from the \$73bn we finished at last year. Looking even further ahead, with current fiscal projections as well as debt maturities, we project borrowing for 24/25 to come in around \$115bn (Chart 5). That latter estimate is somewhat conservative and could eventually be higher, as it does not include the possibility of a more pronounced slowdown and/or recession into the mix.

**Chart 4: Change in fiscal metrics vs pre-pandemic**



Source: Haver, Provincial Budget Documents, CIBC.

**Chart 5: Aggregate provincial borrowing programs**



Source: Provincial budgets and updates, CIBC Capital Markets.

## International issuance to alleviate heavy supply in domestic markets

As a result of the substantially reduced borrowing requirements, at the same time as large demand for HQLA products from bank treasuries, a large portion of provincial funding was completed in domestic markets last year (i.e. 22/23). In fact, domestic demand was so high that last year finished with only 13.4% completed in international markets. That percentage was significantly lower than the previous five-year average of 28.5%.

However, with the increase in funding needs year-over-year and with demand not as great as last year, this year's percentage has returned back to norms at 27.6%. What's even more interesting is the discrepancies from provinces, as some are noticeably above their usual averages while others are below. For example, British Columbia currently sits at two-thirds of their funding completed internationally, while Ontario is essentially at 0% (having only done a small AUD30mn deal). However, the latter has said they plan to issue a significant portion of the \$7.2bn increase in borrowing in their core foreign currencies of USD and EUR. Looking ahead, we believe last year was a one-off and non-domestic issuance should return to the usual levels around 25-35% annually.

## Spreads to be pressured

Around this time last year, the Bank of Canada just hiked 50bps to take the overnight rate to 3.75% while elevated inflation persisted. That created a narrative where higher rates were needed to tame inflation which would most likely cause a recession. Meanwhile, that translated into risk-off in credit resulting in the provincial benchmark (ONT) widening to levels last seen during the initial phase of the pandemic. Fast forward, we are now higher at 5.00% while inflation still persists creating the narrative of a recession forthcoming. Sound familiar?

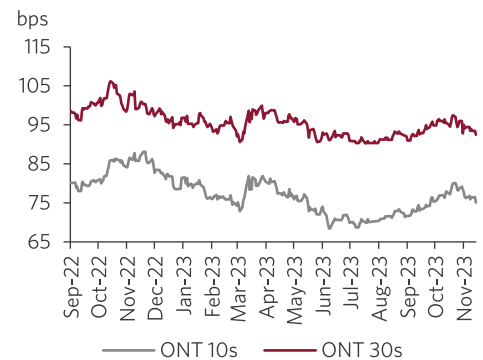
And despite this continued voiced rhetoric of a potential recession on the horizon producing larger borrowing programs, provincial spreads have remained resilient and are on a tightening trend as of late (Chart 6). One reason being the aforementioned return in international supply alleviating domestic spreads, while another is the continued asset swap demand in certain parts of the curve from HQLA buyers.

However, we believe this narrowing trend may begin to turn as more supply eventually does manifest itself. In fact, an issuer recently selected to execute a larger foreign transaction versus the volume it could have otherwise completed in the domestic market. That size would have no doubt pressured their spreads upwards if it were all completed on the home front. What was interesting though was that deal was double digits offside compared to its relative value domestically. And from what we can recall, that was the first time for this specific issuer where they 'paid up' to this magnitude to complete an international deal. That leads us to believe that issuers are now becoming more cognizant of their domestic spreads due to all the incoming supply. However, we feel that provinces can only issue internationally for so long, before they eventually end up paying significantly more in non-domestic markets.

As a result of fiscal outperformance last year, some provinces were flush with cash and had the ability to wait for opportune times to come to market which supported spreads. That has resulted in many provinces being behind in their borrowing pace, thus creating a scenario where an influx of issuance could crowd each other out, especially if funding requirements increase. Coupled with a possible risk-off narrative stemming from recession fears, makes us believe spreads should widen from these current levels. We believe the benchmark (ONT) 10yr and 30yr could reach similar levels as last year at this time, widening some 10bps each over the coming year.

Overall, the high degree of fiscal uncertainty stemming from the consequences of higher rates on household debt and consumer spending, creates a more difficult scenario for provincial finances. Coupled with the higher funding requirements going forward, should push spreads wider in the coming year.

**Chart 6: Ontario spreads have tightened from a year ago (CMT, bps)**



Source: Bloomberg, CIBC Capital Markets.