Economics

PROVINCIAL FORECAST

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Provincial fiscal outlook: Easy beats?

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We are only three months into the current fiscal year, and only a month removed from the final provincial budget landing. However, in this quick-changing, pandemic-driven economy, it feels like much longer. A lot has changed since provinces tabled their 2021/22 budgets, much of it positive as relates to future revenue streams.

Vaccination rates have surged over the spring, case counts throughout most of the country are dropping, commodity prices are generally higher and the US economy is rebounding quickly to support exports. The delta variant is a concern that prevents us from raising our GDP forecasts even higher. However, even with that caution, all provinces should see economic growth, and by extension provincial revenues, handily beat budget forecasts.

Those that were most cautious in their planning include British Columbia, Alberta and Saskatchewan. But, with provincial bond spreads tracking rising commodity prices closely, that good news appears to be largely priced in, particularly for Alberta and Saskatchewan. Since budgets were tabled, spreads have outperformed significantly, especially against Ontario, which is the 'benchmark' most provincial names trade off-of, owing to the size of the province's borrowing program and liquidity of the underlying debt. What that means, though, is that there is scope for Ontario spreads to outperform going forward, particularly with that province also expected to see economic growth and revenues handily beat budget plans.

A long road back?

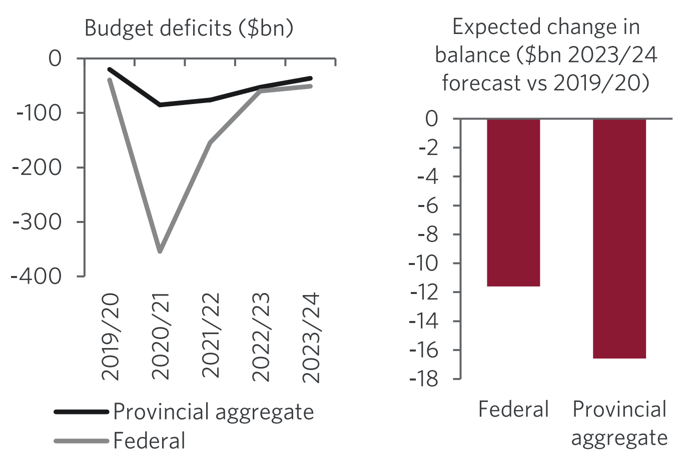
Throughout the pandemic so far, the Federal government has stepped up to the plate and provided provinces with extra transfers to support municipalities, cover increased health care costs and compensate for lost revenues. Because of that, even though the aggregate provincial deficit rose from just under 1% of GDP in 2019/20 to almost 4% in 2020/21, that is obviously much less severe than the 16% of GDP deficit at the Federal level (Chart 1 left).

That support from the federal government will continue in the current fiscal year. And, because a $7.2bn support package announced in late March would not have been included in many provincial budget plans, there is already scope for this year's provincial deficits to be somewhat lighter than planned.

However, more interesting is where province's see budget balances recovering to in later years, after the extraordinary spending related to fighting a pandemic is (hopefully) in the rear view mirror. For most, this year's budget was the first time such long-run forecasts had been released since the pandemic struck.

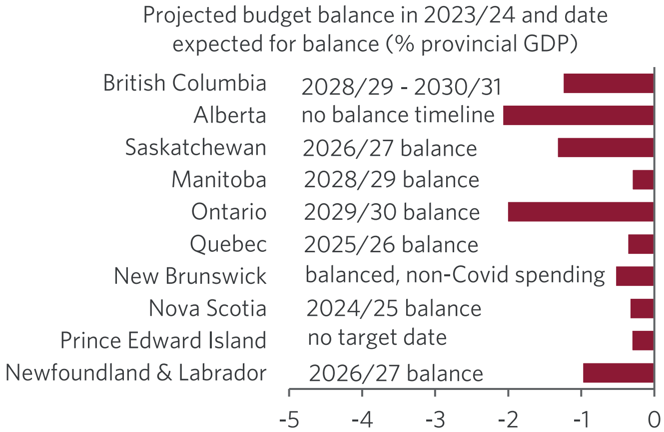
Although we'll argue that the actual results should be better, on aggregate the budgets planned for a slower path back to either balance, or at least the sort of deficits that were run before Covid-19 struck (Chart 1, right). Indeed, even the provinces that were in the best fiscal positions pre-pandemic, such as BC and

Chart 1: Aggregate provincial deficit forecast to remain wider than pre-pandemic



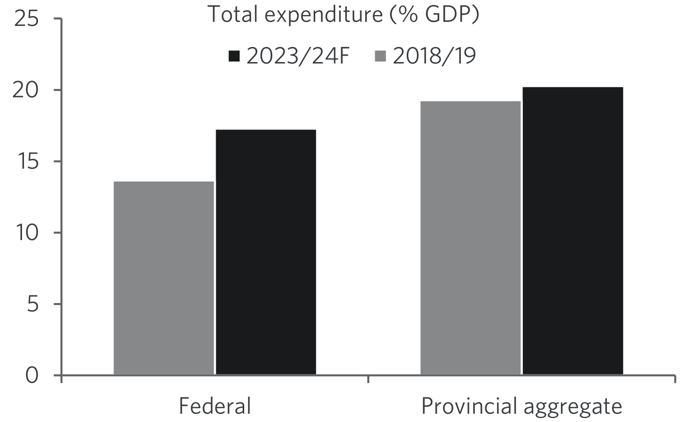
Source: Federal and provincial budgets, CIBC

Chart 2: Long timelines to balance, although some deficits only very modest by 2023/24



Note: Quebec on public accounts basis
Source: Provincial budgets, CIBC

Chart 4: Government spending projected to remain slightly higher relative to GDP



Source: Federal and provincial budgets, CIBC

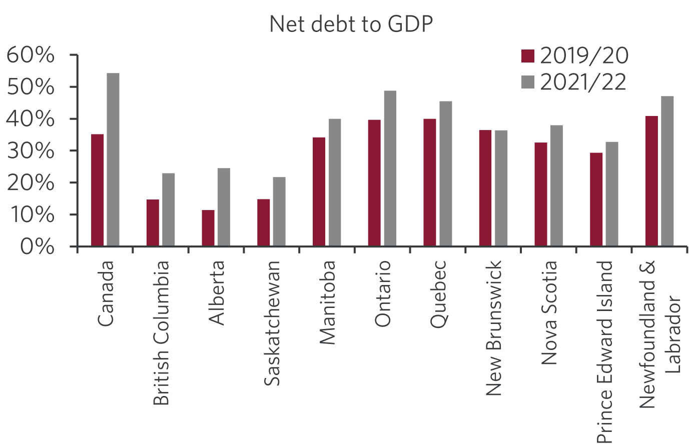
Saskatchewan, are projecting modest deficits even by 2023/24 and a return to balance well beyond that point (Chart 2).

The run of deficits, as well as additional borrowing for capital spending, sees most provinces forecasting jumps in sometimes already high net debt-to-GDP ratios (Chart 3). The exception to that rule is New Brunswick, where Federal government transfers and a more modest economic decline resulted in a surprise surplus during the 2020/21 fiscal year.

In part, the prolonged return to balance reflects the fact that government spending is expected to remain slightly higher as a proportion of GDP, even by 2023/24, when Covid-specific expenditures should have faded to zero (Chart 4). While this is more notable at the federal level (reflecting some program spending and also higher debt service costs due to the bigger increase in debt), there is projected to be a slight uptick at the provincial level as well. The pandemic has highlighted shortfalls in areas such as long-term care, mental health services and childcare, which a number of provinces have chosen to address.

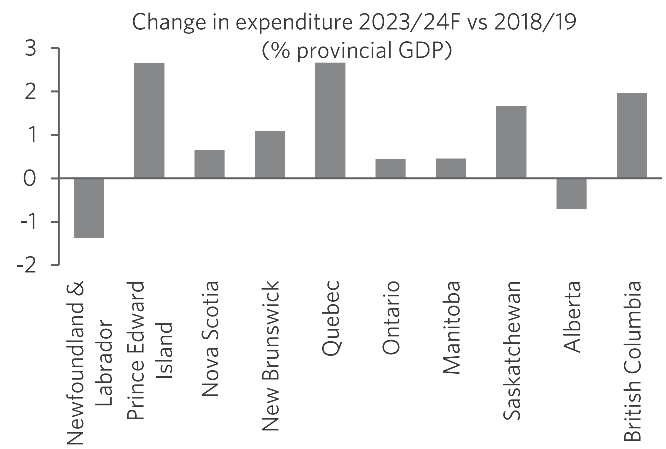
While provinces that had the best fiscal position prior to the pandemic, such as PEI, BC and Saskatchewan, are the ones projecting the largest increases in spending as a proportion of GDP (Chart 5), those that were in restraint mode previously, such as Ontario and Alberta, have lightened up on that

Chart 3: Rise in net debt as deficits continue in most provinces



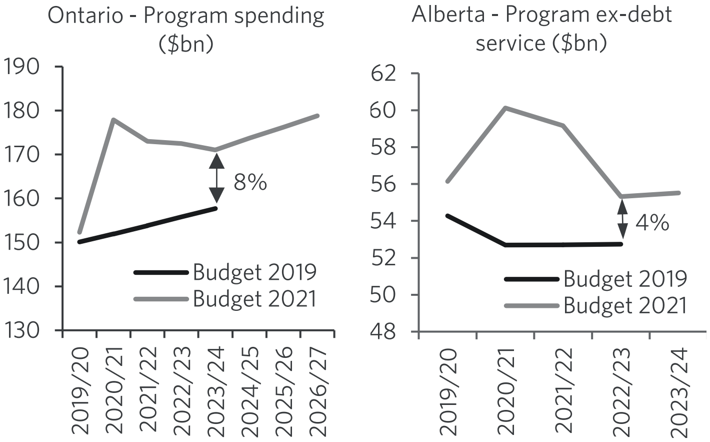
Source: Federal and provincial budgets, CIBC

Chart 5: Provinces with best fiscal position pre-pandemic projecting greatest increase in spending



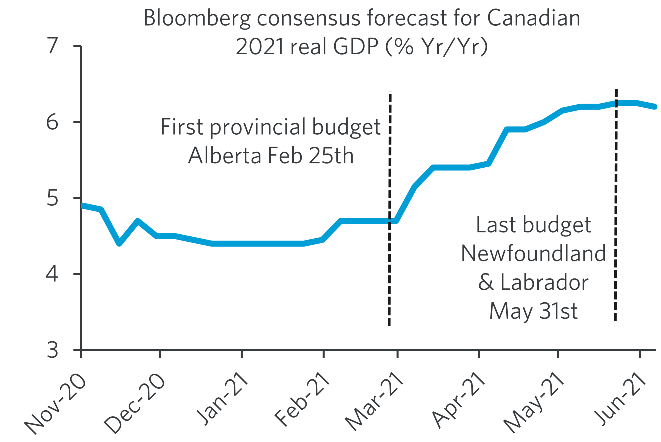
Source: Provincial budgets, CIBC

Chart 6: Ontario and Alberta have loosened up on spending restraint somewhat



Source: Ontario and Alberta budgets, CIBC

Chart 7: Economic forecasts were raised significantly as budget season progressed



Source: Bloomberg, CIBC

somewhat (Chart 6) due to the aforementioned spending needs in certain areas.

However, these modest increases in spending and the long timelines back to balance shouldn't be of too much concern to buyers of provincial bonds. For one, markets and rating agencies have already had months to digest this news and incorporate it into spreads and ratings outlooks. And importantly, the latest round of provincial budgets were based on very conservative forecasts for economic growth, and by extension provincial revenues.

As such, there is plenty of scope for deficits to be slimmer, and paths back to balance to be shorter, than projected. Recent releases from Alberta and Saskatchewan have already shown last year's deficits to be slimmer than previously anticipated, and with economic reopenings now in full swing across the country the good news should continue to roll in. Stronger economic growth not only brings in greater revenue, lowering the dollar value of deficits, but also lowers debt ratios by raising the denominator.

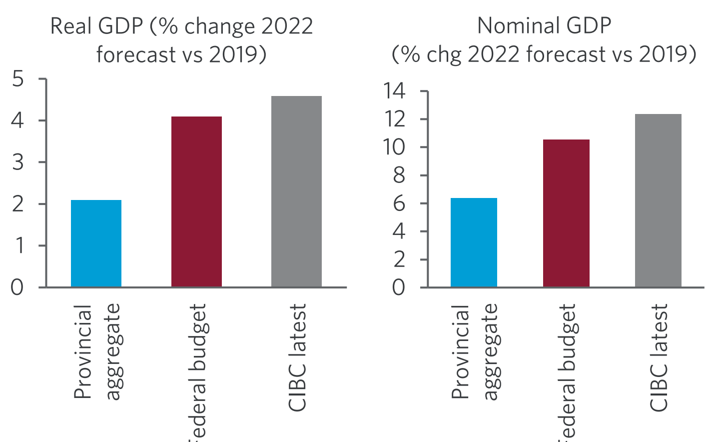
A low bar for growth

Economies around the world are starting to emerge quickly from the pandemic-driven recession of last year, with household savings ready to be spent and the hardest hit service industries able to reopen fairly quickly as health constraints ease. The latest consensus forecasts show GDP levels not just returning to the pre-Covid growth path (implying little/no scarring from the recession) but in some cases actually surpassing it.

That fuller/faster recovery compared to previous purely economic downturns is now becoming a very consensus view. However, that was not the case at the time the first provincial budget was tabled in late February. There were still concerns regarding long-term scarring from the recession, and forecasts for the current year were fairly conservative due to an initially sluggish vaccine rollout and concerns over the impact that a third wave of cases would have. But, shortly after the first budget was tabled, economic forecasts started to ramp up significantly (Chart 7). Meanwhile, between late February and May, the Bank of Canada's basket of commodity prices rose by another 8%, having already been on an uptrend earlier in the year, implying even more upside to nominal GDP.

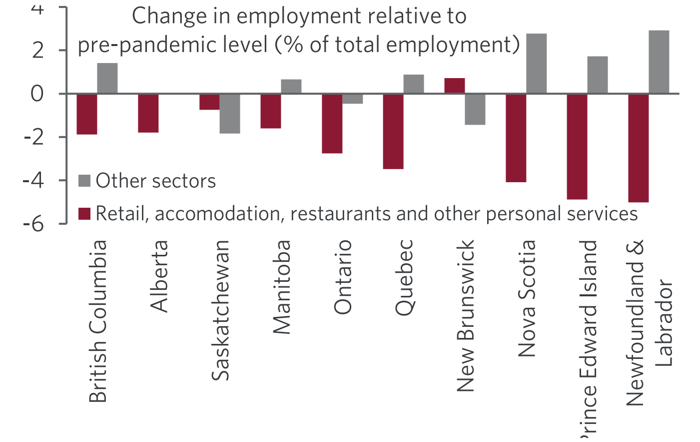
With some provinces even applying conservatism to their economic projections relative to the prevailing consensus, forecasts used in provincial budget planning assumed a much smaller economy and revenue base relative to where our forecasts currently lie. For real GDP by 2022, that gap is over 2% (Chart 8, left). For nominal GDP, it is around 6% (Chart 8, right). Note that the same degree of conservatism was not present in the Federal budget because the consensus of

Chart 8: Current forecasts for real (L) and nominal (R) GDP much higher now than provincial budget aggregate



Source: Federal and provincial budgets, CIBC

Chart 9: Employment data generally positive outside of services hit by distancing restrictions



Source: Statistics Canada, CIBC

economists was repolled just prior to release, meaning that the economic forecasts used were more up-to-date.

In terms of the outlook for individual provinces, while there are of course differences which will result in some outperforming others, all will likely see their economies outperform budget plans. The most up-to-date economic data for provinces, from the labour force survey, shows that outside of the ups and downs in service sectors most impacted by the tightening and loosening of health restrictions, employment is either broadly flat or actually up from pre-pandemic levels in most parts of the country (Chart 9).

In terms of where the biggest "beats" in economic growth relative to budget plans could be seen, these are skewed towards provinces that either released their budget earlier than others and/or provinces that derive more revenue and growth from commodities (Chart 10). Those that fit this list are Alberta, New Brunswick, Saskatchewan and BC.

That stronger economic rebound should translate into higher tax revenues and slimmer budget deficits as well. While not all provinces release fiscal sensitivities to nominal GDP, for those that do the economic beat we expect over this year and next would reduce 2022/23 deficits by an average of around 0.5% of provincial GDP (Chart 11, left). With the sensitivities published for Ontario and BC smaller than those for Quebec, but able to vary significantly depending on the composition of growth, the positive impact on revenues in those two provinces could be even larger than shown in the chart.

If an average fiscal sensitivity to nominal GDP were applied across provinces, then the aggregate provincial deficit would be approximately $17bn lighter. That would actually more than account for the gap between pre-pandemic and post-pandemic (2023/24) deficit expectations shown back in chart 1.

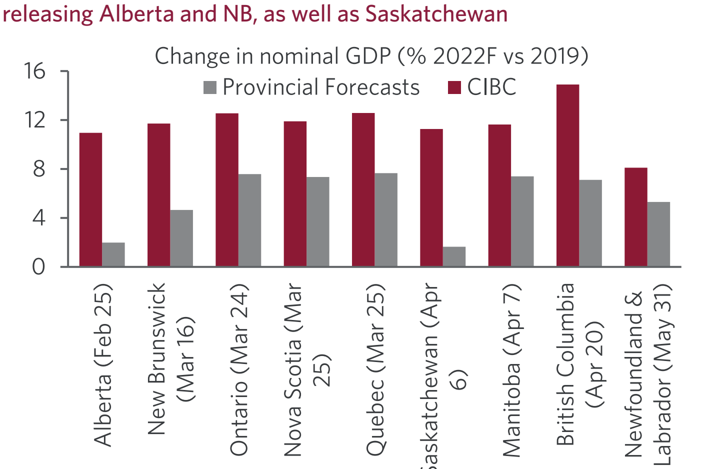
Moreover, for oil producers, the impact of higher prices on commodity revenues alone will be significant (Chart 11, right). Indeed, for Alberta, which was the first province to release a budget this year using very conservative oil and GDP assumptions, the impact of higher oil prices on resource revenues alone could see budget deficits slimmed by around 1% of GDP.

In short, even with the additions to spending shown previously, budget deficits on aggregate could actually be lighter by 2023/24 than they were pre-pandemic, and a number of provinces should have already returned to balance.

Spreads have adjusted accordingly

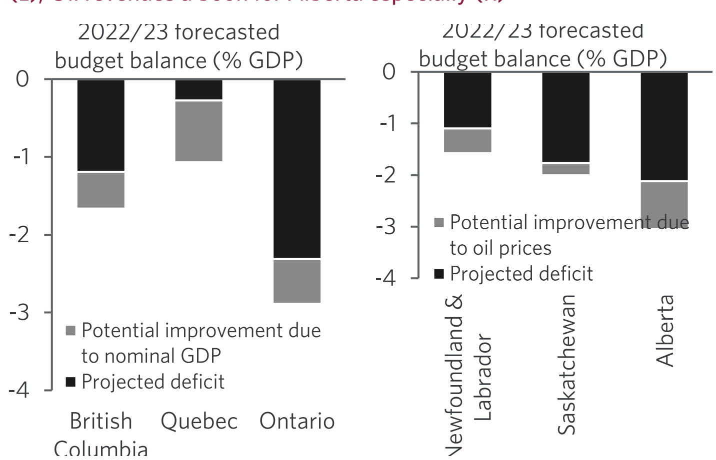
At the start of budget season provincial spreads widened as investors reacted to expectations of supply (given the size of deficit forecasts) as well as the rapid repricing of bond yields

Chart 10: Nominal GDP to beat budget plans, particularly in early-releasing Alberta and NB, as well as Saskatchewan



Source: Provincial budgets, CIBC

Chart 11: Nominal GDP beats could cut deficits by roughly ½% GDP (L); Oil revenues a boon for Alberta especially (R)



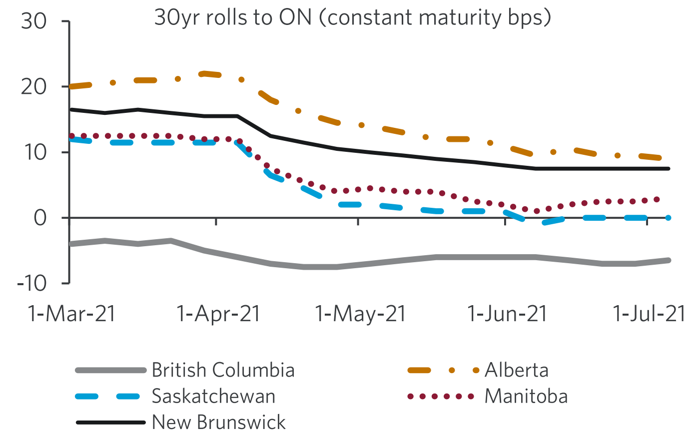
Note: Quebec on public accounts basis
Source: Provincial budgets, CIBC

in the underlying federal bond market. This theme persisted into the start of Q2, until underlying economic optimism, coupled with the rising commodity prices, signaled that some budgets may have actually been too conservative. Suddenly, supply concerns took a backseat to the reality that economic growth should see some budgetary assumptions readily beaten, stabilizing the amount of issuance. Indeed, the market seized that opportunity, particularly in the long-end, as some provinces' relative spread valuation against Ontario tightened significantly.

Unsurprisingly, the two largest gainers in spreads relative to the benchmark are the ones that rely heavily on commodity prices, Alberta and Saskatchewan. Both have seen their 30yr constant maturity spreads improve 11bps and 12bps, respectively (Chart 12). That now places Alberta 9bps back, which is the tightest spread to Ontario since September 2019. Meanwhile, Saskatchewan is now trading on par with Ontario, something not seen since October 2018.

Those tight spreads to Ontario now leave room for outperformance by Ontario in the 30-year. Many of the provinces are trading at or through their pre-pandemic tights, whereas Ontario is still roughly 5bps back of where it was January 2020 (74bps). As we have seen with others, a catalyst for spread performance could come from Ontario posting a budget beat. And while Ontario's nominal GDP forecasts weren't as conservative as others, the revenue sensitivity to changes in nominal GDP appears smaller than those provided by other provinces and so could also be considered conservative.

Chart 12: Provinces where there is greatest scope for economic outperformance vs budget plan have already tightened versus Ontario



Source: Bloomberg, CIBC

Borrowing requirements heading lower

Budget beats will mean that less deficit funding is required, therefore lowering the projected size of borrowing programs this year. That notion of reduced supply, which translates into lower overall debt, is the key driver of tighter spreads. Some provinces are already seeing these improvements in their coffers. That could explain why they are allowing themselves to lag behind the pace they would need if they had to reach their budget borrowing plan. Alberta and British Columbia, provinces with more conservative assumptions, are significantly lagging having only completed 10.1% and 14.0% of their previously stated programs, respectively (Table 1). The releases of 2020/21 public accounts are solidifying this point. The

Table 1: Provincial Government Stated Fiscal 2021/22 Borrowing Programs[1]

Province ($bn)	Borrowing Program	Amount Borrowed	% Raised	% Ahead / Behind[2]	% Non-Domestic	US$ %	Weighted Avg Term[3]
British Columbia	19.2	2.7	14.0%	-12.0%	0.0%	0.0%	17.6
Alberta	24.9	2.5	10.1%	-15.9%	0.0%	0.0%	24.9
Saskatchewan	4.1	1.1	26.7%	0.7%	0.0%	0.0%	17.9
Manitoba	4.2	0.3	6.1%	-20.0%	0.0%	0.0%	31.2
Ontario	53.9	16.6	30.8%	4.7%	33.7%	22.8%	14.4
Quebec/FinQ	28.5	12.8	44.8%	18.8%	41.6%	9.8%	16.9
Hydro-Quebec[4]	3.5	1.7	48.7%	-2.0%	0.0%	0.0%	38.8
New Brunswick	1.7	0.4	24.9%	-1.1%	0.0%	0.0%	5.3
Nova Scotia	2.2	0.6	25.7%	-0.3%	0.0%	0.0%	18.9
Newfoundland[5]	1.7	0.2	10.4%	-15.6%	0.0%	0.0%	29.5
Prince Edward Island	0.2	0.0	0.0%	-26.0%	0.0%	0.0%	0.0
Total	$144.1	$38.8	26.9%	0.3%	28.1%	13.0%	16.9

1 Based on stated public borrowing programs for FY 2021/22 (April 1-March 31), subtracting pre-funding last year for the current fiscal year.
2 Based on estimate of time lapsed in current fiscal year (at time of this report 26.0%)
3 Excludes non-debenture based financing sources
4 Calendar year based fiscal year (51.0%)
5 Includes NF Hydro's borrowing needs

$3.2bn improvement Alberta freshly posted, a figure that was previously borrowed for, has generated excess cash on hand for the province. This trend of improving forecasts, which we see as our base case for many of the provinces, has us lowering our expectations for overall supply. Note that Ontario and Quebec, while also likely to post much slimmer deficits than budgeted for, are ahead of plan, a fact that could contribute to spread outperformance relative to other provinces later in the year as they recalibrate borrowing requirements to slimmer budgetary deficits.

Provincial forecast tables

	Table 1: Real GDP (Y/Y % chg)				Table 2: Nominal GDP (Y/Y % change)				Table 3: Unemployment rate (%)			
Province	2019A	2020E	2021F	2022F	2019A	2020E	2021F	2022F	2019A	2020E	2021F	2022F
British Columbia	2.7	-3.8	5.7	4.1	4.4	-2.0	11.5	5.1	4.7	8.9	6.5	4.9
Alberta	0.1	-8.2	7.9	5.1	2.7	-12.2	19.1	6.1	6.9	11.3	8.5	6.5
Saskatchewan	-0.7	-5.2	5.6	3.4	0.1	-8.2	16.1	4.4	5.4	8.3	6.6	5.5
Manitoba	0.6	-4.8	5.1	3.9	1.0	-3.0	9.6	5.0	5.3	7.9	6.5	5.6
Ontario	2.1	-5.0	5.6	4.4	3.8	-3.2	10.1	5.6	5.6	9.5	8.3	5.9
Québec	2.7	-5.3	6.4	3.7	4.3	-3.5	11.2	4.9	5.1	8.8	6.3	5.4
New Brunswick	1.2	-3.7	4.3	2.9	3.0	-1.9	9.8	3.7	8.0	9.8	8.5	8.1
Nova Scotia	2.4	-3.2	4.0	3.2	3.8	-1.4	8.8	4.3	7.2	9.6	8.2	7.7
Prince Edward Island	5.1	-3.0	3.9	3.9	7.0	-1.2	8.7	5.3	8.8	10.6	8.5	8.2
Newfoundland and Labrador	4.0	-5.3	4.6	3.0	4.1	-9.3	14.6	4.0	11.9	13.7	12.8	12.3
Canada	**1.9**	**-5.3**	**6.0**	**4.2**	**3.6**	**-4.6**	**11.9**	**5.3**	**5.7**	**9.5**	**7.6**	**5.9**

Source: Statistics Canada, CMHC, CIBC

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