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Economics

Ontario: Backing Off From Restraint

by Avery Shenfeld and Andrew Grantham

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.ca

Royce Mendes
(416) 594-7354
royce.mendes@cibc.ca

After achieving a modest surplus in 2017/18, in its final budget before this year's provincial election, the Ontario government has opted to loosen the purse strings somewhat to offer an enriched package of social and health programs. The result is a return to moderate deficits over the medium term, albeit a bit lighter in 2018/19 than what was hinted at prior to today's release.

Borrowing activity will remain elevated, with ongoing deficits combined with escalating funding for capital projects, and will also have to cover larger maturities than seen in the prior year. For this coming fiscal year, however, gross issuance could ease slightly due to heavy pre-borrowing in the prior fiscal year.

The government is judging that its "Plan for Care and Opportunity" will have greater appeal to voters than running a tighter overall fiscal path. The result would be a return to a climbing debt/GDP to a peak of nearly 39% in 2021/22, not far off the highs reached earlier in this cycle. All of this, of course, will be put to the test in what looks to be a hotly contested election in June, so bond investors will also be paying attention to the fiscal platforms offered by opposition parties in the weeks ahead.

Economy Decelerates as Full Employment Reached

Ontario's economy has enjoyed a solid run, with the estimated 2.7% real growth rate achieved in 2017 outperforming the last budget's forecast by nearly a half point. That extended a run at roughly that pace since 2014. That said nominal GDP, which has a closer tie to revenues, grew only a tick above the 2017 budget forecast at 4.4%.

Looking ahead, the province, like the national economy, will to some extent be a victim of its own success, facing a deceleration owing to the constraints of having much less available slack in the labour market. With the current jobless rate

Table 1
Fiscal Summary

$Billions	2016/17 Actual	2017/18 17 Budget*	2017/18 18 Budget	2017/18 Change	2018/19 18 Budget	2019/20 18 Budget	2020/21 18 Budget
Revenue	**140.7**	**150.0**	**150.1**	**0.1**	**152.5**	**157.6**	**163.8**
Own Source	116.2	123.9	124.8	0.9	126.5	131.9	137.0
% change	*2.8*	*6.7*	*7.4*	*0.7*	*1.3*	*4.3*	*3.9*
Federal Transfers	24.5	26.1	25.3	-0.8	26.0	25.7	26.8
Expenditures	**141.7**	**149.4**	**149.5**	**0.1**	**158.5**	**163.5**	**169.6**
Programs	130.0	137.2	137.5	0.4	145.9	150.4	155.8
% change	*1.5*	*5.5*	*5.8*	*0.3*	*6.1*	*3.1*	*3.6*
Public Debt Charges	11.7	12.2	12.0	-0.3	12.5	13.1	13.8
Less: Reserve	0.0	0.6	0.0	-0.6	0.7	0.7	0.7
Budgetary Balance	**-1.0**	**0.0**	**0.6**	**0.6**	**-6.7**	**-6.6**	**-6.5**

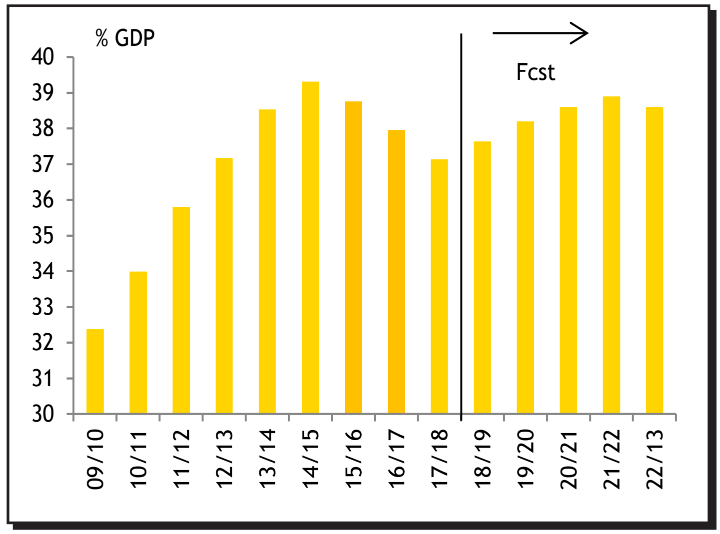
**Revenue and expense figures restated to reflect a presentation change for hospitals, school boards and colleges as described in Ontario Economic Outlook and Fiscal Review*

Table 2
Ontario's Economic Outlook

Y/Y % Chg	2017	2018	2019	2020/21
Economic Assumptions				
Real GDP	2.7	2.2	1.8	1.8
Private Sector Consensus		*2.3*	*1.9*	1.9
Nominal GDP	4.4	4.1	3.9	4.0
Employment	1.8	1.7	1.1	0.9
Unemployment Rate (%)	6.0	5.5	5.4	5.4
Real HH Consumption	4.0	3.0	2.2	2.1
Retail Sales	6.4	4.3	3.8	3.6
Housing Starts (K)	79.1	72.4	69.5	71.6
Corporations Net Op. Surplus	9.2	1.5	3.5	3.5
Consumer Price Index	1.7	2.2	2.2	2.0
Financial Assumptions				
3-month T-Bills (%)	0.7	1.4	2.2	2.7
10-year GoC Bonds (%)	1.8	2.4	3.0	3.5
Exchange Rate (US¢/C$)	77.0	80.1	80.9	81.2
WTI (US$/bbl)	51.0	59.0	59.0	59.5

Note: 2020-21 is two-year average

Chart 1
Debt as a Proportion of GDP Starting to Rise Again



essentially consistent with full employment and unlikely to drop further, growth is expected to decelerate to 2.2% in 2018, and 1.8% in 2019, in close proximity to CIBC's own forecasts. That will see nominal GDP running at roughly 4% per annum.

Much of that deceleration is expected to come from the end of a boom in homebuilding, coupled with a deceleration in consumer spending. As seen in a recent Statistics Canada survey, private sector capital spending is expected to accelerate, supported by high current levels of capacity use, while exports are expected to see modest growth this year after a drop in real terms in 2017. The forecast allows for central bank rate hikes to take bill yields over 2% in 2019, and for 10-year yields to hit 3% in the same year.

Unspent Reserve Generated a 2017/18 Surplus

While last year's budget officially aimed at a balance, that tally included a $0.6 bn reserve allowance to cover unforeseen contingencies. Since the economy ended up delivering no adverse surprises, the lack of a need to dip into those reserves was the largest factor in delivering an estimated $642 mn surplus for 2017/18.

Elsewhere there were largely offsetting hits and misses. Interest costs came in nearly $0.3 bn lower, mostly due to a fiscally neutral accounting change that reduced the revenues from HydroOne share sales by an equivalent amount, but program spending ran ahead of target as an offset. Revenues were essentially in line overall, with the impact of a downward adjustment to the 2016 base year for personal income taxes offset by improved federal transfers and higher crown corporation results. Note that the government's treatment of the impact of electricity rate reductions differs from the provincial auditor's recommendations, so the latter's approach could still show a deficit in the outgoing year.

Back to Moderate Deficits

Has deficit fighting gone out of political fashion? That seems to be the political calculus, because this budget, and the last available plan from the official opposition (which could be modified by its new leader) both allowed for red ink in the coming year.

This budget's projected $6.7 bn deficit in 2018/19 (or an even $6 bn if contingency reserves are not needed), and a similar shortfall in 2019/20, reflect decisions taken over the past year and in the budget that will enrich social and health spending.

While that's lighter than the 1% of GDP ceiling the Finance Minister warned of in recent days, it compares to the prior year's plan to run balanced budgets year after year. Net debt dropped by nearly a percentage point to 37.1% in 2017/18, the lowest since 2011/12, but will nudge up to 37.6% in the coming year, and on a medium-term track to almost 39% in 2021/22, reversing all the progress made in the past three years (Chart 1). This trend could catch the eye of rating agencies and investors. Interest expenses will creep upward to 8.5 cents per revenue dollar by that same year from 8 cents currently, but this is still a far cry from the 14 to 15.5 cent range that squeezed the province in the higher rate 1990s business cycle.

Total program spending will have grown at a roughly 6% pace both last year and in the upcoming fiscal year, after several years with little growth in real terms, but further growth will be more moderate in the medium term. The allocation to programs will be $5.7 bn higher in 2018/19, growing to an extra $8.3 bn by 2020/21, relative to plans envisaged in the 2017 budget. As has been the case in the past, the upcoming year's spending levels assume the province will find $1.2 bn in unspecified savings as some programs fail to hit their allocated ceilings.

The budget includes some new big-ticket programs to support childcare (modest this year, but growing to $1.7 bn by 2020/21), health and dental care, senior care and education. Some of these are aimed at increasing long-term potential growth by raising the labour force participation of women, or educating more Ontarians in the STEM sector. The budget notes that, on a per capita basis, it is starting from the lowest program spending among the provinces.

The government's revenue projections are actually tracking $1.1 bn lower for 2018/19, and $0.7 bn lower for 2019/20 relative to the 2017 Budget path. That largely captures a downward adjustment to revenues realized from 2016 tax returns, which then gets captured into the base for revenue growth in subsequent years, allowances for economic uncertainty, and a less robust housing market.

The damage to the bottom line was partially offset by federal transfers for infrastructure that have been shifted to those years, and from revenue-raising tax measures included in the budget that raise $510 mn in 2018/19, and $780 mn by 2020/21. A mix of higher tax brackets, but the elimination of personal income surtaxes, will leave the top marginal rate unchanged, but increase progressivity in brackets below $220,000, raising an additional $275 mn in the 2018/19 fiscal year. Other significant tax gains will mostly come from paralleling the federal measures affecting small business owners and financial institutions.

Borrowing requirements will also capture the province's ambitious infrastructure plan. The current budget envisages a 14-year plan from 2014 to 2027 fiscal years tallying $230 bn. That appears somewhat larger on a per annum basis than the prior budget's 13-year plan, but judging by borrowing requirements, it appears that the cash costs are rolling out somewhat more slowly than previously planned.

Borrowing Remains Brisk

As the province moves back into deficit, and ramps up the financing needs for capital projects, its underlying net and gross financing requirements will be headed higher. But the bond market won't actually feel all of that just yet.

Ontario has been adept at tapping a diverse source of funds to meet its financial requirements, and took advantage of a period of ultra-low interest rates and a flat yield curve to get ahead of the game. The coming fiscal year's needs will be cushioned by having completed an outsized $11.5 bn in pre-borrowing in the last year, which will be key to maintaining a roughly steady volume of gross long-term issuance this year, or lower if no pre-borrowing is done for the following year's needs. It will continue to build cash reserves to help it manage large maturities of benchmark issues that commence in 2019/20. This budget adds an additional $6.0 bn to liquidity reserves.

The past year's pre-borrowing will mean that, although the underlying financing needs of the province will be climbing, the net supply of Ontario bonds outstanding will actually be growing a bit more slowly in the next two years, at roughly $10 bn per year, versus the $17 bn jump in outstandings registered in the past year. That still represents a growing stock of Ontario bonds on the market, and gross borrowing will be range-bound at still-elevated levels, given a rising tide of maturities.

Table 3
The Financing Plan

$Billions	2017/18E	2018/19F	2019/20F	2020/21F
Borrowing Requirements				
Budget (Surplus)/Deficit	-0.6	6.7	6.6	6.5
Non-Cash Adjustments	-5.9	-7.1	-7.1	-7.6
Investment in Capital Assets	10.7	14.2	15.7	15.8
Net Loans/Investments	-1.5	1.9	1.0	0.8
Net Financial Requirement	**2.7**	**15.7**	**16.2**	**15.5**
Maturities & Redemptions	17.5	21.6	27.4	26.5
Total Funding Requirement	**20.2**	**37.3**	**43.6**	**41.9**
Sources of Funding				
Canada Pension Plan Borrowing	0.0	0.0	-0.9	-0.6
Decrease/(Increase in Short-Term Borrowing	0.0	0.0	0.0	0.0
Increase/(Decrease) in Cash and Equivalents	6.0	6.0	-6.0	0.0
Preborrowing from 2016/17	-3.8	0.0	0.0	0.0
Preborrowing in 2017/18 for 2018/19	11.5	-11.5	0.0	0.0
Total Long-Term Public Borrowing	**33.9**	**31.7**	**36.7**	**41.3**
Net New Issues Bonds & MTNs	17.0	10.4	9.8	14.9

**Net issuance takes account OSB maturities of $0.6bn, $0.3bn, $0.5bn, and $0.1bn in the years shown in the table*

As it ramped up overall bond market issuance to raise $34 bn in the past year, the province took advantage of an appetite for high grade debt in other currencies, in markets where bonds outstanding had been pared back by earlier or ongoing central bank buying. The 38% of 2017/18 issuance in foreign currencies was larger than its traditional one-third share, which the province expects to revert to in the coming year. In the home currency, $18.5 bn was sourced in C$ syndicated bonds, $1 bn in green bonds, and $1.6 bn in FRNs.

The average term of new issues dropped to 12.1 years, after having run in the 13.6 to 14.2 range in the prior four years, although that still left the overall portfolio outstanding with a term of 10.9 years.

Today's budget was not materially different for the near term than markets would have expected after the province alerted investors to its plan to go back into a deficit of less than 1% of GDP. But it does represent a change in course from the prior year's focus on running sustained budget balances and a declining path for the debt/GDP ratio. Since an election is in the offing, one in which this budget plan will effectively be put to the voters, both rating agencies and investors will be watching for reactions in the polls, and the election platforms of opposition parties, before taking this budget as a *fait accompli*. But on its own, it represents a judgment call by the current government that its objectives for health and social programs and longer term growth should be given priority over improving the province's credit quality for now.