Ontario takes step closer to balance in latest quarterly update

A few days removed from a favourable expert panel recommendation on provincial pension accounting (see aside below), Ontario laid down its Q3 fiscal update, showing a nice improvement in the 2016-17 budget balance and a lower trajectory for the closely watched net debt burden. On balance, it's a constructive update, highlighting the improved fiscal base off which Ontario will set down its all-important 2017 budget. After all, 2017-18 is the year Ontario has committed to balancing the books, with another year of black ink meant to follow in 2018-19. All else equal, Ontario's healthy economic expansion and related fiscal traction (very much on display in today's update) should make it easier to reach these key fiscal milestones.

Some finer details:

- The 2016-17 deficit has been lowered to $1.9 billion, equivalent to a scant 0.24% of nominal GDP. The revised budget balance is an improvement from any number of perspectives. It's a smaller shortfall than (a) the prior fiscal year; (b) the 2016 budget plan; and (c) the fall update. And it runs to eight the number of consecutive years in which Ontario has bettered its official deficit target.

  As an aside, note that Ontario's 2015-16 public accounts and 2016-17 fall update temporarily adopted cautious pension accounting treatment for net pension assets in two jointly sponsored pension plans, pending analysis of an independent expert advisory panel. If you followed the issue, you would have seen that Ontario's 2016-17 fall update incorporated a $2.2 billion "pension adjustment" expense, while an associated write-off of net pension assets meant a higher level of net debt. The independent panel rendered its decision in recent days, recommending a return to the traditional approach for accounting for net pension assets. In accepting the panel's recommendation, Ontario has thus removed the $2.2 billion in pension expenses identified in the 2016-17 fiscal year and has likewise restored the net pension assets to its balance sheet, leading to a lower level of net debt than that telegraphed in the fall. The 2015-16 budget balance/net debt level has been similarly restated, taking last year's deficit from $5.0 billion to a more modest $3.5 billion (<0.5% of GDP). Refer to our related Quick Hit for additional information: Link

- As it stands, the 2016-17 deficit is down $2.4 billion vs budget. And Ontario still has a $0.4 billion reserve and some $0.6 billion in spending contingencies set aside. This combined padding (a bit more than $1 billion), alongside a prudent/cautious economic forecast, implies further scope for budgetary improvement when all is said and done. Really, it's conceivable that Ontario could balance its budget in 2016-17, one year ahead of schedule.
- For 2016-17, revenue is running $2.5 billion (or almost 2%) above budget, with positive contributions from a number of key revenue streams. That includes an extra $1 billion-plus of corporate income tax revenue, some $800 million of incremental sales tax revenue, over $700 million in additional PIT/health premium receipts, and above-plan proceeds from the province's land transfer tax (the most direct, but by no means sole fiscal link to a rocking housing market). The revenue picture would be even brighter save for a re-profiling of almost $500 million in anticipated cap-and-trade auction proceeds (which have been moved from the 2016-17 fiscal year to 2017-18). Federal transfers are also a touch lower than anticipated at budget time. On balance, you can view this as a broadly based and non-trivial improvement in the revenue picture heading into 2017-18.
- Program spending has been lifted $1.1 billion (or 0.9%) above plan, capturing (among other things) electricity price relief starting in January and commitments to social/affordable housing, alongside more recent investments in health care (e.g., stem cell transplants) and additional drug benefit requirements.
- Debt servicing costs are once more tracking below budget, with $11.4 billion of interest on debt expense coming in $0.4 billion below plan and consuming a modest 8.5 cents of the revenue dollar. Notwithstanding rising interest rates (flagged as an economic risk), Ontario's interest bite looks to remain manageable. Credit the province for locking in much of its issuance longer-term, dulling the immediate fallout from higher borrowing rates and providing ample flexibility to move some bond issuance down the curve if necessary.
- On that score, Ontario has thus far raised $24.6 billion in debt capital markets, with a weighted-average term of 14.0 years and a bit more than 70% sourced from the C$ market (including a successful third annual trip through the Green Bond market). Recall that the fall update signaled a $23.8 billion long-term requirement. So Ontario is in pre-funding territory and flagged an intention to "pre-borrow over and above the $800 million already pre-borrowed when presented with favourable market conditions." Successful pre-

funding implies scope for the province to reduce its long-term funding requirement for 2017-18, which as of the fall, was pegged at $23.3 billion.

- Having reversed the "pension adjustment" highlighted above, Ontario's 2016-17 net debt level is now estimated at $304.9 billion. Again, that's a lower debt level than that flagged in the fall or in the original 2016 budget plan. Net debt is now equivalent to 38.3% of GDP, which is a lower ratio than both the prior fiscal year (38.6%) or the 2016 budget projection (39.6%).
- As for economic growth, consensus expectations point to a 2.6% expansion in 2016, followed by 2.2% growth in 2017. There was a flourish of job creation to close out 2016, while retail sales and housing market indicators point to a hearty domestic expansion. Meantime, factory shipments and wholesale sales appear to have outpaced the national average last year.
- All in all, Ontario is enjoying superior economic performance, stands at the very cusp of a balanced budget, has turned an admittedly high debt burden lower and boasts a borrowing program that is already whittling away at next fiscal year's requirements. Call it a constructive update, leaving Ontario bonds somewhat better bid in secondary markets today.

Warren Lovely | Managing Director, Head of Public Sector Research & Strategy | National Bank Financial
130 King Street W, 4th Floor Podium | Toronto, ON | M5X 1J9 | T: 416-869-8598 | E: warren.lovely@nbc.ca