Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

The 2019 Federal Budget - Same fiscal path along with measures to improve housing affordability

Benefiting from a smaller-than-expected deficit in FY 2018-19, the federal government had to choose between reducing future deficits or announcing new spending measures. The government has decided to carry on with the same strategy of introducing targeted measures for the middle class and keeping the size of the deficit under control. For FY 2018-19, the deficit was revised down from $18.1B to $14.9B (0.7% of GDP). Virtually all of this improvement came from the unused $3.0B adjustment for risk. For the period covering FY 2019-20 to FY 2023-24, the budgetary balance path proposed in Budget 2019 is mostly unchanged relative to last fall's update (FES) as the average $4.4B annual improvement in revenues is offset by a $4.2B average annual increase in spending. The deficit is projected to decline from $19.8B (0.9% of GDP) in FY 2019-20 to $9.8B (0.4% of GDP) in FY 2023-24.

Program expenditures are projected to grow by 2.7% per year on average during the next five years. The main spending measures include lowering student loan interest payments ($1.7B over 5 years), a new training tax credit, and additional EI benefits for off-the-job workers training (around $800M over 5 years). No major surprise relative to the pharmacare file as the government confirms the creation of a *Canadian Drug Agency.* The objective is to negotiate cheaper drug prices and to create a national list of drugs covered by the federal government. If this plan goes ahead as proposed, Provinces are poised to receive a financial compensation.

The government's forecast for direct program expenditure (DPE; i.e. government operating costs), is ambitious. After surging by 5% on average during the last four years, DPE annual growth is projected to slow down significantly to an average of 1.0% between FY 2019-20 and FY 2023-24. This slower momentum is partly based on the government's assumption that higher interest rates will lower the present value of pension and employee benefits. Since market expectations for higher interest rates disappeared in recent weeks, we see a potential upside risk to DPE.

The deficit for FY 2019-20 could also turn out to be larger due to weaker economic momentum. Since the private sector survey of economists underpinning fiscal revenue projections has been conducted earlier this year, high-frequency indicators disappointed. We currently forecast real GDP growth around 1.3% in 2019, lower than the 1.8% included in the budget. All else equal, based on the government's fiscal sensitivities, this discrepancy would increase the shortfall by $2.5B in FY 2019-20. This could be partially offset by an improvement in the GDP deflator since crude oil prices have ramped up so far this year.

Measures to modestly improve housing affordability for first-time buyers

The 2019 budget includes a variety of targeted measures for many age cohorts. A few initiatives were announced to strengthen housing market activity, even the B20 200bps mortgage stress testing was kept intact. First, the RRSP withdrawal limit to purchase a home immediately increases from $25K to $35K per person. This measure will allow first-time buyers to increase their down payment. Second, an individual will now be able to withdraw from his/her RRSP to purchase a home as a result of a breakdown in marriage or common-law partnership.

This being said, the biggest news relates to the insured mortgage market, namely the eventual introduction of a CMHC shared equity program called the First-Time Home Buyer Incentive (FTHBI). The FTHBI will provide funding of 5% of the existing home's purchase price; or 10% of a newly-built home's purchase price. This will lower the value of the insured mortgage without increasing the cash down needed, ultimately implying lower monthly mortgage payments. For instance, if a first-time borrower buys a $400K brand new home with a 5% down payment ($20K) and a 10% equity-sharing with CMHC ($40K), the size of the insured mortgage will stand at $340K instead of $380K. The borrower will save about $230 per month in mortgage payments. In this example, CMHC keeps the $40K amount offered at a 0% financing rate as collateral. The borrower does not need to gradually reimburse the FTHBI to CMHC on a monthly basis. Instead, the home owner will be able to repay CMHC any time during the lifetime of the mortgage to possess the equity portion held by the crown corporation. Our understanding is that the amount to be reimbursed by the borrower to CMHC would increase if the home value appreciates, implying a capital gain for the crown corporation (more details will be published by CMHC in a few months, before this program becomes effective at some point later this year). In terms of conditions, the FTHBI will be available for first-time buyers with an annual household income under $120K. Thus, this measure is unlikely to be a major game changer in the expensive core markets of Toronto and Vancouver. In contrast, this targeted initiative has more chances to spur sales in Montreal, Ottawa, Winnipeg, Halifax and smaller markets. Also, the FTHBI cannot be greater than 4 times the annual household income, a way to prevent renters with lower incomes to own a home. In other words, the objective of this measure is to facilitate access to the insured mortgage market for a small group of potential first-time buyers without significantly deteriorating long-term financial stability.

Modifications to the Debt Management Program

Investors should take note of several elements in the 2019-20 debt management strategy.

- The government will try to increase the stock of treasury bills for a second consecutive year. With $151B of annual-equivalent T-Bill borrowings, the stock of T-Bills is expected to reach that amount by year-end. The targeted auction sizes are between $9B and $15B in FY 2019-20 (they stood between $8B and $14B in FY 2018-19).
- Relative to FY 2018-19, we see a slight tilt towards the middle of the yield curve with smaller target benchmark sizes in the 2-year sector (from $10B-$16B to $9B-$15B) versus higher target sizes in the 3-year sector (from $4B-$9B to $6B-$12B) and the 5-year sector ($11B-$17B to $12B-$18B). The government highlights that 3-year bond issuances «may be adjusted to address unexpected changes in financial requirements».
- The number of Real Return Bond auctions will drop from 4 in FY 2018-19 to 3 in FY 2019-20.
- The number of 10-year nominal bond auctions will fall from 5 in FY 2018-19 to 4 in FY 2019-20, but the size of each issuance will increase to compensate.
- The gross issuance of bonds is projected to be higher in FY 2019-20 ($119B, see table 1) than last year due to a larger amount of bonds maturing during the next 12 months.

Table 1: 2019-20 Borrowing Program ($B)	
Treasury Bills	151
Bonds	119
Total Domestic	270
Total Foreign	10

Source: Government of Canada.

Table 2: Composition of Market Debt ($B)

	2015-16	2016-17	2017-18	2018-19	2019-20
Domestic Bond	504	536	576	574	583
Treasury Bills	138	137	111	131	151
Foreign Debt	22	18	16	16	19
Retail Debt	5	5	3	2	1
Total Market Debt	669	696	706	723	754

Source: Government of Canada.

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