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Ontario Economic Statement – Fiscal Progress but Recession Could Alter Course

Let us start with the FY 2021-22 public accounts released last September showing a very modest surplus of $2.1B, contrasting with the $13.5B deficit estimate initially proposed in Budget 2022. The extremely strong upside in personal and corporate income tax revenues, to some extent short-lived, were the main positive drivers. Ultimately, a deficit at Queen's Park was avoided for the first time since FY 2006-07.

FY 2022-23 should mark a deterioration relative to FY 2021-22 as total revenue almost stalls (+1%) while the Province plans to boost total expenses by almost 9%. Expenses may end up lower if the $7.5B available funding for COVID is not entirely used.

This being said, what matters the most for markets relates to the major financial improvement relative to the 1st Quarter Update of last August and 2022 Budget of last March. Indeed, today's economic statement proposes a FY 2022-23 deficit of $12.9B instead of $19.9B as reported earlier this year. The largest single driver is the improvement in personal income tax revenues (+$4.8B) booked since the August 1st Quarter Update.

The shortfall is projected to narrow further in FY 2023-24 ($8.1B), followed by almost a balanced budget in FY 2024-25. This projection is based on the base case scenario, namely a soft-landing scenario including 0.5% real GDP growth for the province in 2023. Although the word "recession" was not used in the Economic Statement, the Province offers a proper fiscal planning including two alternatives and plausible scenarios, one positive and one negative. Under the proposed "slower growth scenario" including a 0.9% real GDP contraction next year, the deficit ends up a notch higher in FY 2022-23 ($14.6B) and significantly higher in FY 2023-24 ($13.9B, not far from where it could be this year). If investors filter these numbers with optimistic lenses, they will conclude that the deficit for the next two years will not be as large as predicted in the 2022 budget even if a recession becomes reality.

The buffer is large on the expenses side but thin on the revenue side. First, the buffer for the pandemic is unambiguously the biggest: $7.5B in "time-limited" COVID funding. Second, the Standard Contingency Fund to mitigate expenses risks stands at $3.5B. This amount is key as markets watch new developments surrounding the negotiations between teachers and the government. This Standard Contingency Fund declined by $1.1B since the 2022 budget because of $1.1B in additional expenses announced since the August 1st Quarter Update. These additional expenses relate mostly to targeted income support to the most vulnerable, low-income individuals. Third, the annual reserve to cover for unexpected losses in revenues remains intact at $1B in FY 2022-23 and $1.5B for the following two years, small amounts in our view considering total revenues will reach close to $190B under the base case scenario.

The same heightened economic uncertainty creates different, possible paths for borrowing requirements. According to the base case scenario, borrowing requirements have been cut by $7.8B to $32.2B in FY 2022-23 relative to the 2022 budget and by a cumulative $26B over 3 years. Under the more severe "slower growth scenario", borrowing requirements in FY 2022-23 would be a touch higher this year ($33.8B) and materially higher in FY 2023-24 ($44.2B), above FY 2021-22 ($41.1B). In respect to details surrounding the debt management plan, the province has been in a long blackout period for about a month. 58% of issuance has been done year-to-date and approximately 20% of this borrowing year-to-date has been completed outside the domestic market. Ontario has been extending its weighted-average term on debt to a record high of 11.3 years so far in FY 2022-23, versus the tight 10.7-10.9 range observed since FY 2014-15. Ontario has issued once green bond so far this year for $1B with a focus on public transport electrification. The province plans to issue more green bonds before the end of FY 2022-23. Ontario issued $2.75B in green bonds during FY 2020-21 and had a record year issuance of $4.5B last year. The Economic Statement is very transparent, including the projections used for the all-in average annual borrowing rates: 4.20% in FY 2022-23, almost doubled relative to last year's 2.1%. Annual borrowing rates are assumed to be a notch higher in FY 2023-24 at 4.50%, which could explain the plan of pre-borrowing activity of $3B in FY 2022-23 (for FY 2023-24). Another topic mattering for capital markets relates to prudential liquidity reserves expected to average $32B this year, in line with where reserves stood prior to COVID-19 after above-than-usual levels during the height of the pandemic.

In summary, Ontario's recent economic momentum has slowed lately but outperformed most other provinces and the United States. The Economic Statement shows a significant improvement to the 3-year fiscal outlook relative to the budget and 1st Quarter Update but a possible recession could prevent progress. Numbers proposed under the base case scenario also falls short of the FAO late October projections including surpluses and rapid decline in the net debt-to-GDP ratio to 32%. According to the Economic Statement, the net debt-to-GDP ratio projected at 38.4% this year is poised to stay on its gentle downward path.

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