Québec Fiscal Update 2019 – A Cyclical Surplus

The newly released Public Accounts reveals a surplus of $4.8B in FY 2018-19 after the $3.5B contribution to the Generations Fund. This positive revision is large, considering that a $2.5B surplus was expected in the March 2019 budget and that the March 2018 budget's forecast was a balanced budget. The main source of improvement is the upward revision in own-source revenues, up 6.6% in FY 2018-19 from the previous year. Similar to Ontario's fiscal update also released this week, the strong improvement in Quebec's labour market conditions explains a considerable part of the $2.3B upside surprise relative to the March 2019 budget expectation. For instance, annual growth in wage and salaries is expected to remain high, near 5%, for a third consecutive year in 2020, reflecting the lowest unemployment rate in the Province's history (5%). Also, the trickle-down positive effect on housing activity in the Province is particularly noticeable: housing starts are running at the fastest pace since 2010 (close to 50K units annualized) and MLS residential resale transactions are standing at an all-time high (close to 80K units annualized).

The government decided to spend slightly more than one-third of the $2.3B fiscal balance improvement. The total cost of new measures announced in the *Update* is estimated at $0.9B per year. For instance, money will go back directly to families through the faster enhancement of the family allowance per child and the abolition of the additional contribution for childcare. The *Update* also includes the new formula to increase transfers to municipalities equivalent to 1% of the Quebec Sales Tax ($1.1B over 5 years); this new 5-year deal was signed last week between the Province and municipalities in Quebec City.

Altogether, the government forecasts a $1.4B surplus instead of a balanced budget in FY 2019-20, after another generous contribution (of $2.7B this time) to the Generations Fund (the book value of the Generations Fund is anticipated to reach $9.0B in March 2020). Own-sources revenues are expected to be virtually unchanged in FY 2019-20 (+0.3%) relative to the previous year. The drag will likely come from the expectation of a 20% decline in government enterprises revenues associated with the anticipated profit normalization at Hydro-Québec following the very cold temperatures of last winter. Also, the *Update* includes a temporary 10% boost in federal transfers during FY 2019-20 due to Ottawa's financial contribution related to the spring 2019 floods and the asylum seeker situation.

On track to register a 6th consecutive surplus in FY 2019-20, the Province will continue to reduce the public debt burden. For instance, the gross debt-to-GDP ratio (debt on financial markets *plus* the commitments in respect of the retirement plans of public sector employees *minus* the Generations Fund) is projected to fall from 45.8% in March 2019 to 44.6% in March 2020, a giant leap relative to the 54.3% figure of March 2015. Still, the government expresses adequate prudence in the *Update*. Indeed, by using the comparable net debt-to-GDP ratios, Quebec's debt burden will likely remain above the current provincial average of 30.3% even though it is projected to drop further: from 39.7% in March 2019, to 38% in March 2020 and to 34% in March 2024. Second, fiscal prudence is imperative given the limited future upside of Quebec's economic potential coming from the labour market. Indeed, the elevated employment rate for the key cohort 15-59 years old (78.6% today vs. 69.8% in 2000) that cannot go more than another inch higher. Third, the remarkable cyclical strength is unlikely to last: annual real GDP growth is poised to range close to 1 ¼% - 1 ½% starting in 2020, supporting the Sherbrooke University's finding that the current surplus is entirely cyclical rather than structural.

This being said, in our view, Quebec is in a better position than any other Province to shield its economy from an expected negative economic shock. First, the household savings rate stands at a 15-year high of 6%. Second, the stabilization reserve stands at $12B and is expected to reach $13.4B in March 2020 once the projected $1.4B surplus materializes. In reality, and as explained in the *Update*, "*the stabilization reserve is not money in the bank*". The accounting entry of each surplus dedicated in the stabilization reserve ultimately reduces the gross debt. Thus, if the government eventually needs to use the stabilization to balance the books or decides to deposit new sums in the Generations Fund, it will need to borrow additional dollars on financial markets that are not part of the current borrowing program. Speaking of, borrowing requirements have been revised up modestly from $11.8B to $12.5B in FY 2019-20 (92% of the scheduled financing program is completed; 80% of the borrowings had a maturity of 10yrs+). This upward revision stems from several sources: higher repayments of borrowings, net financial requirements, the use of pre-financing and the government's intention to add $1.5B to the Retirement Plans Sinking Fund. The RPSF is used to pay the retirement benefits of public sector employees (its net liability was estimated at $18.4B last March; put differently, the RPSF was equal to 78% of the actuarial obligations on a book value basis as of March 2019).

Finally, until the 2020 budget is released next spring, one key development investors should monitor is the labour negotiations between the government and public sector employees. Current union contracts expire at the end of March 2020. Premier François Legault mentioned earlier this fall that wage increases will be limited to the rate of inflation for most groups. Teachers recently asked for a cumulative 9% wage increase over 3 years.

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