# Under Scrutiny: Canada's AAA Credit Rating

On April 8th, S&P Global Ratings revised its credit outlook for Australia from AAA-stable to AAA-negative, citing an important deterioration in the country's economic outlook and the resulting impact on its fiscal performance due to COVID-19. Should investors expect the same revision to Canada's AAA-rating? The short answer is yes. Does it matter in the present context? Not so much.

**What does a negative outlook imply**

A negative outlook is not a credit downgrade. It indicates the rating agency's opinion that, over the long term, a credit rating may be lowered. For example, S&P Global Ratings assigns a negative outlook when it sees "at least" a 33% chance of a credit downgrade over the next two years for an investment grade issuer such as a sovereign state.[1] The negative outlook is not based on current economic and fiscal forecasts, but on the fact that the risks to the forecasts are strongly tilted to the downside.

**What threatens Canada's credit outlook**

Ratings agencies use a list of factors to determine credit ratings.[2] For sovereign states, a number of institutional, economic and fiscal variables are being considered to assign each factor a score: institutional, monetary, economic, external and fiscal factors. Thus, a majority of key credit factors applied to advanced economies remains strong despite the severe recession brought on by COVID-19. For instance, in its review, S&P continued to assign its highest score (1 on a scale of 6) to Australia's institutional framework and monetary system. Canada should also preserve an elevated score for these factors. However, for both Canada and Australia, other factors are quickly deteriorating because of the COVID-19 recession.

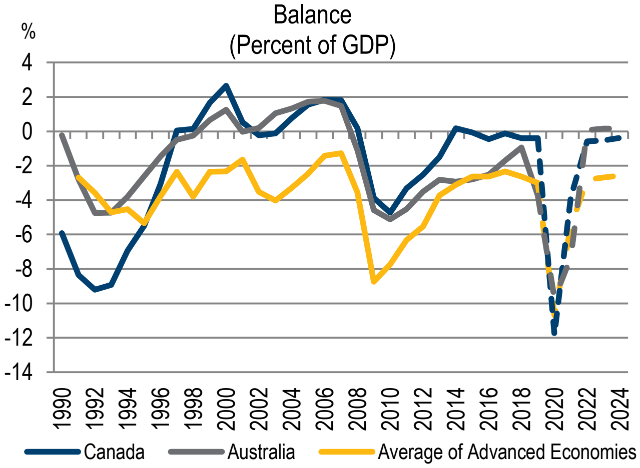
*The fiscal factor*

Public debt is rising very quickly. Revenues are drying up due to the economic contraction. At the same time, authorities, especially at the federal level, introduced unprecedented fiscal packages to support households and businesses. In Australia, total revenues and spending measures introduced are estimated by the IMF at A$194B (9.9% of GDP) through FY 2023-24, with the vast majority to be effective in FY 2020-21.[3] Canada had introduced the equivalent of $193B (8.4% of GDP) in fiscal measures as of April 16th. While Canada's federal response stands slightly below Australia's, it has been expanding regularly. The combination of lower revenues and higher spending results in ballooning deficits. Canada's Parliamentary Budget Officer estimates Canada's federal government deficit for FY 2020-21 at $184B. Representing 8.5% of GDP, this would be the largest federal deficit since FY 1984-85. That number is likely to be revised up based on the new federal programs announced in the last two weeks. Including provincial and local governments, a concept called *general government*, the IMF estimates Canada's deficit at 11.8% of GDP for FY 2020-21 (chart 1). This figure stands above Australia's (9.7% of GDP) and the average for advanced economies (10.7% of GDP). As a result, Canada's net debt-to-GDP, which strips out financial assets from total debt, is poised to rise 15 ppts to 41% in FY 2020-21 (chart 2). This would form the highest debt ratio since FY 2001-02 but would remain much lower than the average for advanced economies. Altogether, as was the case for Australia, we

[1] For more details, see S&P Use Of CreditWatch And Outlooks (2009).
[2] For more details, see S&P Sovereign Rating Methodology (2017).
[3] As of April 23rd. Source: IMF Covid-19 Policy Response Tracker.

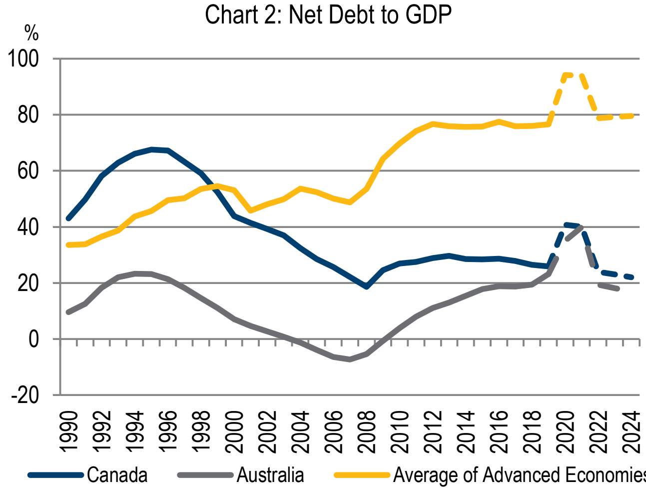
believe those projected debt levels will not result in an imminent credit downgrade but will likely translate into a negative outlook.

Chart 1: Net Lending (Borrowing) / Budgetary Balance (Percent of GDP)




Source: IMF Fiscal Monitor April 2020.

Chart 2: Net Debt to GDP




Source: IMF Fiscal Monitor April 2020.

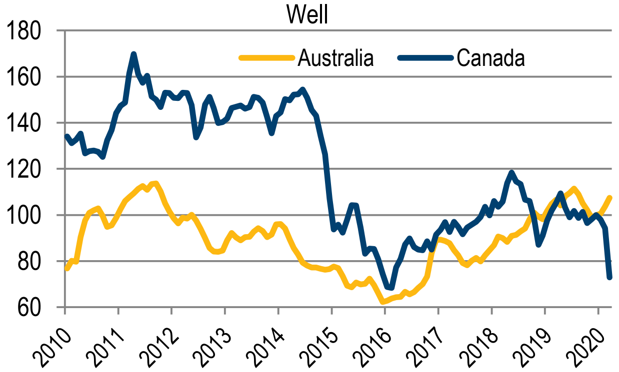
*The external factor*

Similar to Australia, Canada is a small, open economy. External events affect its outlook through many different channels. First, the global economy is arguably in its worst shape since the end of the Second World War. In March, the J.P. Morgan Global Composite PMI index fell to its lowest level in eleven years and the April number is likely to be worse. While services industries hit a record low in March, the export-oriented manufacturing sector also severely contracted. Hence, Australia and Canada are being hit by collapsing external demand. Second, while Canada might get the epidemic under control and partly re-open its economy within the next 6 weeks, Canada-U.S. trade activity will remain in the slow lane until authorities reopen the border, which is not expected for at least another 30 days.

*The compounding impact of oil*

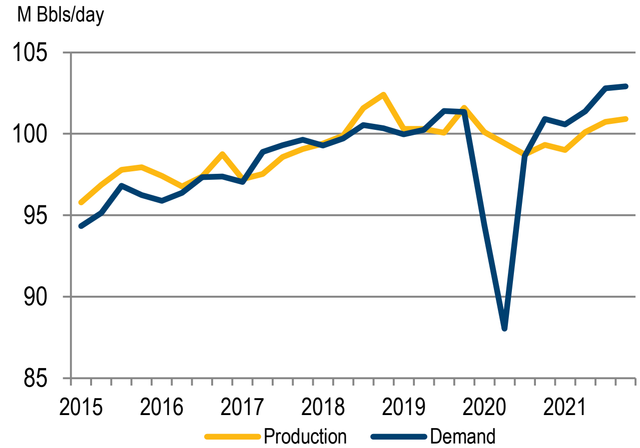
As a major oil producer, the collapse in oil prices will affect Canada's terms of trade and nominal GDP disproportionally relative to other countries. Granted, other large commodity producers such as Australia are feeling the pinch of lower demand for commodities and from supply chain disruptions. However, the value of Australia's top non-energy export commodities such as iron ore and coal has not declined as much as crude oil (chart 3). Moreover, natural gas prices have been stable and gold prices have increased. In the case of crude oil, the very large imbalance between supply and demand in the market, estimated at least to 11M bbls/day in 2020Q2 (chart 4), contributed to a 79% decline in prices since the beginning of 2020. As a result, Canadian energy companies have slashed capital expenditure programs. We estimate that investment in the Canadian oil and gas industry will shrink by more than 60% in 2020 based on companies' updated capital investment plans. Some also disclosed a plan to cut oil production by as much as 10% in 2020. Altogether, this will undoubtedly lead to more permanent layoffs, increasing the costs of the Emergency Response Benefit and the EI programs. The federal government could also offer direct financial support to oil-producing provinces and companies. Beyond 2020, the structural damage post-virus will likely lead to a slower path to recovery for Canada relative to Australia.

Chart 3: Australia's Commodity Price Index Held Up Well




Note: Rebased to December 2019 = 100.
Source: Reserve Bank of Australia, Bank of Canada, LBS Econ. Res. and Strategy.

Chart 4: The Imbalance in the Global Oil Market




Source: EIA.

**Governments need to worry about the economy before debt**

DBRS and Moody's confirmed Canada's AAA-stable rating in late March and early April respectively. Nonetheless, compounding the oil dynamic to the two above-mentioned factors could very well lead to a negative outlook on Canada's credit ratings in the future. An outright credit downgrade could also be possible but only under a gloomier economic scenario *e.g.* if authorities cannot bring the pandemic under control by the end of 2020Q2, in the case of a severe second wave of infection or if economic activity remains depressed for longer-than-expected.

Would a negative outlook matter? Under the current context, not so much. Governments need to focus on supporting businesses facing permanent closure and households facing bankruptcy. Taking on more public debt might be the appropriate prescription to prevent this recession from turning into a depression. Although fiscal sustainability issues still matter, they will need to be addressed in a different context than a pandemic.

**A limited market impact**

Would a negative outlook lead to higher borrowing costs for the Canadian government? Again, not in the current context. The big difference between this recession and previous ones is the proactivity of monetary authorities to support the economy. The Bank of Canada (BoC) recently joined the chorus of central banks reinforcing low interest rates and market liquidity. First, the BoC has been increasing its participation in T-Bills auctions. Second, the BoC launched a large-scale asset purchase (LSAP) program to keep a lid on the net supply of Government of Canada (GoC) bonds in the market in spite of rising gross issuances. Set at a minimum of $5B per week at the moment, this pace of purchase is equivalent to 11% of GDP on an annualized basis and could be increased if market conditions worsen. The BoC said it will continue to purchase federal bonds in the secondary market well after the recovery is underway. Third, the BoC also introduced a $50B provincial bond purchase program and a $10B corporate bond purchase program. Since they both consist of cash injection in the system, they contribute to maintain demand for GoC securities in the secondary market.

Finally, the Australian-US dollar exchange rate's reaction to the negative outlook on Australia's credit rating was not material. The same reaction can be expected should a credit rating agency places a negative outlook on Canada's debt. However, an outright downgrade, especially if unanticipated, would generate in our view a more significant depreciation of the Canadian dollar.

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