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Amidst unsettled backdrop, Ontario takes important steps forward

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Highlights

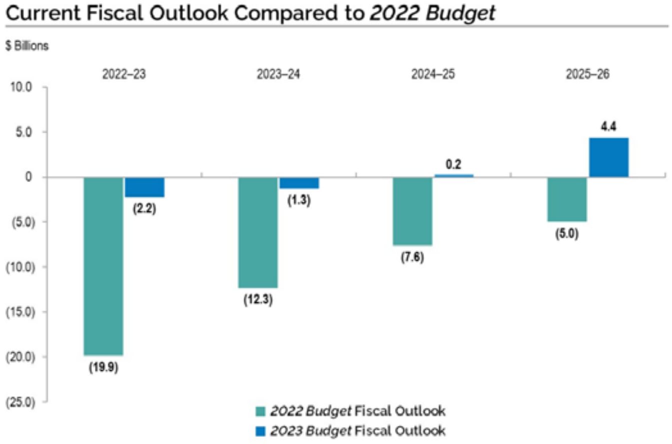
A lot can change in a year, or even a few days as we've been reminded of late. This time last year, Ontario presented a pro-growth, pre-election budget amidst what in hindsight was a relatively solid outlook for the local, national and global economies. Fast forward to spring 2023 and reading the global tea leaves (be they economic or financial) is a bit tougher, with anxiety having been primed by restrictive monetary policy settings and most recently by banking sector wobbles abroad. It's against this somewhat unsettled backdrop that Ontario presents Budget 2023, dubbed 'Building a Strong Ontario'. Despite being pulled in a few different directions, the government appears keenly focused on maintaining its recent fiscal momentum. Certainly, there's no shortage of progress to report on. In what amounts to a second-straight budgetary beat of immense proportions, the outgoing fiscal year's deficit has been cut again, to just $2.2 billion. An even more modest shortfall of $1.3 billion has been pledged for 2023-24. Once again, this is much improved vs. prior guidance and all-but-balanced when scaled to Ontario's rather sizeable nominal GDP. The coming fiscal year's budget balance target once again embeds non-trivial prudence, protecting against weaker growth (i.e., recession) should it arrive. A fully balanced budget is telegraphed for 2024-25, Ontario bringing forward the timeline for deficit elimination by three years (vs. Budget 2022's plan). There's significant and wide-ranging action on two main fronts: 'Building Ontario' and 'Working for You'. The former focuses on spurring economic growth, including tax relief for manufacturers and small businesses, alongside supports/incentives for mineral development (including the Ring of Fire). Among other things, the latter stream keys on health care, where major investments significantly outstrip the marginal cash recently pledged by Ottawa. Having bettered fiscal targets by a considerable margin in the past two fiscal years, Budget 2023 tightens up commitments on key debt sustainability anchors, including a pledge to keep the closely watched net debt-to-GDP ratio below 40%. That ratio is currently 37.8% and is expected to move sideways in 2023-24. The interest bite looks to be 6.9% of revenue in the coming fiscal year and is not to exceed 7.5%. Notably for bondholders, Ontario is telegraphing a significantly smaller bond program. Indeed, 2023-24's $27.5 billion gross long-term borrowing requirement looks to be one of the lightest requirements in the post-GFC era, capturing substantial budgetary progress and also pulled down by some nifty (some might say prescient) pre-funding. Note that in contrast to the economic and financial market uncertainty noted raging globally, Ontario's political picture is stable, as Doug Ford's PC government secured a fresh (and stronger) majority government in last year's general election.

- **Economic outlook** – Ontario's economy has been on an impressive run, the province generating ample jobs and growth since a pandemic recovery took hold. Building on a very rapid 2021 advance, real GDP climbed a brisk 3.7% in 2022, while the jobless rate averaged an historically low 5.6%. Manufacturing/wholesale activity and exports all bounded ahead, while consumers likewise remained well engaged in 2022. Not all sectors of the provincial economy were firing strongly mind you, as rapid interest rate hikes precipitated a 30%-plus downturn in home resales. Overall, it would be fair to characterize Ontario's recent economic performance as 'resilient'. This resilience looks to be tested somewhat in 2023. The budget envisions just 0.2% real GDP growth this year, a forecast that was set 0.1%-pt below the private sector consensus prevailing in late January. While some may be revisiting their economic forecasts in the wake of recent turbulence, a multi-faceted approach to budgetary prudence would appear to provide material insulation as we detail below. Having generated an exceptional number of new jobs in the past two years, hiring is due to moderate in 2023 (employment growth of 0.5% is assumed). Factor in labour force growth—spurred by robust population gains, that have in turn been powered by a wave of primarily economic immigration—and Ontario's unemployment rate is expected to rise to a still-healthy 6.4% in 2023. Resale housing activity may remain challenged and the average resale price is slated for near-10% decline this year. Consumers are also expected to be somewhat less enthusiastic. Meanwhile corporate profitability looks to be pressured, which partly contributes to an anticipated slowing in nominal GDP growth (to 2.8% for 2023 vs. last year's 9.4% advance). The medium-term economic outlook sees growth picking back up starting in 2024. Further out, real GDP growth is thought to average a relatively solid 2½% in 2025/2026, the corresponding pace of nominal GDP growth averaging 4½% during that time period. As with 2023, the budget planning assumptions for future year real GDP growth are in all cases set 0.1%-pt below consensus.
- **Outgoing fiscal year update (2022-23)** – Ontario's deficit continues to melt away. The province now estimates a budget deficit of $2.2 billion for 2022-23. That works out to a scant 0.2% of GDP or barely 1% of total provincial revenue. If you've tracked the progression of the 2022-23 deficit, it's been a pretty impressive ride: Budget 2022 = $19.9 billion ➢ Q1 = $18.8 billion ➢ FES = $12.9 billion ➢ Q3 = $6.5 billion ➢ Budget 2023 = $2.2 billion. And this isn't the last word either. The final budget balance will be confirmed via forthcoming public accounts. Past is necessarily prelude but final public accounting adjustments have proven positive in recent years. And we would note the presence of $1.75 billion in residual contingencies for 2022-23 "which is available to offset additional expenses that may materialize before the end of the fiscal year". As it now stands, revenue is a whopping $20.6 billion or 11½% above budget, as a number of vital own-source revenue streams (e.g., personal income tax, corporations tax, sales tax) benefited from a heretofore vibrant economic expansion. You won't find any major revenue line items missing the budget by much, save for land transfer tax where proceeds are off as housing market activity ran headfirst into aggressive monetary policy tightening. As it

stands, Ontario's program outlays are running $4.0 billion or ~2% above budget, which clearly implies that the vast majority of 2022-23's windfall revenue has been applied right to the bottom line (and by extension the debt). We have given Ontario (and certain other provinces) credit for committing a material share of bonus revenue to budgetary consolidation, a move that looks increasingly prudent in light of decelerating global growth. Which leads us to…

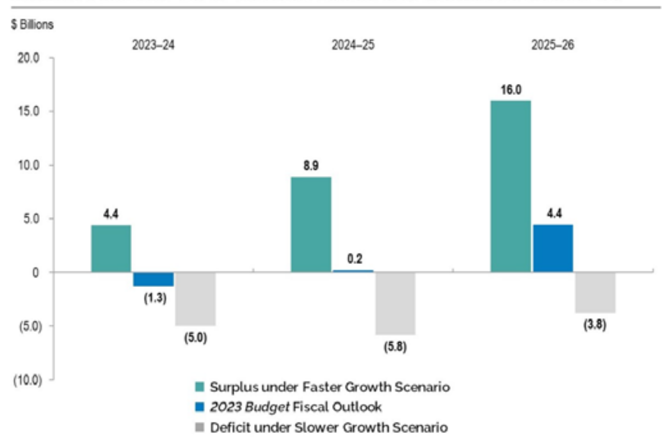
- **Coming fiscal year outlook (2023-24)** — For all intents and purposes Ontario sees itself in a broadly balanced fiscal position for 2023-24. Technically, the budget projects a modest deficit of $1.3 billion, which barely registers when stacked up against the province's $1 trillion-plus of nominal GDP. (The freshly projected deficit is a tiny 0.1% of GDP if you do the math.) Moreover, as has long been the case, the budget embeds considerable prudence (outlined in a separate bullet below). So while there are external risks and uncertainties to navigate, Ontario has once again taken steps to protect from disappointment; think of this as budgetary insurance for an unsettled economic day and age. Consistent with the comedown in nominal growth, total revenue growth will moderate to 2%. From an own-source revenue perspective, a pullback in corporations tax (as profits decline) looks to be offset by further gains in personal income tax (capturing Ontario's strong labour market). Federal government transfers are due to grow, including recently announced enhancements for health care. Saying that, the province is prepared to make much larger investments in health, with new provincial commitments outstripping marginal federal supports by roughly 3.5:1 over the coming three years. Indeed, it's in health care where the program spending impulse is most obvious… not just for 2023-24 but longer term. Note, however, that certain time-limited COVID expenditures are now ending, while other one-time outlays booked into 2022-23 (notably for land claims) won't be repeated in the fiscal year ahead. With these special/chunky outlays dropping away, total program spending is positioned for 0.8% growth, helping to secure some marginal budgetary progress even in the face of an economic slowdown. All in all, Budget 2023 shows Ontario on an improved fiscal footing vs. prior guidance (e.g., the 2023-24 deficit was last forecast at $8.1 billion in the FES). And the budgetary upgrade doesn't end there…
- **Revised medium-term outlook** – Ontario now officially projects budget surpluses starting in 2024-25, bringing the timeline for deficit reduction forward. Just one year ago, in Budget 2022, the province believed it would need until 2027-28 to return to balance. The first surplus, in 2024-25, is expected to be modest at $0.2 billion, but would grow to $4.4 billion by 2025-26 under the baseline scenario. Getting into the black and staying there assumes a gradual strengthening of economic growth, resulting in average annual revenue growth of 5.2% for the two-year period ending 2025-26. Program spending growth would look to be limited to roughly 3%/year during that same timeframe. If you go in for sweeping comparisons, the new fiscal framework delivers a net $61.4 billion cumulative improvement for the five-year period ending 2025-26 compared with Budget 2022's estimates/forecasts. To be clear, this cumulative enhancement includes sizeable upgrades to prior and/or outgoing years which are appropriate to include in our opinion as they ultimately contribute to a lower debt level than would otherwise have been the case.
- **Alternative fiscal scenarios** – There's no shortage of uncertainty these days, so credit Ontario for once again detailing faster and slower scenarios (not just for the budget balance but for other key debt and borrowing metrics). When it comes to the budget balance, a slower growth scenario characterized by a 0.7% contraction in real GDP for 2023, would add to the deficit: moving the 2023-24 shortfall from a projected $1.3 billion to $5.0 billion. Under the slower growth scenario, Ontario would not return to balance by 2025-26, all else equal. There are of course, faster growth scenarios that would speed the fiscal recovery along, although it might be fair to say that many are focused on downside risks in light of recent banking sector stress and financial market turbulence.

Current Fiscal Outlook Compared to *2022 Budget*



Source: Ontario Ministry of Finance.

Ontario Medium-Term Outlook Based on Alternative Scenarios



Source: Ontario Ministry of Finance.

- **Select investments/initiatives** — The budget's plan to "build a stronger Ontario" is laid out as a two-pronged approach, focused on (a) growing the economy by spurring investment and building infrastructure and (b) improving public services (including healthcare and education) and addressing costs pressures for those who need it most.
  - In its plan for 'Building Ontario', the province aims to drive growth by lowering costs, getting key infrastructure projects built faster, attracting more jobs/investment, and cutting red tape. You'll even find an explicit reference to the U.S. Inflation

Reduction Act, which "is threatening Ontario jobs and competitiveness". To address this, the budget proposes a new manufacturing tax credit which would provide a 10% credit on qualifying investments in buildings, machinery and equipment used for Ontario manufacturing. This would come at an estimated cost of $780 million over three years. There's also a pledge to expand access to the small business corporate tax rate by increasing the phase-out range, which would provide $265 million of tax relief over three years. These are part of a broader suite of measures for businesses big and small, that the province says would enable $8 billion in cost savings and support. You'll also see the budget prioritize attracting investments from global automakers and advancing Ontario's Critical Minerals Strategy. An ongoing commitment to building highways, transit, schools, hospitals and other infrastructure is prominent too, with $184 billion in spending planned here over ten years. This includes more than $48 billion in hospital infrastructure, $70 billion for transit and $15 billion for schools/child care over the next 10 years.

- Unsurprisingly, a key focus of 'Working for You' is related to health care. The government pledges funding for growing the number of doctors/nurses, improving the access to and quality of in-home care, and supporting mental health. Funding is also earmarked for expanding employment in skilled trades and helping immigrants find employment in their fields. On the cost-of-living front, the province plans to continue providing relief from gas and fuel taxes until the end of 2023, reduce transit costs, provide more support for seniors and fund homelessness prevention. Finally, there's also a focus on safety as the government plans to fight gun- and gang-related crime and improve the province's emergency preparedness system.

- **Contingencies/prudence & official sensitivities** – Consistent with past practice, the budget incorporates meaningful prudence across a few dimensions. First, there's the sub-consensus forecasts for real GDP growth in 2023 and beyond. For the current fiscal year (2023-24), a reserve of $1 billion has been set aside. The reserve doubles to $2 billion for 2024-25 and doubles again to $4 billion come 2025-26. As per the budget: "These increases reflect Ontario's commitment to maintaining a prudent and flexible fiscal plan that can respond to elevated economic uncertainty, notably higher levels of inflation and the impact of higher interest rates on the economy." There's another important buffer in the form of a standard contingency fund, amounting to a sizeable $4 billion for 2023-24. All told, we consider this significant prudence outright and also by provincial standards. To be treated with caution, official fiscal sensitivity analysis suggests a 1%-pt 'surprise' on nominal GDP growth is worth ~$1.3 billion in total taxation revenue/year (all else equal). The budget assumes 3-month GoC T-bills average 4.3% in 2023 before gradually receding. Meantime, 10-year Canadas are assumed to average 3.1% in calendar 2023. In terms of related sensitivities, it's believed that a 1%-pt parallel shift up in Ontario borrowing rates adds over $600 million to the interest bill in year one.

- **Debt burden & interest bite** – Ontario's net debt is now projected to end 2022-23 at $396 billion, diving nearly $33 billion below the level projected in Budget 2022. That rather striking evaporation of net debt captures both the outgoing year's significant budget beat but also the impact of positive final revisions to 2021-22 (confirmed after Budget 2022 was presented). It follows that the net debt-to-GDP ratio was also considerably better than expected, as this closely watched metric is ending 2022-23 at 37.8% (or 3.6%-pts lower than plan). Notwithstanding the tiny deficit in 2023-24 and anticipated move into surplus starting in 2024-25, an ambitious capital plan will keep the level of net debt moving higher in future years (e.g., +$10.6 billion to $406 billion for 2023-24). Nonetheless, continued growth in nominal output is believed to keep the debt-to-GDP steady in the coming year before returning to a downward trajectory thereafter. The baseline scenario puts net debt at 36.9% of GDP by 2025-26, while the slower growth/recession scenario would have this ratio closer to (but not quite at) 40% in the medium-term. Which brings us to the revised and tougher fiscal anchors outlined in today's budget. With net debt-to-GDP coming down faster-than-expected, Ontario now pledges to keep this ratio below 40%; previously the commitment was not to exceed 42%. By lowering this notional debt ceiling, the province is effectively aiming to lock in recent fiscal progress and we welcome this stronger and well-publicized commitment. Note that Ontario also keys on its net debt-to-revenue ratio as a formal 'debt sustainability measure'. Here too Budget 2023 makes a stronger commitment: net debt is not to exceed 200% of revenue vs. <250% previously. This ratio is forecast at 199% for 2023-23, so once more Ontario is signaling that it means business. The interest on debt-to-revenue ratio (aka 'interest bite') is another area where the government's targets/anchors are being tightened up. Interest charges are set to consume 6.9% of revenue in the coming fiscal year, up modestly vs. 2022-23 (6.7%). Still, the budget pledges to keep the interest bite at less than 7.5% of revenue (prior target: <8.0%). We'd note that higher borrowing rates are adding to the interest bill, but a lower-than-planned level of debt is neutralizing things from a budgetary perspective, as the trajectory for total IOD charges is now more favourable (i.e., lighter) than what was telegraphed in Budget 2022.

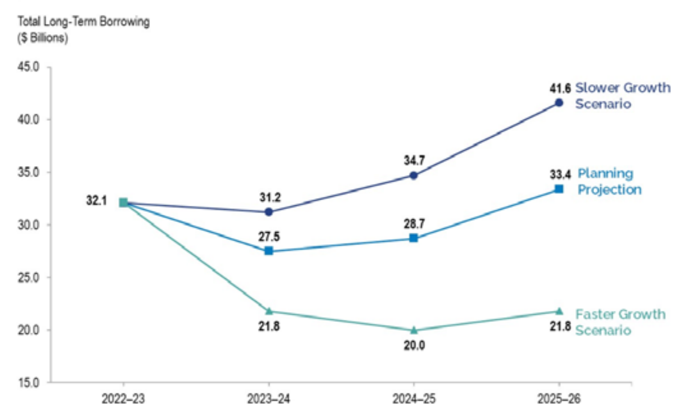
Net debt-to-GDP to stay below **40.0 per cent**

Net debt-to-revenue to be below **200 per cent**

IOD-to-revenue to stay below **7.5 per cent**

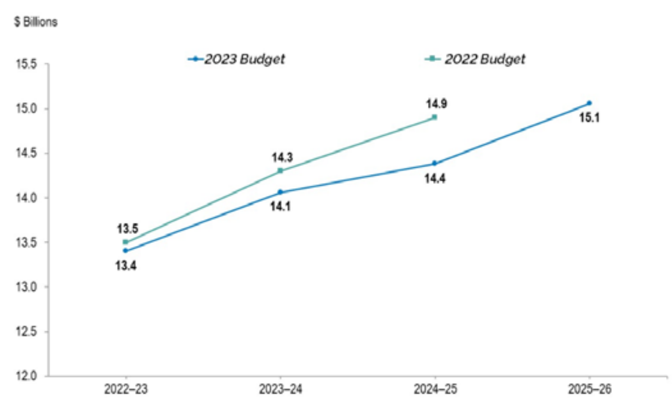
- **Long-term borrowing requirement** — Ontario completed $32.1 billion in gross long-term borrowing in 2022-23, a bond tally that fell more than $9 billion shy of Budget 2022 guidance. To be clear, Ontario could have stepped its borrowing activity down much more, such was the magnitude of the cash enhancement from 2021-22 and 2022-23 revisions. But the province opted, prudently in our view, to leverage still-favourable market conditions and solid demand for its debt, ultimately pre-financing a tidy $14.5 billion. That was an even larger amount of pre-funding than was conducted the prior fiscal year and shows the province's preference for getting ahead of things when and where they can. In the final analysis, some short-term debt was paid down, contrasting with the increase in short-term outstandings that was part of the original plan. With so much pre-borrowing in hand, Ontario is able to officially project $27.5 billion in gross bond issuance for the coming fiscal year. For context, total debt maturities/redemptions are scheduled at $31.2 billion for 2023-24. The borrowing plan outlines a temporarily build up $5 billion in cash in the coming fiscal year to help manage some large maturities coming due in early 2024-25. After accounting for this year-to-year cash management, the medium-term plan would see Ontario issuing $28.7 billion of gross bonds in 2024-25, followed by $33.4 billion in gross supply in 2025-26. Suffice it to say, the fresh borrowing figures represent a dramatic improvement vs. prior guidance and are one of the more effective means of illustrating the budgetary enhancement being secured by Canada's largest province. One imagines that having slashed planned issuance so materially, Ontario has with this budget soothed any supply-related fears that might have exisited. For our part, we are impressed and view this budget as constructive for the credit. Under the slower growth/recession scenario, there could perhaps $4 billion of additional debt to issue in 2023-24, although we'd remind you of the significant prudence embedded in the budget target alongside the potential scope for positive cash adjustments via the upcoming public accounts. On borrowing strategy, note that 88% of the 2022-23 program was sourced domestically. To us, it follows that the borrowing program becomes more domestic in orientation as total issuance steps down. Ontario will aim to source 75-90% of its 2023-24 borrowing from the domestic market, responding as always to the evolving tastes/demands of its broad and deep investor base. Term extension has remained the name of the game, with weighted average term of 2022-23's $32.1 billion in supply a relatively lengthy 15.0 years (the longest in the post-GFC era in fact). Green Bonds also remain a strategic focus, with two offerings totaling $2.5 billion in 2022-23. Guidance once again indicates that the province will seek to issue "multiple Green Bonds each fiscal year, including 2023-24". As previously noted, an update to the Green Bond Framework is being considered, including the potential expansion from green to sustainable offerings. Notwithstanding considerable short-term borrowing capacity and demonstrated access to term markets at home and abroad, Ontario maintains a sizeable liquidity buffer. Liquid reserves were equivalent to $43 billion at time of budget.

Borrowing Outlook Scenarios for Long-Term Borrowing



Sources: Ontario Financing Authority and Ontario Ministry of Finance.

Comparison of Interest on Debt Expense Forecast



Source: Ontario Financing Authority.

- **Current long-term credit ratings** — S&P: A+, Stable | Moody's: Aa3, Stable | DBRS: AA(Low), Stable | Fitch: AA-, Stable
  [Refer to our Provincial Ratings Snapshot for additional colour on specific credit rating drivers/considerations]

Details of Ontario's Fiscal Plan
($ Billions)

	Actual 2021–22	Interim[1] 2022–23	Medium-Term Outlook 2023–24	Medium-Term Outlook 2024–25	Medium-Term Outlook 2025–26
Revenue — Personal Income Tax	46.8	52.8	56.0	58.7	62.0
Revenue — Sales Tax	30.4	35.9	35.4	36.8	38.6
Revenue — Corporations Tax	25.2	27.9	24.7	25.9	28.2
Revenue — Ontario Health Premium	4.4	4.7	4.9	5.1	5.3
Revenue — Education Property Tax	5.7	5.8	5.7	5.7	5.8
Revenue — All Other Taxes	19.2	17.6	17.6	19.8	20.6
Total Taxation Revenue	**131.7**	**144.7**	**144.2**	**152.1**	**160.4**
Government of Canada	30.6	31.3	34.8	35.1	37.1
Income from Government Business Enterprises	6.4	6.5	6.3	6.7	8.5
Other Non-Tax Revenue	16.3	18.0	19.0	19.2	20.0
Total Revenue	**185.1**	**200.4**	**204.4**	**213.0**	**226.0**
Total Programs	**170.4**	**189.1**	**190.6**	**196.4**	**202.5**
Interest on Debt	12.6	13.4	14.1	14.4	15.1
Total Expense	**183.0**	**202.6**	**204.7**	**210.8**	**217.5**
Surplus/(Deficit) Before Reserve	**2.1**	**(2.2)**	**(0.3)**	**2.2**	**8.4**
Reserve	–	–	1.0	2.0	4.0
Surplus/(Deficit)	**2.1**	**(2.2)**	**(1.3)**	**0.2**	**4.4**
Net Debt as a Per Cent of GDP	39.8%	37.8%	37.8%	37.7%	36.9%
Net Debt as a Per Cent of Revenue	205.6%	197.5%	198.9%	197.3%	190.2%
Interest on Debt as a Per Cent of Revenue	6.8%	6.7%	6.9%	6.8%	6.7%

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