

Red is the New Black

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Overview—It's the End of the Surpluses as We Know It... and Ottawa Feels Fine

What a difference a year makes. After last year's Federal Budget, we crowed that Ottawa's deficit was "a thing of the past", as the prior government projected a string of surpluses, starting in FY15/16. Fast forward 11 months and, with a new administration in place, Finance Minister Morneau is now projecting a string of budget deficits as far as the eye can see, with even FY15/16 starting with a small deficit (after a small surplus the prior year, which also was not expected a year ago). But, this comes as little surprise, as it was well-advertised ahead of today's budget that we would be looking at years of red ink, especially in light of a weaker-than-expected economic backdrop, loaded on top of the government's election pledge to crank up spending and run \$10 billion shortfalls. The two major areas of uncertainty heading into today were: 1) how much net new stimulus would be planned for the coming fiscal year; and 2) how aggressively would it be wound down in coming years, if at all? In other words, how big would the deficit be in FY16/17, and how soon would it head back towards balance?

On each of these questions, the answer is not shocking. As mostly expected, Ottawa will stick to their initial election plan of injecting just over \$10 billion of net new stimulus in the coming year (equivalent to 0.5% of GDP), which will push the expected deficit to \$29.4 billion. Deficits in excess of \$20 billion then persist for two more years, and a \$14 billion shortfall still remains by FY20/21—in other words, no plan to balance the books, even beyond the first mandate. This scenario would see the closely-watched debt/GDP ratio rise again this coming fiscal year, to 32.5%, before grinding back down to 30.9% by FY20/21, essentially back to where it started when the government took office.

Note that above and beyond the headline-grabbing \$29 billion deficits over the next two years, arguably the bigger story in the budget plan is the notable lack of a serious reversal of stimulus in the ensuing years. Recall that this government was elected on a pledge to run deficits for two years (at that time, just under \$10 billion), and then bring finances back to balance over the next two years. That plan has gone out the window, and not just because the economy is more challenging in the near-term. Indeed, today's budget includes net new fiscal measures of \$7 billion per year as far out as FY20/21, leaving the above-noted \$14 billion gap at that point. Thus, even five years out, the fiscal plan now includes deficits well above the previously pledged maximum limit of \$10 billion. Has the long-term economic outlook changed that dramatically in the past five months? In a word, no.



- **Budget deficit jumps to \$29.4 billion in FY16/17, as broadly expected**
- **Oil price shock, slow growth, fat contingency, and spending hikes cause the hefty deterioration**
- **Deficits persist through the forecast horizon**
- **Few surprise new measures**
- **Infrastructure spending a focus; Canada Child Benefit biggest-ticket item**
- **Debt-to-GDP ratio edges up on \$133 billion of bond issuance**
- **Budget assumption: Oil prices average \$40 this year, \$52 in '17**

Table 1
Fiscal Outlook

(C\$ blns, except where noted)

	Est. 15/16	— Forecast —		
		16/17	17/18	18/19
Revenues	291.2	287.7	302.0	315.3
Expenditures	296.6	317.1	331.0	338.0
Program Spending	270.9	291.4	304.6	308.7
Public Debt Charges	25.7	25.7	26.4	29.4
Budget Balance	(5.4)	(29.4)	(29.0)	(22.8)
Federal Debt	619.3	648.7	677.7	700.5
As a percent of GDP:				
Budget Balance	(0.3)	(1.5)	(1.4)	(1.0)
Federal Debt	31.2	32.5	32.4	32.1

Source: Federal Budget

Note: totals may not add due to rounding () = deficit

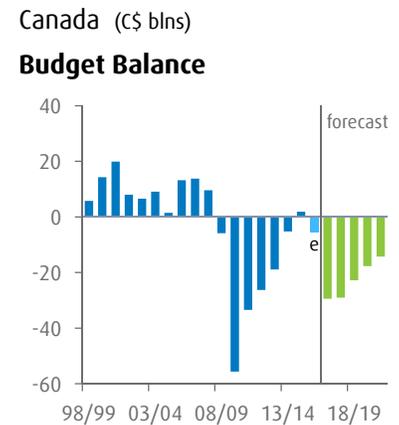
While we fully agree that a moderate dose of stimulus is an entirely appropriate response to current economic realities, we have counseled caution in minding the dosage, for two distinct reasons: 1) The growth restraints on Canada look to be structural in nature (a reset lower on commodity prices), and not a short-term cyclical phenomena that can be countered with a quick fiscal boost, and 2) an overly aggressive fiscal boost could do lasting damage to Canada's finances, casting doubt on the country's hard-won triple-A credit rating, especially at a time when provincial credit has been steadily deteriorating. In other words, we believe that, barring a much more serious slowdown in the economy, \$30 billion should be the absolute ceiling for deficits, and certainly not the floor. Note that the latest deficit estimate includes a fattened \$6 billion contingency, which means that if the economy performs broadly as expected, there will be plenty of scope to beat fiscal targets. In reality, we might see a page taken from the Ontario playbook—that is, part of the cushion gets backfilled with more spending, while the Finance Minister is still able to report better-than-expected bottom lines through the forecast horizon.

Summary of Major Policy Measures: Spending is this Year's Hot Trend

Of course, the main reason that Finance fed us so much information ahead of time on the economic backdrop and the size of the deficit was that the government wanted today's focus to be on what is actually in the budget. New measures announced in this year's budget net out to roughly \$11.6 billion in FY16/17. Here is a quick recap of the largest of the many new initiatives:

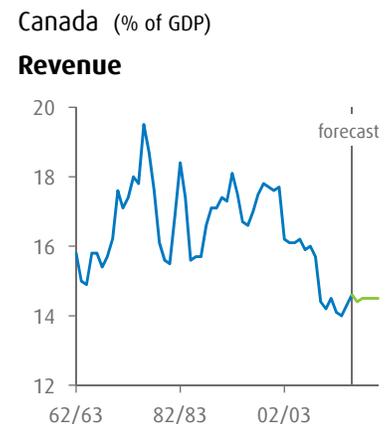
- **Infrastructure spending:** This budget will famously “invest” in a wide range of infrastructure projects. That said, the total amount delivered in FY16/17 will be somewhat less than previously expected at \$4.0 billion, but a much larger \$7.3 billion in FY17/18. Infrastructure is loosely defined to include transportation, social and green infrastructure, each accounting for roughly a third of the spending pie. Public transit infrastructure will actually be relatively modest at \$852 million this coming fiscal year, rising to \$1.7 billion in FY17/18.
- **Program spending** will rise a hefty 7.6% in FY16/17, the strongest clip since 2010 (post-recession stimulus), and a further 4.5% in FY17/18. As a share of GDP, program spending will rise from just under 13% in FY14/15, to 14.6% by FY17/18. Note that is back above the 30-year average of 14.2%. Notably, program spending will begin to decline in real per-capita terms by FY18/19 in order to reduce the size of the deficit further out in the forecast horizon.
- **Canada Child Benefit:** The new benefit replaces a trio of programs (UCCB, CCTB and NCB supplement), and tops them up with an additional \$4.5 billion per year. The new plan is a tax-free benefit starting at \$6,400 per child under the age of 6, and \$5,400 per child between 6 and 17, phased out gradually based on income. At household income above \$150,000, families will be worse off than under the prior set of benefits, and the benefit will fall to zero for a family with one child and household income above roughly \$190,000 (under 6) and \$165,000 (age 6-17). In other words, child benefit payments get fattened meaningfully in the low-to-middle income range at the expense of those in the middle-to-upper income ranges. The change will take place on July 1st, and be based on prior-year income.

Chart 1
Deficits Persist



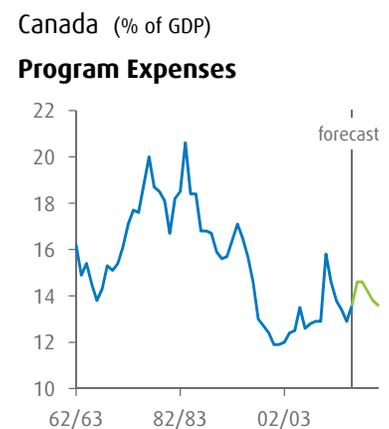
Source: Federal Budget e = estimate

Chart 2
Revenues Grow with GDP



Source: Federal Budget

Chart 3
Spending Jumps



Source: Federal Budget

- **Income splitting (for families) eliminated:** *The ability of families with children under the age of 18 to effectively split their income will be eliminated for the 2016 tax year, saving roughly \$2 billion per year (and offsetting part of the cost of expanded child care benefits). The maximum benefit was \$2,000.*
- **Tax avoidance:** *Ottawa aims to find \$450 million by FY17/18 through a variety of measures aimed at eliminating tax evasion and avoidance, and collecting outstanding tax debts.*
- **Targeted tax measures:** *A few smaller-ticket items such as the **children's fitness and arts credits** are eliminated; others such as **school supply credit** for teachers are introduced.*
- **Canada Student Grant:** *A 50% increase in Canada Student Grant amounts—the maximum grant for a full-time student rises to \$3,000 from \$2,000 currently. Cost will be roughly \$750 million per year; increase in the income threshold at which students have to repay loans, to \$25,000.*
- **Employment Insurance changes:** *The waiting period for EI benefits (after a lost job) will be reduced to one week from two; accumulated hour requirements will be relaxed for new entrants; a portion of benefits will be maintained while shifting back to work; benefit period will be extended by 5 weeks in the hardest-hit areas. Also, EI premiums will fall in 2017 to \$1.61 from \$1.88, but note that is a smaller decline than previously planned. All told, changes to the EI system will cost \$602 million this coming fiscal year.*
- **GIS/OAS changes:** *The Guaranteed Income Supplement will receive a 10% boost, and OAS/GIS will be indexed to a new Seniors Price Index. The eligibility age for OAS will be returned to 65 after being raised to 67 for those born April 1, 1958 or later. Total cost is roughly \$775 million in FY16/17.*
- **Federal-provincial transfers:** *Ottawa will carry on with the plan for sustainable growth in health and social transfers to the provinces. Recall that the current 6%-per year growth rate in transfers is set to become indexed to nominal GDP growth starting in 2017 (realistically something around 3.5%-to-4%).*
- **What didn't change:** *The **capital gains inclusion rate** (which was widely speculated); the **treatment of stock options**, and the **small business tax rate**.*

These measures are **in addition to the \$1.3 billion of measures announced in the fall**. Here's a recap of the major changes:

- **Income tax changes:** *The tax rate on income in the \$44,600-to-\$89,401 range fell from 22% to 20.5%; a new tax bracket (33% from 29%) on incomes above \$200,000 was introduced.*
- *The **TFSA contribution limit** was also reduced from \$10,000 to \$5,500 for 2016.*

Measures Affecting the Financial Services Industry

There is not much ground breaking in the budget for the financial services industry. Various measures include a review of the Bank Act to add a chapter on **consumer protection**; introducing a **bail-in regime** that will allow authorities to convert long-term debt of the big banks to equity in times of crisis—though this is not new.

Debt Management Strategy: Debt/GDP on the Rise Again

With a string of deficits looming, government borrowing requirements are going to move considerably higher. Gross marketable bond issuance will total \$133 billion in FY16/17, up from \$92 billion in FY15/16. After accounting for maturities, buybacks and other adjustments, the net increase in bonds will be \$41 billion in FY16/17, versus \$16 billion this year. The government will consider issuing bonds with a maturity of 50 years “*subject to favourable market conditions*”. The stock of treasury bills is projected to drop from \$136 billion to \$134 billion in an effort to lessen refinancing and rollover risks. The average term to maturity of domestic market debt is expected to remain stable around 7-to-7.5 years. If there was a surprise in the debt management strategy, it is that Ottawa is focusing more of its issuance in the 2-, 3- and 5-year sectors, not at the longer end.

Reflecting the above, Ottawa is projecting net new domestic **borrowing requirements of \$37 billion** in the coming fiscal year, with cash balances unchanged. In turn, total federal debt/GDP will back up again, to 32.5% in FY16/17. The debt ratio is projected to eventually reverse course again, grinding down to 30.9% by FY20/21—effectively where it was in FY14/15.

Economic Assumptions—All About Oil

Ottawa’s economic assumptions are based on the latest private sector consensus, as has been the convention for more than a decade. We are slightly below the average on real GDP growth at 1.3% this year, and at 2.1% in 2017, but just by a tick both years. Our call assumes that growth firms slightly as we progress through 2016 from sluggish conditions in the first half to eventually north of 2% next year, with the extra fiscal spending accounting for some of the growth pick-up (note that our GDP growth forecast had already factored in about \$10 billion of net new spending from today’s budget). The consensus expects that WTI oil prices have found a bottom, and will average around \$40 this year before rising to \$52 in 2017—again, this is slightly more upbeat than our view, but not significantly so. Importantly for revenues, this will drive a rebound in nominal GDP growth to 4.6% next year (consensus view, we’re at 4.3%), after a very sluggish 0.6% pace in 2015 and 2.4% this year (our call is 2.2% for 2016).

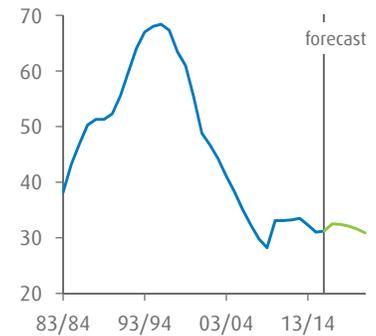
Note that the nominal GDP projection for this year is less than half of the assumption in last year’s budget of 4.9%. In light of that huge misfire by forecasters, Ottawa has built in a much larger cushion for error. To factor in additional risks related to oil prices or economic underperformance, the government has based its projections on a nominal GDP undershoot of a honking \$40 billion (equal to about 2% of GDP), which translates into \$6 billion per year in fiscal wiggle room (this is \$3 billion above the norm and \$5 billion higher than last year’s budget). Thus, if the economy performs as we expect, the deficit would theoretically be \$5-to-\$6 billion lower than Ottawa projects in the coming year.

Three-month interest rates are expected to average 0.5% this year and 0.7% next year, only slightly above our call of 0.5% and 0.6%,

Chart 4
Debt to Edge Up

Canada (% of GDP)

Federal Debt



Source: Federal Budget

Table 2
Economic Assumptions

(percent)	— Ottawa —			BMO Capital Markets	
	2015	2016	2017	2016	2017
GDP Growth					
Real	1.2	1.4	2.2	1.3	2.1
Nominal	0.7	2.4	4.6	2.2	4.3
Yields					
3-month T-Bill	0.5	0.5	0.7	0.5	0.6
10-year GoC	1.5	1.6	2.3	1.4	1.8

while 10-year GoC yields are expected to rise from 1.6% on average this year to 2.3% next (well above the current 1.3% yield, and our view of 1.4% and 1.8%).

Market Impact—Not So Much

Canadian dollar: Today's budget is unlikely to have a major impact on the recently-revived Canadian dollar. Net new short-term measures are broadly in line with market expectations of about \$10 billion in new stimulus (actual \$11 billion) and a deficit of just under \$30 billion (actual \$29.4 billion). Even with the suddenly-sizeable deficit, Ottawa's relatively favourable fiscal backdrop still sets it aside from most other major industrialized economies, something the budget highlights. Indeed, the projected deficit and debt build-up will just nudge up the debt/GDP ratio, despite the sluggish economic backdrop. Looking ahead, the currency will be driven much more by the vagaries of oil prices, and the relative outlook for the BoC and the Fed. On both fronts, the C\$ has caught a major bid in the past month—WTI touched \$40 for the first time this year, the Fed was more dovish than expected, and the BoC apparently has little appetite to cut further. We still look for the currency to come under some heavy weather in the months ahead, as the market builds back in Fed rate hikes and a possible setback in oil. While the comeback in oil and less-dovish BoC have given the loonie a lift of late, with the Fed expected to raise rates later this year, the outlook remains for some weakness through the course of 2016, with the C\$ likely to finish the year at \$1.35 (i.e., 74 cents US).

Bonds: The projected deficits and generally as-expected fiscal measures in the coming year should make only a slight impression on Bank of Canada policy—we expect rates to stay steady until well into 2017. The significant tax relief, announced in the fall, was already factored into the Bank's projections, and we suspect the new spending measures were well-anticipated. Still, we expect a small increase in long-term interest rates this year, assuming the U.S. continues grinding ahead and the Fed stays on track for two rate hikes later in the year (June and December). We also look for long-term Canadian/U.S. spreads to move deeper into the red. The outlook for more negative spreads is similar at the short end, though the starting point is a tad different with Canadian two-year yields sitting roughly 30 bps below their U.S. counterparts. Today's measures should have only a modest impact on bond yields. To reiterate, it has been obvious since the October 19 election to anyone listening that the new government was going to embark on around \$10 billion in new stimulus measures.

Stocks: There is precious little for stocks in this document. Ottawa continues to support the creation of an LNG industry with a preferential CCA rate on new investment, but there is little to impact equity market performance. The broader fate of oil prices and the global economy are much more crucial—budget measures will have little say in these global trends, and even at \$11 billion they won't be enough to fundamentally change the domestic growth outlook. Still, it is notable that after an extremely rough start to 2016, we are heading into the final week of Q1 with the TSX poised for a gain of roughly 4%, a very respectable quarter indeed.

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