

Ontario: Now ‘Open for Business’?

Robert Kavcic, Senior Economist • robert.kavcic@bmo.com • 416-359-8329

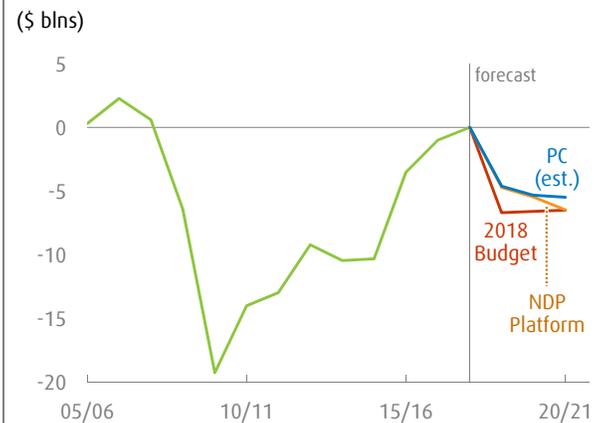
Every once in a while, the polls nail it. Ontario voters opted for change, electing a Progressive Conservative government to a majority mandate after 15 years under Liberal leadership. As we await the first budget, we can sketch a picture of what to expect, and consider some of the economic issues facing the new leadership.

Centrepieces of the PC election platform included lower corporate and personal income taxes, elimination of the cap-and-trade program and other measures to reduce hydro rates and gas prices. The platform famously did not include a bottom-line projection. But, tallying up the costed items and building off a base 2018 budget (i.e., before new measures—the same approach used in the fully-projected NDP platform) very roughly suggest that **the budget deficit could track in the \$5 billion-to-\$6 billion range by FY20/21**. That is before any “*spending efficiencies*” are found, before any other items without a dollar figure in the PC platform, and before any changes to reporting standards as per the auditor general (*Chart 1* and *Table 1*). While this is a crude estimate given the limited information at hand, the bottom line is roughly in-line with the levels proposed by the other two parties. The big difference, however, is that the source of the deficit is almost entirely the result of tax cuts. This is a stark change from the era of higher spending and taxes—program spending rose from 13.2% of GDP in FY02/03 to nearly 17% today.

Suffice it to say that, from a credit perspective, none of the election platforms were giving investors the warm fuzzies, and **a shift back into deficit at this later stage of the cycle opens the door to bigger challenges down the road**. The bond market has already been charging more to lend to Ontario than Quebec, and the election campaign certainly hasn’t helped (*Chart 2*). Starting with the turn back into deficit in the 2018 budget (Liberals), spreads widened further versus Quebec, a province which continues to run modest surpluses. The initial sense is likely that the PC victory is the ‘least bad’ credit outcome, but we again must wait for details on what a “*reasonable timeframe*” to balance the budget means.

From a business perspective, the real conundrum in Ontario is that **business confidence is depressed** despite some of the best macroeconomic conditions in the province in more than a decade. For example, the jobless rate recently hit a near 28-year low of 5.5%, while real GDP growth averaged 2.8% in the three years through 2017, the strongest in 16 years. Yet, small business confidence slumped to the lowest level since the financial crisis over the latest 12-month period (*Chart 3*). Taxes and regulatory costs are currently the biggest hindrance to confidence, though that is the case

Chart 1
Ontario Budget Balance



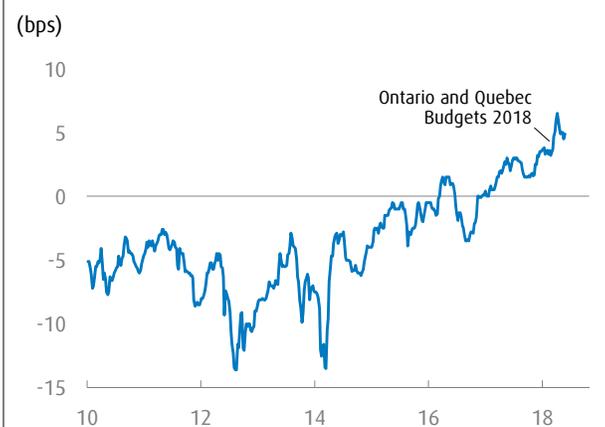
Sources: BMO Economics, Provincial budgets, party platforms

Table 1
PC Platform: Major Economic Measures

- Tax cut of 20% for incomes in the \$43k-to-\$86k range
- Elimination of income tax for minimum-wage earners
- Corporate tax rate reduction of 1 ppt, to 10.5%
- Small business tax reduction
- Cancel 2019 minimum wage increase (\$14/hr to \$15/hr)
- Eliminate cap-and-trade program
- Lower gas tax by 10 cents per litre
- Child-care tax credit up to age 15
- More housing supply; keep rent control for existing tenants
- Balance the budget in “a reasonable timeframe”

Sources: BMO Economics, PC Party

Chart 2
Ontario – Quebec 10-year Yield Spread



Sources: BMO Economics

in most provinces (Ontario actually ranks slightly ‘less bad’ than average on this front). On a relative basis, energy costs and wages are the biggest issues (*Chart 4*). If there’s a consolation to potential deficits over the near term, it’s that this election outcome addresses a number of key concerns in the business sector—a pause in minimum wage increases; measures to address energy costs, most significantly scrapping the cap-and-trade program; and, tax rate reductions. Unlike the alternative platforms, **this at least moves the province in the right direction from a competitiveness perspective**, at a time when its U.S. counterparts are doing the same. Note that Ontario will have the lowest corporate income tax rate (10.5%) in Canada if measures go through as planned.

Another key consideration for the incoming government is that **peak economic growth is likely already behind Ontario**. Many indicators point to slower growth through 2018Q1, and our index of economic performance is now running at the softest year-over-year clip since 2013. That’s consistent with our view that real GDP growth will slow to 2.0% this year, down from 2.8% in 2017, and further to 1.9% in 2019 as growth settles in around potential (*Chart 5*). Some of the challenges the incoming government will have to deal with:

- The **housing market** is only now stabilizing in the wake of past policy measures, while a continued gradual increase in interest rates should temper any rebound.
- The **auto sector** has likely peaked, with sales and production down from cycle highs. Overall export volumes are also fading, and manufacturing jobs are only slightly above post-recession lows. There’s a risk that **factory activity** is merely being sustained by cyclical strength, and the next downturn could further hollow out the sector.
- Ongoing tension on the **trade** front with the U.S.—if tariffs imposed on steel and aluminum on national security grounds are extended to autos, the impact in Ontario would be significant.
- **On the plus side**, Ontario is seeing some of strongest **demographic trends** in more than a decade, with population growth accelerating on the back of new millennial households and migration from outside and within Canada. This is a challenge as well, from spending and housing perspectives.

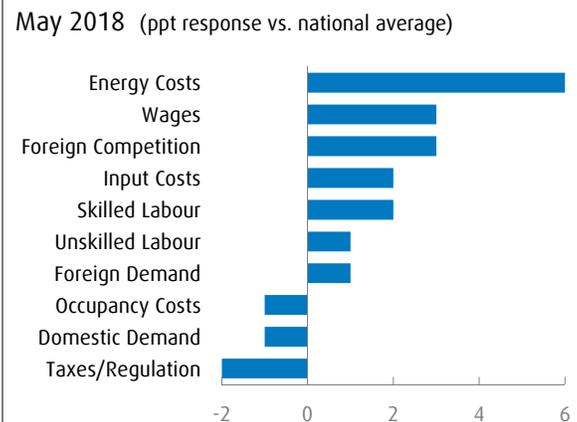
The Bottom Line: This is a significant turning point for Ontario fiscal policy. While uncertainty about the deficit will persist until a budget is tabled, the mandate sets up a clear tack away from higher taxes and big program spending, to tax relief, leaner government and competitiveness, and could be a first indication that Canadians’ appetite for deficit spending has peaked.

**Chart 3
Business Confidence Low**



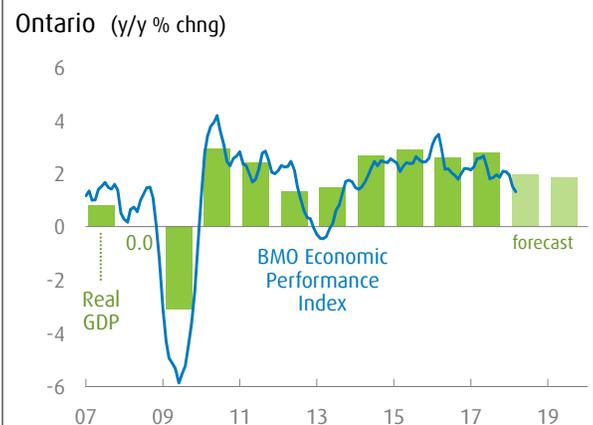
Sources: BMO Economics, CFIB

**Chart 4
Issues Facing Ontario Businesses**



Sources: BMO Economics, CFIB

**Chart 5
Peak Growth Likely Past**



Sources: BMO Economics, Haver Analytics

General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <http://economics.bmocapitalmarkets.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

® Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group