In Focus

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Economics

The Tables Have Turned: Provincial Outlook 2015

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Budget season is upon us, and for Canada's provinces, it will be a very different game than the one played out only a year earlier. A dramatic drop in oil prices, juxtaposed against a still-healthy US economy, has turned the tables on relative provincial growth with Alberta at risk of a recession, but central Canada's prospects brightening. Still, for bond market investors, it's important not to lose sight of equally dramatic gaps in these jurisdictions' fiscal starting points.

A glance at our projections for major indicators shows just how sharply the growth leadership is likely to swing (Table 1). Alberta looks headed for a mild, and short-lived recession. Even if we had a small positive for annual real GDP growth, that would have included at least two negative quarters, and nominal GDP would be well into negative territory. Newfoundland and Labrador, still coming off a huge 7% climb in 2013, could also be in negative territory. In contrast, Central Canada and BC should enjoy a small upside surprise.

That will translate into commensurate shifts in the employment picture alleviating pressure in some areas where, if anything, workers are currently in scarce supply, and lowering the jobless rate in central Canada, where it has been stuck above the national average.

Key Drivers of the Growth Swing

The key positives for the national outlook are the strengthening performance of US demand, and the additional lift that exports will garner from a now-weaker Canadian dollar. But these lifts aren't uniform across the provinces. In terms of leverage to the pick-up we expect in US GDP, stripping out the impact of oil prices, Ontario is the

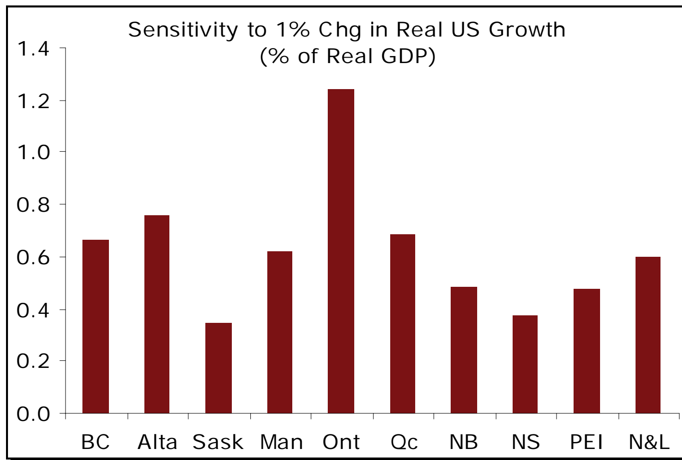
Table 1

The Shifting Canadian Growth Outlook

	Real GDP Y/Y % Chg			Employment Y/Y % Chg			Unemployment Rate %			Housing Starts 000s Units		
	2014F	2015F	2016F	2014A	2015F	2016F	2014A	2015F	2016F	2014A	2015F	2016F
BC	2.4	2.5	2.7	0.6	1.1	1.7	6.1	5.8	5.3	28.3	29.0	27.0
Alta	4.1	-0.3	2.3	2.2	-0.4	2.0	4.7	6.8	5.8	40.6	28.0	34.0
Sask	1.0	0.8	2.4	1.0	0.6	1.2	3.8	5.4	5.1	8.3	6.0	9.0
Man	2.2	2.6	2.5	0.1	1.8	1.1	5.4	6.1	5.9	6.2	7.5	5.8
Ont	2.1	2.8	2.8	0.8	1.1	1.2	7.2	6.6	6.4	58.4	64.0	61.0
Qué	1.8	2.4	2.6	-0.1	0.7	1.4	7.8	7.2	6.7	39.1	46.0	42.0
NB	1.1	1.7	1.6	-0.2	0.1	0.3	9.9	9.8	10.3	2.3	2.6	2.5
NS	1.5	1.6	2.2	-1.1	0.2	1.0	8.9	8.6	8.5	3.1	3.8	3.5
PEI	1.8	2.0	1.8	-0.4	0.4	0.8	10.5	10.0	10.1	0.5	0.6	0.5
N&L	0.5	-1.3	-1.0	-1.9	-1.0	-0.5	12.0	12.8	14.0	2.2	2.2	2.0
Canada	2.4	1.9	2.5	0.6	0.7	1.4	6.9	6.8	6.4	189	190	187

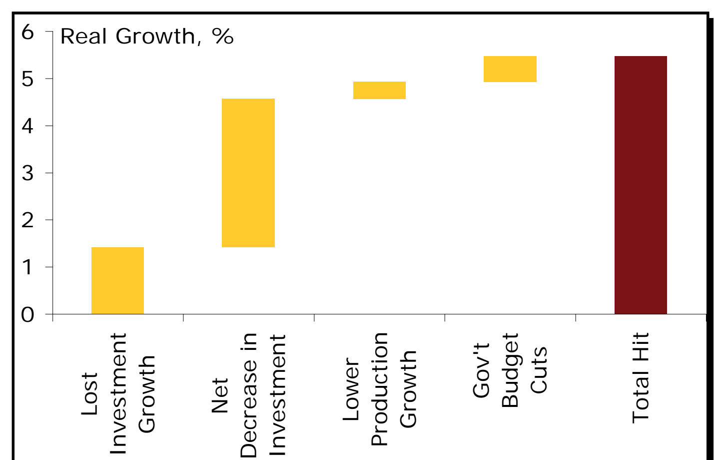
Sources: CIBC, Statistics Canada, CMHC

Chart 1
Sizing Up Provincial Winners from US Strength



Source: Statistics Canada, CIBC

Chart 3
Oil Rout's Damage to Alberta's Real Growth

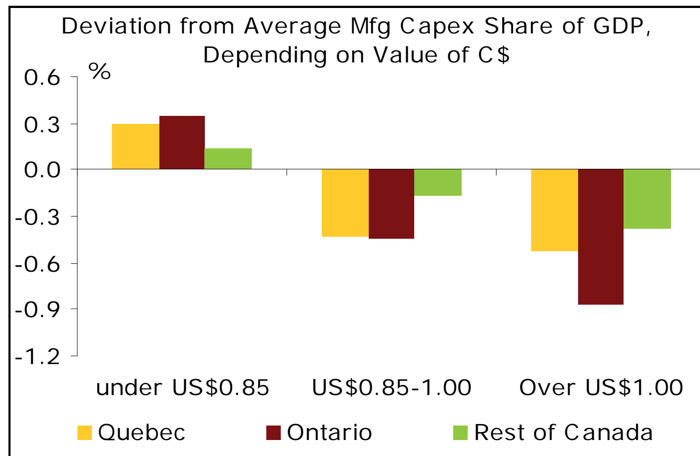


Source: Statistics Canada, CIBC

standout, with a 1% acceleration in US growth typically adding about 1.2%-points to Ontario's real GDP pace (Chart 1).

The softness in the Canadian dollar works its way through to real exports. While resource exports will be hit by soft prices, the same isn't true for manufacturers. There, however, the challenge is that, after a spate of plant closures during the strong C$ era, capacity use is now fairly tight. Further growth will therefore require capital expenditures to add capacity, but history suggests that, by making Canada a more cost-effective location, a cheaper Canadian dollar does indeed boost factory capital spending, particularly in Ontario and Québec (Chart 2).

Chart 2
Manufacturing Investment in Different Loonie Eras



Source: Statistics Canada, CIBC

Focussing in on Canada's largest oil/gas exporter, Alberta, the hit to GDP growth will be less about producing fewer barrels and more about the squeeze on its energy sector's capital spending. In total, a small reduction in planned output growth, the loss of investment growth that might have otherwise occurred, the negative from year-on-year cuts to capital budgets in the energy sector, and new government spending restraint, will shave over 5% from real GDP (Chart 3).

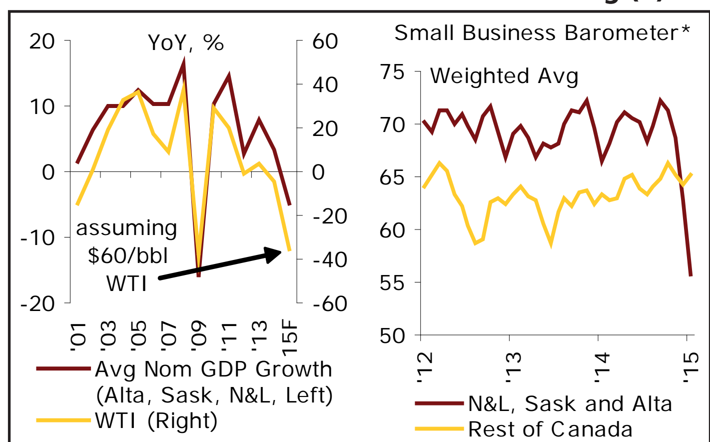
There are some offsets, as the province's non-energy exporters will be helped by the weaker currency, and its domestic spending will be supported by interest rate cuts.

Nominal GDP, which forms the base for most sources of government revenue, is even more clearly linked to oil prices, since the change in the value of the energy sector's output will far outstrip any shifts in the number of barrels produced. Note the strong historical correlation between nominal GDP and oil prices in Canada's three energy producing provinces (Chart 4, left).

The linkage also captures swings in business and household confidence in these provinces, and therefore in non-energy spending decisions, that are generated by energy price booms and bust. Witness, for example, the gap between the significant drop in small business sentiment in Alberta, Saskatchewan and Newfoundland and Labrador, relative to the steady conditions elsewhere (Chart 4, right).

Chart 4

Nominal Growth & Oil for Producing Provinces (L), Where Small Business Sentiment is Tumbling (R)



Source: StatCan, Bloomberg, Cdn Federation of Independent Business
**Note: Readings over 50 mean performance expected to improve over next year.*

Revenue Surprises and Shortfalls

The focus in the upcoming budget season will be on changes in the revenue outlook across the provinces, and their fiscal implications. For own-source revenues, nominal GDP is a key determinant, with elbow room being created when it exceeds the government's assumptions. To varying degrees, that looks to have been true for the prior calendar year (Table 2).

For 2015, our projections suggest that both Ontario and Québec could end up with a revenue fillip if, as we expect, nominal GDP runs about a half-point above the provinces' original projections, and those released in recent mid-year updates. Both of these central Canadian provinces are budgeting for virtually no spending growth in an effort to contain borrowing needs, a tough bar to meet. The additional revenue might therefore give a bit of spending elbow room that will make 2015-16 deficit targets easier to attain.

At the other end of the spectrum, Alberta has published updates that have slashed the outlook for nominal growth, the latest pointing to a 0.9% increase. That figure's well below the original 4.7% forecast, but there's still room for further disappointment. It has, however, discussed a $7 bn revenue shortfall associated with that miss, which it plans to offset with roughly $2 bn in spending cuts (Chart 5, left). That suggests a willingness to live with a roughly $5 bn deficit in the coming year.

The bond market is well aware of the linkage between the energy sector's fortunes and the province's fiscal results. While there are other drivers, including a recent preference for the liquidity associated with larger issuers, Alberta's spreads to Ontario have been closely tracking Western Canadian Select priced in Canadian dollars (Chart 5, right).

But investors should also not lose sight of the yawning gap between Alberta's fiscal starting point and that of provinces to its east. It alone starts from a net asset position, that leaves it the latitude to run large deficits as a share of GDP for a couple of years without jeopardizing its status as a safe haven asset.

While we expect an oil price recovery in the medium term, coupled with some future tax/revenue decisions, to bring deficits into line, it's worth noting that even if Alberta ran a $5 bn deficit year after year, and nominal GDP growth was held to only 1% beyond 2016, it would take decades for Alberta to have the same debt/GDP ratio that was planned for Ontario last year (Chart 6).

Table 2

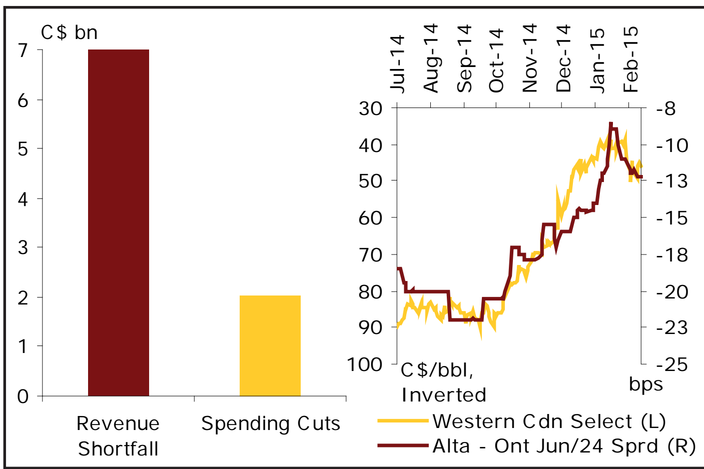
Nominal Growth: Current CIBC vs Last Year's Budget

Y/Y %	CIBC Fcst			2014 Budget			Difference		
Chg	2014F	2015F	2016F	2014F	2015F	2016F	2014F	2015F	2016F
BC	4.2	3.8	5.2	3.6	4.3	4.4	0.6	-0.6	0.8
Alta	7.5	-5.4	6.0	6.1	4.7	4.8	1.4	-10.1	1.2
Sask	1.5	-3.2	5.8	1.2	3.5	3.5	0.3	-6.7	2.3
Man	4.0	3.8	4.9	3.5	4.4	N/A	0.5	-0.7	N/A
Ont	3.8	4.9	5.0	3.5	4.4	4.4	0.3	0.5	0.6
Qué	3.2	4.3	4.8	3.4	3.9	3.6	-0.2	0.4	1.2
NB	2.5	3.4	3.8	2.0	3.4	3.6	0.5	-0.1	0.2
NS	3.5	3.1	4.3	2.9	4.3	N/A	0.6	-1.2	N/A
PEI	3.5	2.8	3.9	N/A	N/A	N/A	N/A	N/A	N/A
N&L	1.0	-5.8	4.1	4.0	2.3	-1.9	-3.0	-8.1	6.0
Canada	4.2	2.0	5.1	3.9	4.5	4.5	0.3	-2.5	0.6

Source: Provincial budgets, Federal budget, CIBC

Chart 5

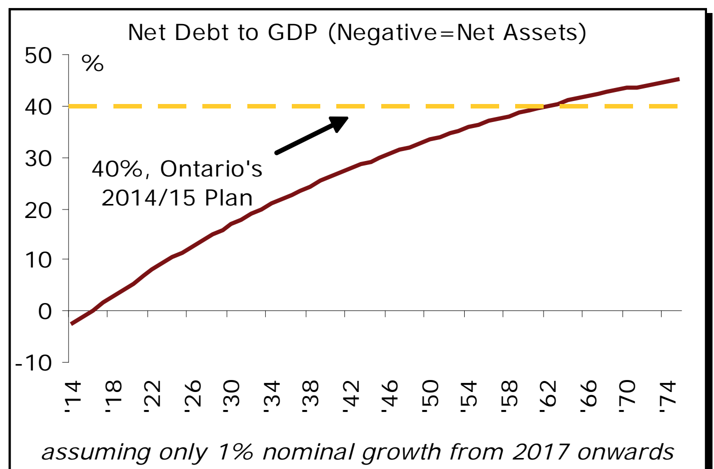
Alberta's Revenue Decline Only Partly Offset (L); Alberta's Debt Yields Move With Oil (R)



Source: Bloomberg, CIBC

Chart 6

Alberta Net Debt/GDP With $5 bn Deficits



Source: Statistics Canada, Provincial budgets, CIBC

While not quite as blessed, Saskatchewan also enters fiscal 2015/16 as a low debt province that gives it time to allow energy-related revenues to recover. But the $600-$800 mn shortfall that the government has recently noted still represents over 5% of government revenues. That hole would swallow the $70 mn or so surplus previously expected, testing the government's resolve to run a balanced budget.

Newfoundland is further up the net debt scale. A planned balanced budget in 2015/16 now looks out of reach even with additional restraint measures, given that even a half year of below target crude prices, coupled with lower than forecast production, took nearly $0.8 bn off its revenue forecast in 2014/15, leaving it with a deficit topping $0.9 bn. The province's net debt of $9 bn at the end of fiscal 2013/14 represents roughly 25% of GDP and will be backing up materially in the current environment, but is still miles below the 60-70% range that had prevailed until the early 2000s. Even here, as long as oil recovers after 2015/16, the province has time to adjust.

Canada's federal government will also see a revenue shortfall, given that it too has oil revenues, and more broadly, has a tax base tied to nominal GDP. But the damage to Ottawa's coffers, at this point, will be roughly in line with the contingency reserve that it typically sets aside before the fiscal year begins. Rather than project a $3 bn surplus, and then deduct the contingency to forecast a balance, it's likely that it will "spend" all or most of that contingency upfront, enabling it to project a balanced budget without a significant additional fiscal restraint effort.

Add it all up, and the biggest budget shortfall, that of Alberta, is in the province that is best positioned to weather the storm. Provinces with higher debt loads, including Québec and Ontario, will actually see a modest economic and fiscal benefit from weaker oil prices. So while the tables have turned on growth, for national fiscal stability, they are turning in the right direction.

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