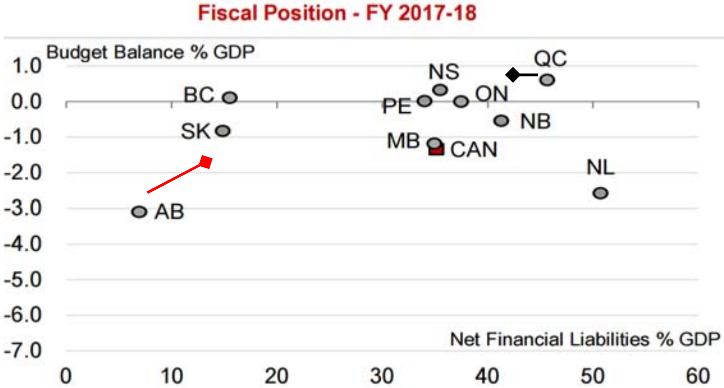
QV Investors Inc.

Red and Black

Annual provincial budget season has come and gone as the last finance ministers publicly unveiled their plans for the upcoming fiscal year a couple weeks ago. Our fixed income strategy holds bonds from the four largest provinces of British Columbia, Alberta, Ontario and Quebec. Altogether these regions account for over 85% of Canada's population and economic production. They are some of the largest issuers in the Canadian market and their bonds provide higher yields than federal bonds of similar maturity. This week's BC election was a tight race and may result in a revised budget if the final count (on May 24th) does not sway what looks to be a new minority government for the Western province.

Evaluating provincial budgets is helpful in assessing a government's ability and willingness to maintain healthy credit. Regardless of their legislative taxing power, some governments simply do not place balanced budgets as a priority. At times, there's good reason for running fiscal deficits. But if held in the red for too long, the debt burden could grow to a size that heightens credit risk and potentially lead to disappointing bondholder returns.

The chart below highlights provincial fiscal positions, with each budget balance (surplus/deficit) as a percent of GDP on the vertical axis and net debt as a percent of GDP on the horizontal axis. Provinces that pose consecutive deficits naturally accumulate debt over time, increasing their financial liabilities as a % of GDP on the horizontal scale (vice versa for regions that run budget surpluses).



Source: CIBC Macro Strategy & QV Investors

There is currently a dichotomy of fiscal trends in Canada, evidenced by sluggishness in resource rich provinces and faster growth in others. Alberta (AB) and Quebec (QC) are two provinces that best illustrate this fiscal contrast.

AB was hard hit and is still recovering from the energy price shock that affected most energy producing regions. From 2010 to 2014, resource revenue accounted for 20% of operating revenue. This is expected to come in at 8% this year, leaving a $5.5B revenue shortfall. Coincidentally, program spending growth is forecast to outstrip revenues, leaving fiscal deficits to the tune of $10B this year and next. In conjunction, new borrowing to fund large capital investments is projected to raise net debt/GDP to 12.3% in three years' time. There are no signs yet of slowing debt accumulation as the government continues to operate deep budget deficits. From a bondholder perspective, the silver lining still remains its relatively low debt level and an idle sales tax lever that could potentially bring its finances out of the red.

Quebec, on the other hand, has a declining debt burden but one that started from an elevated level of 50% net debt/GDP. Its budgetary performance has been the best fiscal story in Canada, with Finance Minister Carlos Leitão reversing serial deficits and tabling the province's third consecutive budget surplus. QC's annual debt service expense remains one of the highest in Canada at 9.3% of total expenditures. We believe this is not the most appropriate usage of taxpayer's money, and this realization likely helped escalate the urgency to balance its books. Three years later, QC is slowly on its way to better fiscal shape. We applaud QC for their achievements thus far, but the province still remains one of the higher indebted regions in the country.

These opposing trends have caused AB's cost of borrowing to rise above its peer group, resulting in lower relative bond returns. QC's bond yields have narrowed, reflecting its improved credit and augmenting returns in the process. Provincials account for 37% of our bond strategy and are key holdings to providing stability, liquidity and a higher relative return over lower yielding federal bonds. Evaluating credit strength and budgetary trends and weighting the exposure appropriately helps ensure our clients grow their capital through changes in both election cycles and market cycles.