Ontario: 2018–19 Outlook

TRADE DOWNSIDE AVERTED, BUT OTHER RISKS EMERGE

- **After annual advances averaging 2.7% during 2014–17, Ontario's economic growth is forecast to moderate to an average of about 2% over 2018–19, with business investment gains partly offsetting easing consumer spending.**
- **The recent free-trade agreement with the US and Mexico is a positive development for Ontario; fiscal challenges and housing affordability constraints present downside potential over the near- and medium-term.**

POPULATION GAINS OFFER OPPORTUNITY

Ontario is expected to enjoy hefty population growth through 2019. The number of provincial residents expanded 1.7% ytd y/y from January to June 2018—the second-strongest gain of any jurisdiction. Net interprovincial migration over 14,000 in both 2015/16 and 2016/17—the first inflows of that magnitude since 1998–2000—is unlikely to recede given the gradual recovery expected in Alberta and restrained affordability weakening BC's draw. Natural population growth should remain positive in the province. Given Ontario's range of large urban centres and rising national immigration targets, we also anticipate that the province will continue to attract international newcomers over 2018–19.

The composition of this year's wave of immigrants bodes well for Ontario's longer-term productive capacity. From January to July 2018, the number of economic immigrants—newcomers selected on the basis of their skills and ability to contribute to Canada's economy—is up more than 100% versus year-earlier level. Integration of economic immigrants augurs well for a province in which labour productivity trails that in BC, Saskatchewan, and Alberta and where immigrant labour market outcomes have traditionally lagged the national average.

BREATHING A SIGH OF RELIEF ON TRADE

The US-Mexico-Canada Agreement (USMCA) free-trade pact averts the considerable downside associated with NAFTA termination. With motor vehicles and parts sent to the US accounting for 30% of Ontario's 2013–17 nominal merchandise exports, the chief risk was a 25% tariff on foreign-made automobiles promised in the event of no resolution to recent trade negotiations. USMCA side letters exempt up to 2.6 mn passenger vehicles from duties annually, a threshold far exceeding current levels of US auto imports from Canada. The agreement comes as motor vehicle assembly and exports are still adjusting following a labour stoppage and a line closure in 2017 (chart 1).

The near-term outlook for agricultural output and exports is mixed. In July, farmers anticipated increased production of key crops such as soybeans and corn for grain this year, and demand for protein in the Indo-Pacific region should broadly support exports of beef and pork, grains and pulses. Yet the global market for wheat—a staple of Ontario's harvest—is becoming more competitive and output of the crop is expected to decline this year. Moreover, the province's crop production sector remains mired in labour shortages—reflected in a lofty 14.8% Q1-2018 job vacancy rate—that are likely to be exacerbated by population aging.

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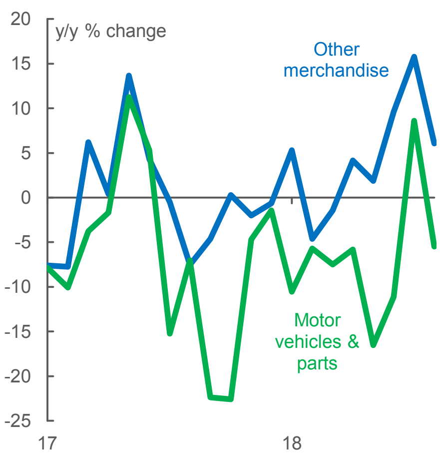
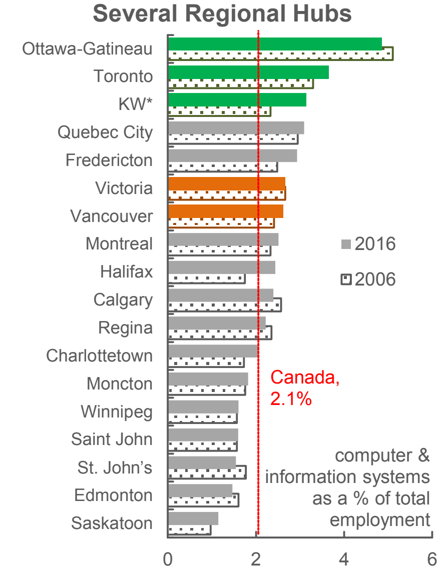
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



* Kitchener-Cambridge-Waterloo. Sources: Scotiabank Economics, Statistics Canada *Census of Population.*

Tech sector activity is expected to support Ontario's services exports and play a key role in attracting skilled workers. Healthy 3.2 % ytd y/y job creation as of July in technology-oriented industries—from advanced manufacturing to select business services—builds on the 4.4% mean annual gains in information & communications technology output over 2014–17. The latter advance was the fastest of any province over that period. Toronto's international reputation as a tech hub is reflected in investments by a self-driving vehicle company and an e-commerce firm to expand their footprints in the city. Public- and private-sector funding awarded via the federal AI and Advanced Manufacturing Superclusters should support expansion across the range of other centres with an existing tech sector presence (chart 2, p.1).

INVESTMENT STRENGTHENING...

The recent upswing in private-sector capital expenditures is expected to persist this year, also propelling Ontario's expansion. With capacity constraints reported in multiple industries, many firms in the province are planning plant upgrades, a trend already evident in real machinery & equipment (M&E) spending gains approaching 25% (q/q ann.) in Q1-2018 (chart 3). We look for M&E outlays to pace last year's 7% advance in 2018. Our investment forecast for 2019 no longer includes the dampening effects of NAFTA-related uncertainty, but we still anticipate more modest M&E gains next year as capacity restraints are addressed.

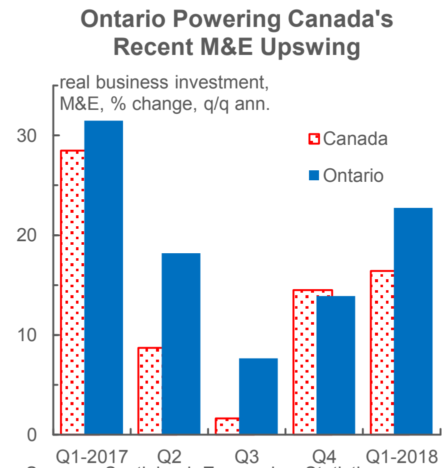
Non-residential construction investment, up double digits (q/q ann.) to begin 2018, should also contribute to economic growth this year before easing in 2019. In 2017, an auto maker announced plans to establish a research and development centre in Ottawa as part of plant refurbishments totaling CAD 1.2 bn over the next four years. Industrial and commercial activity will likely boost non-residential building in Toronto, Hamilton and Kitchener-Waterloo this year and next, with the second phase of a light rail transit expansion proceeding in Ottawa. Work on the CAD 5.7 bn Gordie Howe International Bridge linking Windsor and Detroit has also begun, with scheduled completion in 2024.

Planned capital outlays in the mining sector are also auspicious. In Sudbury, the CAD 760 mn first phase of the Cooper Cliff nickel mine expansion and work on the USD 700 mn Onaping Depth venture are proceeding. These add to investments aiming to bring smelters into compliance with stricter sulphur dioxide regulations by 2023. Timmins should see many gold mine openings and exploration activity. The new provincial government has also signaled its desire to end delays with respect to development of the Ring of Fire, containing significant chromite and nickel deposits.

… AS CONSUMERS STEP ON THE BRAKES

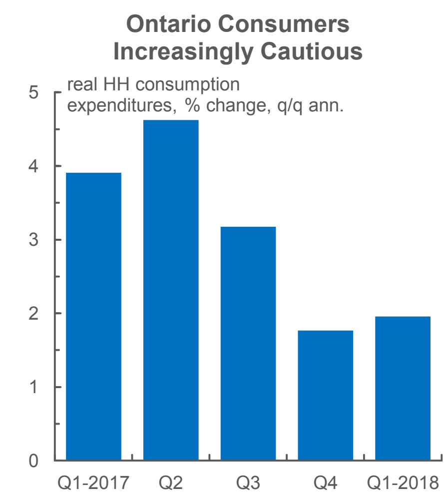
We look for softer job creation to result in moderating household spending this year and next. In 2017, Ontario's 1.8% total employment growth contributed to 3.6% household spending gains; both figures were post-recession highs. We expect more sustainable job creation of 1.5% this year and 1.0% in 2019 as broader economic growth slows and labour shortages limit gains in several industries. Alongside waning Canada Child Benefit stimulus and rising interest rates, this should exacerbate the easing in consumer outlays already in progress (chart 4).

Chart 3



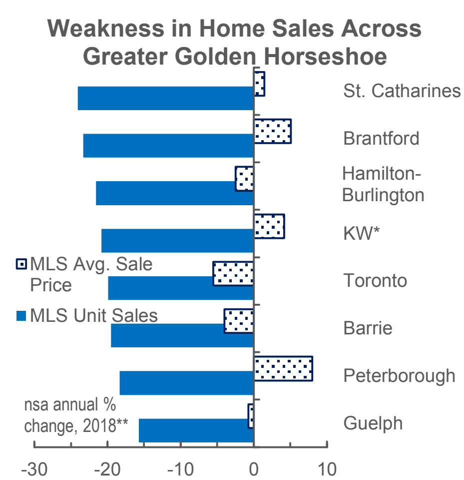
Sources: Scotiabank Economics, Statistics Canada, Ontario Finance.

Chart 4



Sources: Scotiabank Economics, Ontario Finance.

Chart 5



* Kitchener-Cambridge-Waterloo. **Jan.–Aug. Sources: Scotiabank Economics, CREA.

A NEW FISCAL REALITY

Ontario's fiscal position looms over its near-term outlook. A CAD 3.7 bn deficit is reported in FY18, with a further budgetary shortfall in the order of CAD 15 bn expected for FY19. These figures contrast with past administration estimates of a CAD 0.6 bn surplus and a CAD 6.7 bn deficit in FY18 and FY19, respectively. The revisions reflect proposed changes to the accounting treatment of net pension assets and the findings of a report from the *Independent Financial Commission of Inquiry*.

Stepped-up provincial government spending restraint is the most likely consequence of the deficit revisions. The new administration has thus far been circumspect in describing its path to balance, but we now expect the more-difficult-than-anticipated fiscal situation will be used to bolster arguments for public sector cuts. As easing economic expansion results in more modest revenue growth, the government may also need to postpone planned personal and business tax relief, proposed during the campaign as means to improve the province's competitiveness.

Federal fiscal policy may offer some support for near-term growth. Ontario will receive CAD 11.8 bn in infrastructure funding over the next 10 years in the second phase of the federal government's plan. Tax changes are expected in Ottawa's fall fiscal update that could boost the province's competitiveness following the US federal corporate and income tax rate cuts in January.

HOUSING MARKETS STABILIZE AFTER EARLY-YEAR PAUSE

Real estate markets across Ontario's Greater Golden Horseshoe (GGH) appear to be recovering after substantial weakening in early 2018. Alongside rising interest rates and strained affordability, stricter mortgage qualification tests that took effect January 1st, 2018 discouraged many marginal buyers from entering markets in and around the Greater Toronto Area (chart 5, p.2). Yet home purchases and prices have trended higher since June, implying buyers and sellers are adjusting to new mortgage rules amid healthy employment and population growth.

Despite the slowdown in home-buying, we anticipate that residential construction in Ontario will remain elevated. Still-high GGH home prices and still-low interest rates continue to incite new building, with units under construction as of August 2018 near an all-time high in Toronto and elevated in Hamilton, St. Catharines and Oshawa.

Ontario Profile, 2017

Population, July 1	14.2 million (38.7% of Cda)
annual % change	*1.6*
Toronto CMA	6.3 million (44.7% of ON)
annual % change	*2.0*
Ottawa CMA	1.0 million (7.3% of ON)
annual % change	*2.2*
Hamilton CMA	787,000 (5.5% of ON)
annual % change	*1.2*
Kitchener-Waterloo** CMA	528,000 (3.7% of ON)
annual % change	*1.8*
Rest of Province	5.5 million (38.7% of ON)
annual % change	*1.0*
Real GDP, C$ 2007 bn	703.8 (38.8% of Cda)
Per Capita Nom. GDP, $000	58.7 (100.4% of Cdn avg.)

Economic Outlook

	2010–16	16	17*	18f	19f
	annual % change except where noted				
Ontario					
Real GDP	2.3	2.6	2.8	2.1	2.0
Nominal GDP	4.2	4.3	4.8	4.1	4.4
Employment	1.2	1.1	1.8	1.5	1.0
Unemployment Rate, %	7.7	6.5	6.0	5.5	5.4
Housing Starts, 000s	67	75	80	78	72
Canada					
Real GDP	2.2	1.4	3.0	2.1	2.1
Employment	1.1	0.7	1.9	1.2	1.0

Governance

Premier	Doug Ford, Progressive Conservative (as of 2018)
Legislature	76 of 124 seats
Next Election	June 2022
Credit ratings:	
Moody's	Aa2 (N)
Fitch	AA- (N)
S&P	A+
DBRS	AA (low)

* ON real GDP growth, 2017, by industry at basic prices.
** Includes Cambridge. Sources: Scotiabank Economics, Statistics Canada, CMHC, ON Legislature, Ratings Agencies.

Yet many GGH housing markets remain undersupplied, a factor we expect will further erode affordability. In August, completed and unsold units in Toronto sat more than 60% below their 2010–16 annual mean. Tight Toronto rental market conditions are reflected in a rental vacancy rate of 1.1% late last year—well below the 3% consistent with balanced conditions. The dearth of available housing is less pronounced in Hamilton, St. Catharines and Oshawa, but sharply declining unabsorbed units to date this year in all three centres suggest a resumption of strong home price growth entering 2019. Affordability pressures in the GGH are not as acute as in Southern BC, but a further ramp-up in GGH home prices may increasingly restrain the ability of businesses to attract and retain talent.

CONCLUSION

Ontario holds a number of advantages over other Canadian provinces but maintains some risks. The resolution of recent trade tensions avoids damage related to US protectionism. The province's buoyant tech sector and its cities' growing international reputation present new opportunities for enhanced economic prosperity. Yet housing affordability is likely to remain a concern in many of the province's major centres and strained public finances may limit policy options available to the provincial government.