

USD Supranational and non-US Agency Notes

Spreads of ONT Should Remain Stable on the Potential Downgrade

- The Province of Ontario is currently on negative credit watch by S&P. We estimate that any potential downgrade would have a marginal negative impact on ONT spreads for maturities under ten years.
 - In the event of a one-notch downgrade, ONT would have equal ratings to Q. Spreads of ONT and Q currently have comparable spreads in sub-ten-year tenors.
 - We estimate that ten-year ONT spreads have approximately 10bp of room for potential widening in case of a downgrade under this methodology.
- The market may have started to price in the risks associated with a potential downgrade (Figure 1).
 - The market implied rating for Ontario has typically been higher than its actual ratings from the agencies.
 - While the market implied rating is currently AA and better than the actual ratings of Aa2/AA-, it has deteriorated recently, possibly indicating increased concern.

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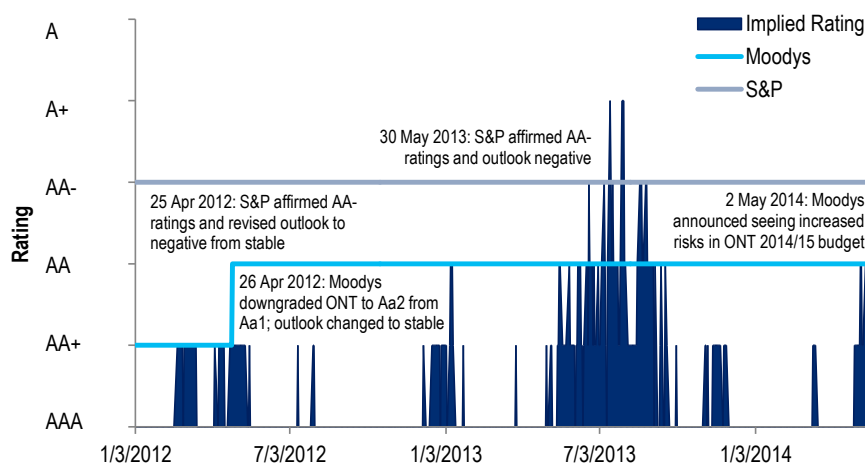
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Figure 1. Market Implied Ratings (Province of Ontario)



Source: Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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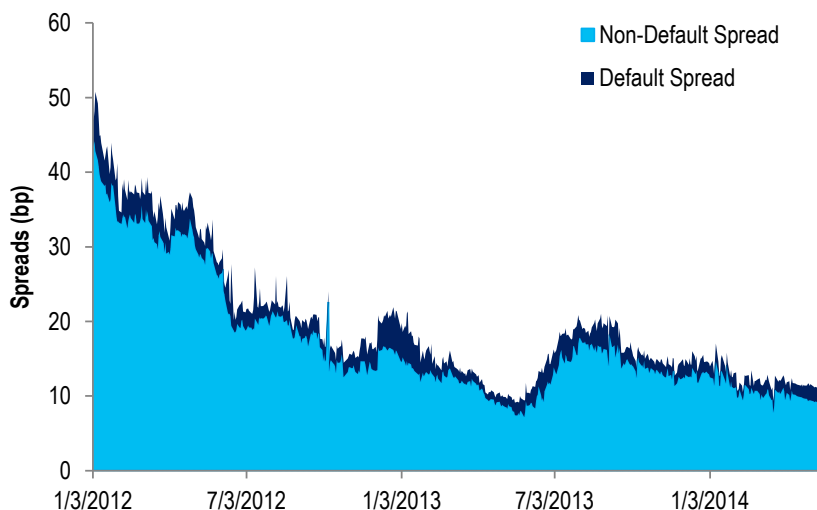
Spreads of ONT Should Remain Stable on the Potential Downgrade

Rating and Spread History

The Province of Ontario is currently rated Aa2 Stable/AA- Negative by Moody's and S&P. But its market implied rating¹ is higher than the actual ratings from the rating agencies. For most of the past 2.5 years, ONT's market implied rating has been AA+ or even AAA, and its spreads have been comparable to SSA issuers with higher ratings, like BNG and CADES (Figure 1).

In our model, we attribute spreads to the risk of default (default spread) and issuer spread volatility (non-default spread). It is the default spread that determines the market implied probability of default for issuers. For ONT, we can see that most of the spread comes from volatility (Figure 2).

Figure 2. Default and Non-default Spreads of Province of Ontario



Source: Citi Research

2012

S&P first revised Ontario's credit outlook to negative from stable on April 25, 2012. The next day, Moody's downgraded Ontario by one notch from Aa1 to Aa2. In their statement announcing the negative outlook, S&P suggested that Ontario had "at least a one-in-three likelihood" to be downgraded by one notch within two years².

ONT spreads widened in April and May (Figure 3). However, the spread widening during this period was universal within the SSA sector. The overall market implied probability of default had been declining and the widening had little impact on Ontario's implied market rating (Figure 4).

¹ Please refer to [Market-Implied Default Probabilities: Update - Market-Implied Default Probabilities: Update](#) on Sept 9, 2011 by Terry L Benzschawel and Mike Lee

² Please refer to S&P's media release on Apr 25, 2012 ➡

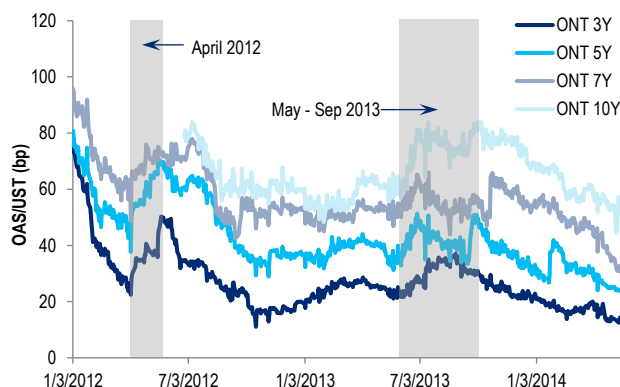
2013

On May 30, 2013, S&P affirmed ONT's AA- rating and the negative credit outlook. The commentary suggested the same likelihood ("at least a one-in-three") that ONT's rating could be lowered, now within one year³. It is worth noting that the one-year timeframe would suggest a potential rating action before the end of May, 2014.

Post this event, we also observed widening in ONT spreads (Figure 3). The spread widening during this period was also fairly broad-based given the market expectation of an earlier QE tapering from the Fed. However, ONT spreads widened more than most SSA issuers, accompanied by an increase in ONT's market-implied default. The market implied rating also deteriorated over the same period, but was still equal to or better than the actual ratings most of the time (Figure 4).

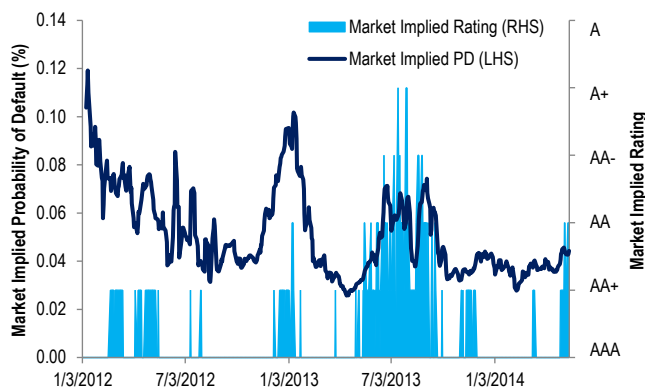
Interestingly, the spread and market-implied default probability peaked in late September, while the market-implied rating hit its worst point at the end of July. The market-implied rating is based on the market-implied default probability relative to the broader bond universe. Thus it does not move in lockstep with the default probability.

Figure 3. Spread History to Treasuries (Province of Ontario)



Source: Citi Research

Figure 4. Market Implied Default and Ratings (Province of Ontario)



Source: Citi Research

2014

On May 2, 2014, Moody's announced that they saw higher risks in Ontario's 2014/15 budget which increased planned deficits in the next three years. Moody's also announced that they will evaluate assumptions and potential risks⁴.

Based on their schedule observed over the last two years, S&P is likely to announce their rating actions on ONT in May or June. And it is possible that ONT's rating will be lowered this time given the existing negative outlook and continued budget deficit.

ONT spreads tightened sharply recently on the new ten-year issuance from ONT and its Canadian peer Manitoba (MP), despite the credit negative announcement from Moody's. Market implied ratings for ONT fell to AA, but remained higher than its actual ratings of Aa2/AA-.

³ Please refer to S&P's media release on May 30, 2013 ►►

⁴ Please refer to Moody's media release on May 2, 2014 ►►

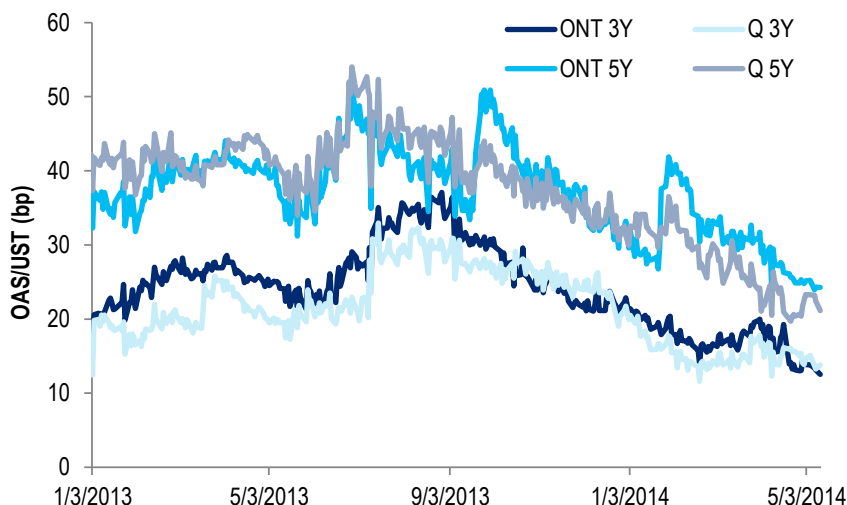
Though the implied default rating is still better than the actual ratings, it has deteriorated markedly recently suggesting increased concern in the market (Figure 4).

Possible Impact on Spreads in Case of a Downgrade

We don't think there would be a significant impact on sub-10-year ONT spreads in case it gets downgraded by S&P.

- First of all, the market largely shrugged off the Moody's downgrade in 2012.
- If Province of Ontario gets a one notch downgrade from S&P to A+, it then will have equal ratings to its peer, Province of Quebec, which is currently rated Aa2 Stable/A+ Stable. Spreads of ONT and Q have been comparable in tenors under ten-year (Figure 5).

Figure 5. ONT and Q Spreads to Treasuries



Source: Citi Research

- However, the ten-year ONT spread is currently tight.
 - The old ten-year ONT (a currently eight-year note) is 17bp tighter than the ten-year Q (an 8.75-year note)
 - The new ten-year ONT is approximately 10bp tighter than single-A corporate notes.

As a result, we don't expect ONT spreads under the ten-year to widen dramatically. But for ten-year ONT, there is room for potential widening in the event of a downgrade.

Appendix A-1

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