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Federal budget preview: Brace for (budgetary) impact

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It's been some 550 days since the Government of Canada last tabled a budget. That may not be the record wait for a spending plan, but even in 2020—arguably the most uncertain year in the post-WWII era—the government managed to deliver a timelier fiscal update. Better late than never? That's for taxpayers and investors to decide.

Officially, the November 4th budget will be for the upcoming fiscal year (i.e., 2026–27). But as part of the transition from spring to fall budgeting, this will be a two-for-one fiscal plan, offering our first look at 2025–26 finances since the spring election. The last fiscal update from December 2024 came under PM Trudeau's leadership and before President Trump took office. Needless to say, economic and fiscal priorities have shifted. Naturally, most attention is focused on the size of the budgetary shortfall, both for this fiscal year and beyond. By the government's own admission, the deficit will be "substantial"… but just *how* substantial will it be?

The PBO's latest official scoring, incorporating policies announced through August 11th, pegs the 2025-26 shortfall at $68.5 billion. While that's an already substantial step up from the $42 billion deficit projected in the 2024 FES, there will likely end up being much more red ink. The PBO's analysis does not fully account for the NATO Defence Investment Pledge (investing 5% of GDP in the military/national defence by 2035). Nor does it incorporate unannounced measures from the Liberal election platform. You also won't find the corporate tax breaks that PM Carney has teased in recent weeks. Conversely, there may be *some* spending cuts as part of the government's pursuit of efficiency, but we expect these to be modest, at least in the short term. In the end, **we see the all-items 2025-26 deficit settling between $80 and $100 billion**. Slightly smaller but still large deficits will likely be telegraphed in future fiscal years.

Complicating the picture is the government's new fiscal presentation (i.e., separate operating and capital balances). Early guidance suggests there's a lot of flexibility in how spending can be categorized, so we won't bother guessing at the exact split. Consistent with the Liberal election platform, the budget should show a declining *operational* balance but more important to investors is the all-items tally, as discussed above.

Whether the deficit is on the low or high end of our expected range, it will be a major shift towards looser fiscal policy. It does not, however, leave Canada's fiscal situation in a historically extreme or relatively egregious state. A quick glance at the 1980s and early 1990s can demonstrate what wholly unsustainable fiscal policy really looks like. According to some independent and reputable third parties, Canada *does* have some fiscal capacity at its disposal, although there's some nuance here.

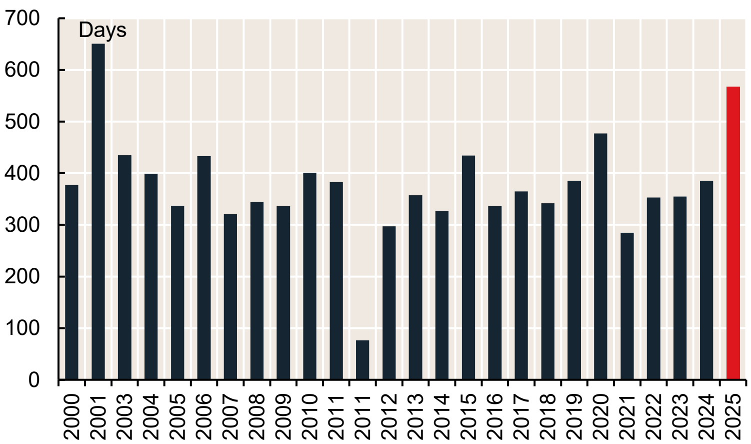
Earlier this month, IMF Managing Director Georgieva applauded the government's plan to use its fiscal space to make productivity-improving strategic investments. Moreover, the PBO estimated last year that the federal government had ~$46 billion of *annual* fiscal room that it could deploy without compromising sustainability. Keep in mind though, the PBO's definition of sustainability is a very long-term concept (i.e., 75 years) and using this room would involve a growing debt burden in the shorter run. That does appear to be the path we're headed down, despite PM Carney's commitment to the fiscal anchor as recently as September.

Of course, Canada is not the only country embarking on fiscal expansion. And the nation's general government sector *is* better positioned to do so than others. But make no mistake, this will be a credit negative fiscal plan. Even though ratings agencies haven't really been sounding the alarm in the lead-up to the budget, keep in mind that Canada's presence in the 'AAA' club is a more function of economic, institutional and monetary considerations. It's less a function of its balance sheet. In fact, no other 'AAA' nation scores worse than Canada on indebtedness.

There's no doubt that *some* fiscal 'bad news' and related risks are already priced in. Nonetheless, a deficit at the higher end of our expected range would produce higher borrowing costs and a steeper yield curve, all else equal. And when it comes to federal borrowing, which has already been stepping up, the budgetary deficit is only part of the equation. Non-budgetary requirements have been rising too. Structurally, the amount of maturing debt needing to be refinanced is also on the rise. It means a large GoC bond program is here to stay as we'll explore in greater detail in a follow-on *Market View*. Stay tuned.

Chart 1: Been a minute (or 816,480 of them) since last budget

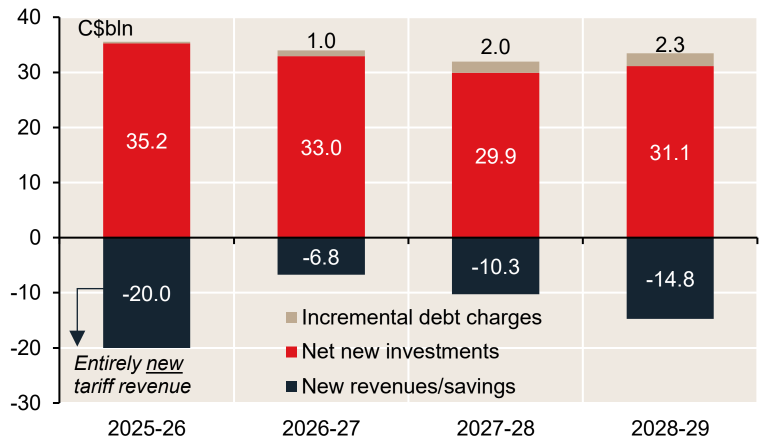
Days between Canadian federal government budgets



Source: NBC, GoC | Note: Economic & Fiscal Snapshot used in lieu of 2020 budget.

Chart 2: LPC promised plenty of investment, some offsets

Liberal Party of Canada (LPC) election costing platform decomposition

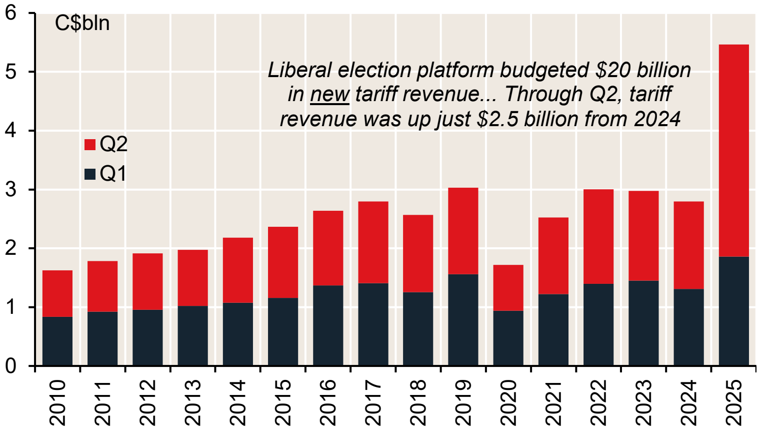


Source: NBC, LPC | Note: LPC Fiscal & Costing Platform released on 19-Apr-2025

To go this long without a budget is rare and our current wait is among the longest on record. But we're not *totally* in the dark as the LPC released a costed election platform in the spring. That plan already involved substantial net new red ink, and the government has since committed to ramp up military spending. They've also removed most tariffs, a material revenue source in their platform.

Chart 3: Tariff revenues come in smaller than anticipated

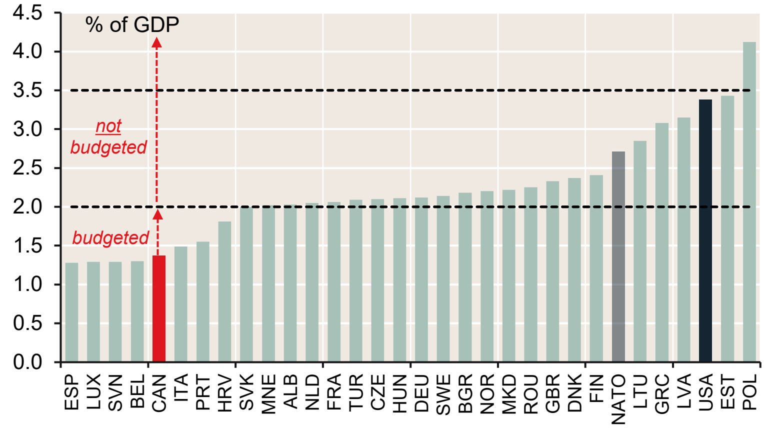
Sum of quarterly customs revenue, by calendar YTD



Source: NBC, StatCan

Chart 4: Canada (and others) to spend big on military

2024 defence spending as a % of GDP, by NATO member

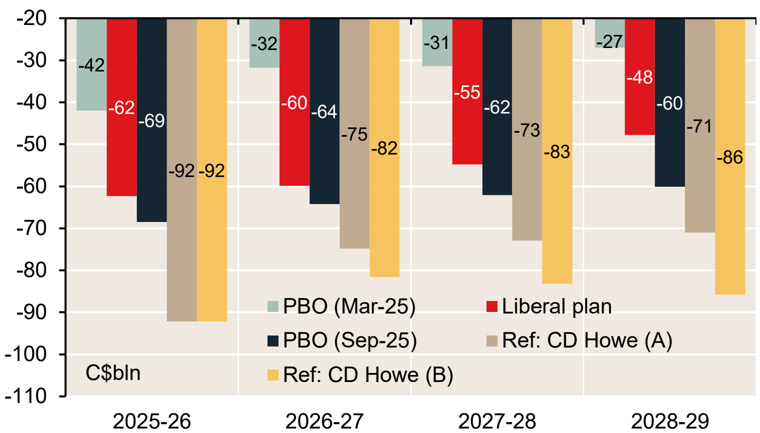


Source: NBC, NATO | Note: Dotted lines denote 'core' spending targets

The $20 bln of new tariff revenue in the LPC election platform will not materialize because most tariffs were lifted and earlier receipts underwhelmed (e.g., Q2 tariff revenue was up just ~$2 bln from Q2:2024). Meantime, defence spending commitments amount to tens of billions which the feds can ramp up over a decade. Still, deficit estimates (see Chart 5) don't account for much of this pledge.

Chart 5: Wide range of potential outcomes on the deficit

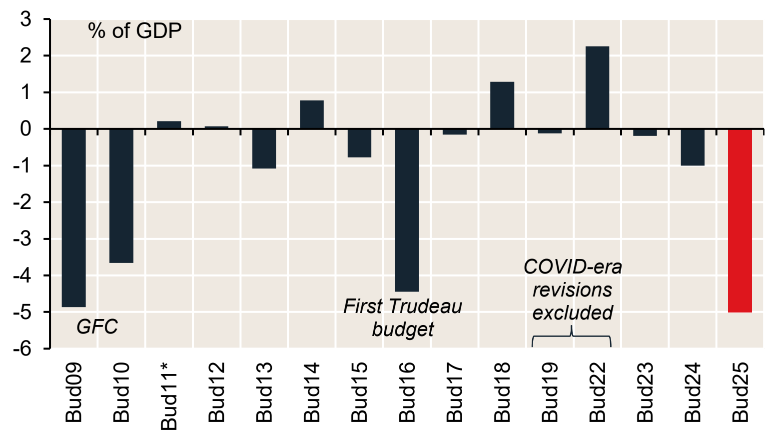
Canadian federal budget balance estimates: PBO pre-election to more recent



Source: NBC, LPC, PBO, CD Howe | Note: CD Howe estimates from Jul-25 report w/ (A) including uncertain savings and (B) excluding uncertain savings (hence larger deficit)

Chart 6: Bracing for one of the largest budgetary revisions

Cumulative 3Y change in projected deficit as a % of GDP, by budget

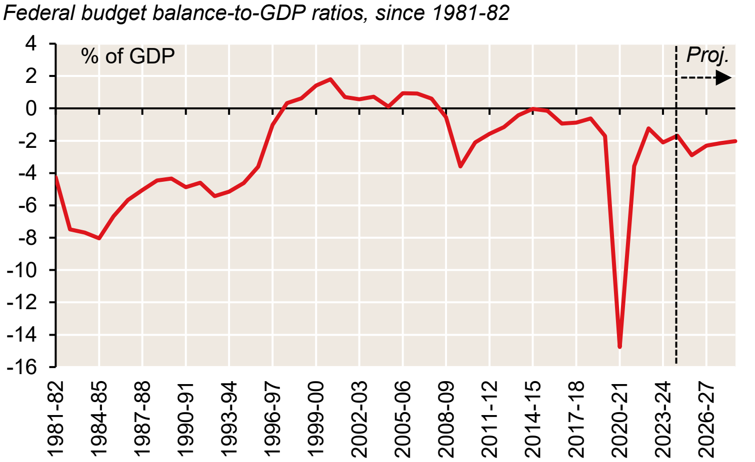


*Source: NBC, GoC | Note: Bud25 = avg of CD Howe (A), (B); Projected deficit includes prior FY, 3FY forward (Bud25 = deficit chg. from 24-25 to 27-28). * Refers to 2nd budget in 2011.*

Stating the obvious, the 2025-26 deficit will be much larger than pre-election guidance but *how* much larger is unclear. It's hard to envision a deficit smaller than the PBO's pre-budget scoring. Instead, red ink should amount to $80-100 bullion with smaller (but still large) deficits thereafter. If we're correct, this would be among the largest budgetary revisions in recent memory (ex-COVID).

Chart 7: Perspective on federal government budget balance

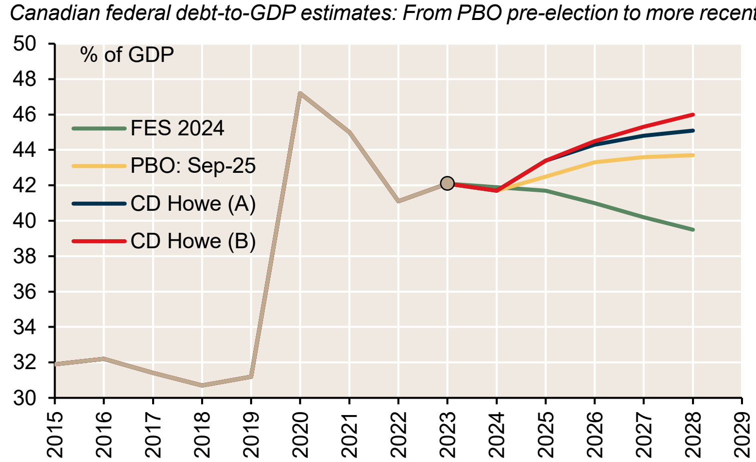
Federal budget balance-to-GDP ratios, since 1981-82



Source: NBC, GoC, StatCan | Note: Projections based on average of CD Howe scenarios

Chart 8: It will be difficult to keep the debt burden from rising

Canadian federal debt-to-GDP estimates: From PBO pre-election to more recent

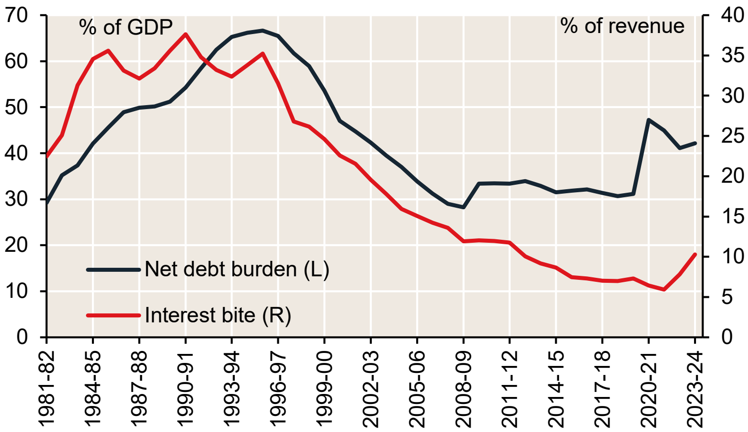


Source: NBC, PBO, CD Howe, GoC | Note: X-axis refers to when the fiscal year began

After some rapid post-COVID budgetary consolidation, the deficit is set to widen to ~3% of GDP this year and remain above 2% thereafter. While large relative to recent decades (excluding COVID), this is not historically extreme (see the 80s & 90s). Expected shortfalls would likely keep the government's net debt burden pointed higher, which could jeopardize one of its earlier fiscal anchors.

Chart 9: Thankfully, this is not the 1990s

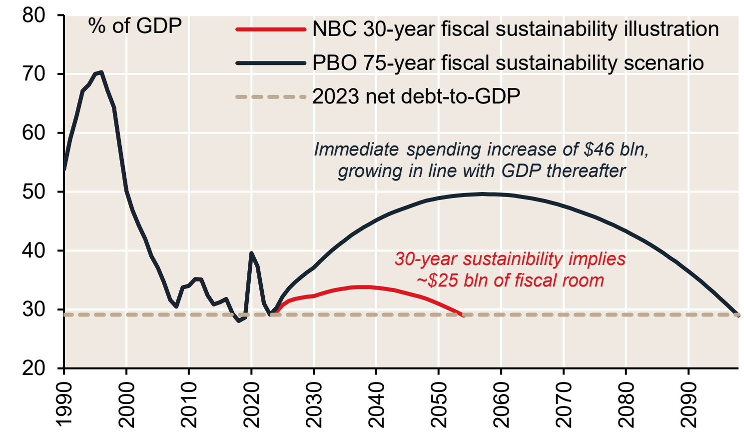
Net debt as a % of GDP and public debt charges as a % of revenue



Source: NBC, GoC

Chart 10: Fiscal sustainability ≠ declining debt burden

Canada net financial liabilities-to-GDP, using the PBO's estimate of fiscal space

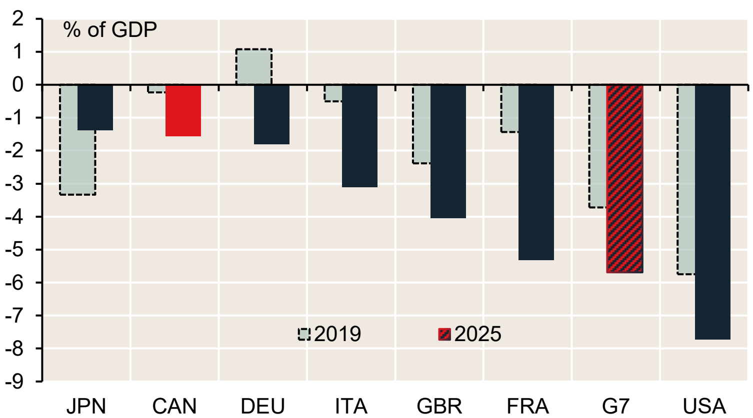


Source: NBC, PBO | Note: Estimates begin in 2024. 30-year scenario run by NBC, using same framework PBO uses for long-run fiscal sustainability analysis.

Despite the expected fiscal expansion, Canada's finances are better positioned than the past when debt was mounting and interest consumed 1/3 of revenue. Is there fiscal room? Yes, some. Last year, the PBO said Ottawa could "sustainably" spend ~$46 billion more per year. But that analysis was based on keeping the debt burden unchanged in *75 years*. Shorter horizons imply less room.

Chart 11: Canada has a relatively smaller structural deficit

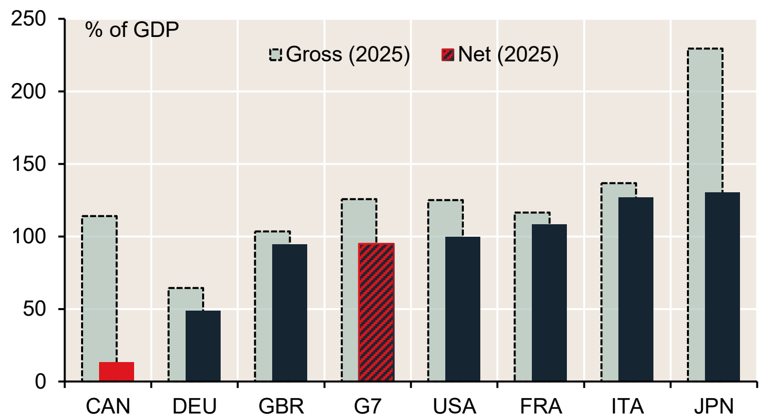
General government structural balance: 2025 vs. pre-pandemic level (2019)



Source: NBC, IMF | CAN includes federal outlook from Dec-24

Chart 12: Canada's debt edge not the same in gross terms

General government gross & net debt-to-GDP ratios: 2025

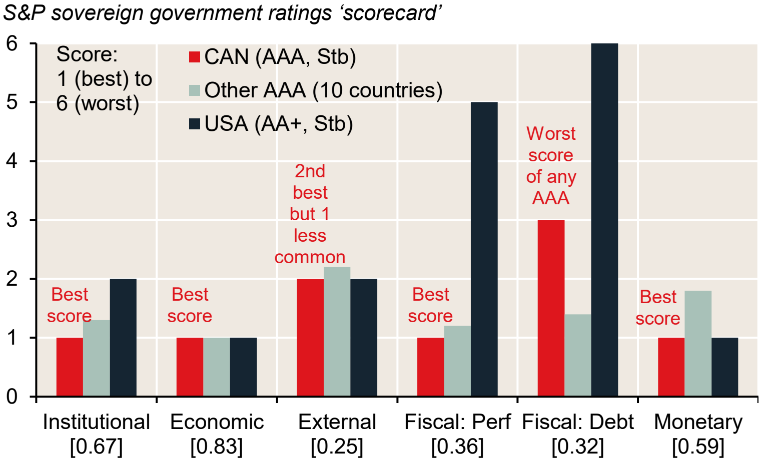


Source: NBC, General government gross & net debt-to-GDP ratios: 2025

Compared to other G7 nations, Canada's general government sector is in *relatively* good fiscal shape, with *relatively* more fiscal room. Comparisons of net debt look especially flattering since financial assets include those held in the social security system (i.e., CPP/QPP). Gross debt comparisons are much less flattering, so Canada's balance sheet edge is in the eye of the beholder.

Chart 13: Credit rating not solely a function of debt/deficits

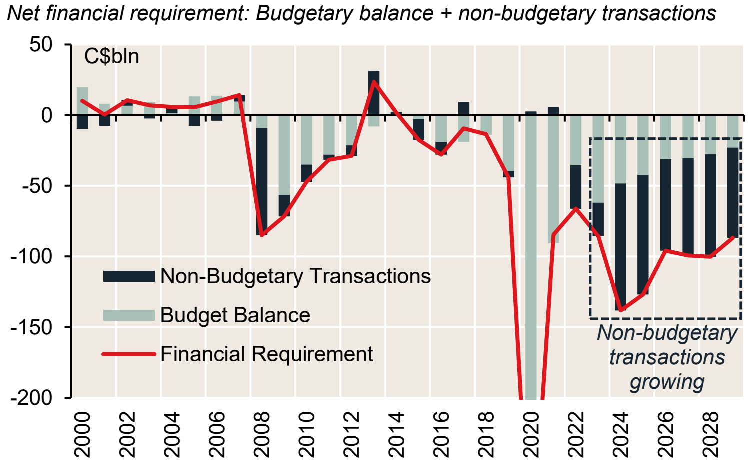
S&P sovereign government ratings 'scorecard'



Source: NBC, S&P | Note: Figures in [:] refer to correlation between factor scores and linear translation of long-term rating for 75 IG-rated sovereigns as at Feb-25

Chart 14: Non-budgetary requirements have stepped up big

Net financial requirement: Budgetary balance + non-budgetary transactions



Source: NBC, GoC | Note: Projections of deficit and non-budgetary transactions via FES:2024. X-axis refers to year in which fiscal year began.

Canada's 'AAA' rating is *not* a function of its debt. In fact, Canada scores the worst of *any* 'AAA' credit on this measure. Ratings agencies haven't been sounding the alarm, but this will nonetheless be a credit negative fiscal plan. Increasingly, net new debt is as much about non-budgetary transactions (e.g., CMB purchases) as it is the deficit. These are a wildcard when projecting bond issuance.

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