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Of muni themes, explicit and unspoken

By Warren Lovely

Amidst a decidedly fluid/volatile economic and financial market backdrop, Canada's relatively stable municipal government sector is about to step into the spotlight. A number of large and/or strategically important issuers in the sector will have an opportunity to update investors as part of National Bank Financial's 11th Annual Municipal Borrowers Conference. (See the below Box and/or speak to your NBF representative for additional details.)

To be clear, there are no specific bond offerings tied to our annual conference and this *Market View* note is not meant as a solicitation of interest. Those familiar with the municipal market likely appreciate that fall is a traditionally active period for municipal bond issuance. And while we could see the odd issuer in the market, overall muni bond supply could well be lighter-than-normal in the coming months. Some issuers are apt to stand down in the face of higher borrowing costs and elevated market volatility. Scheduled municipal elections in some provincial jurisdictions could likewise delay bond issues that might have otherwise come this fall.

We offer this report as a complement to the various credit-specific stories on offer via our conference. Whether you're able to participate in our conference or not, consider this an opportunity to reflect on a variety of economic, fiscal and financial themes impacting/influencing the outlook for Canada's municipal government sector.

Economic-fiscal-financial situation in Canada's muni sector

Box: NBF's 11th Annual Municipal Borrowers Conference

September 12-13, 2022

National Bank Financial's 11th Annual Municipal Borrowers Conference will be held (virtually) over Monday, September 12th and Tuesday, September 13th. This conference provides interested investors an opportunity to hear directly from (and question) nine individual issuers, listed below in presentation order:

Monday, September 12th:

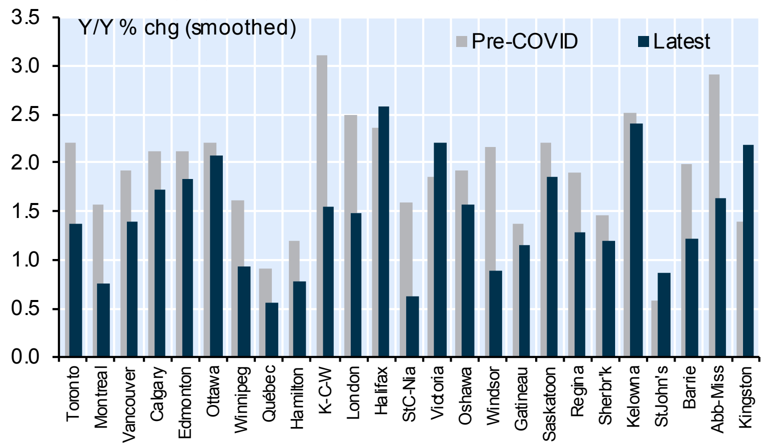
- Region of Peel
- First Nations Finance Authority
- City of Ottawa
- Municipal Finance Authority of British Columbia
- Municipal serial bond auctions, Province of Quebec

Tuesday, September 13th:

- Region of York
- City of Toronto
- City of Montreal
- TransLink

Chart 1: Generally solid growth in working age populations

Growth in working age population in Canada's largest CMAs

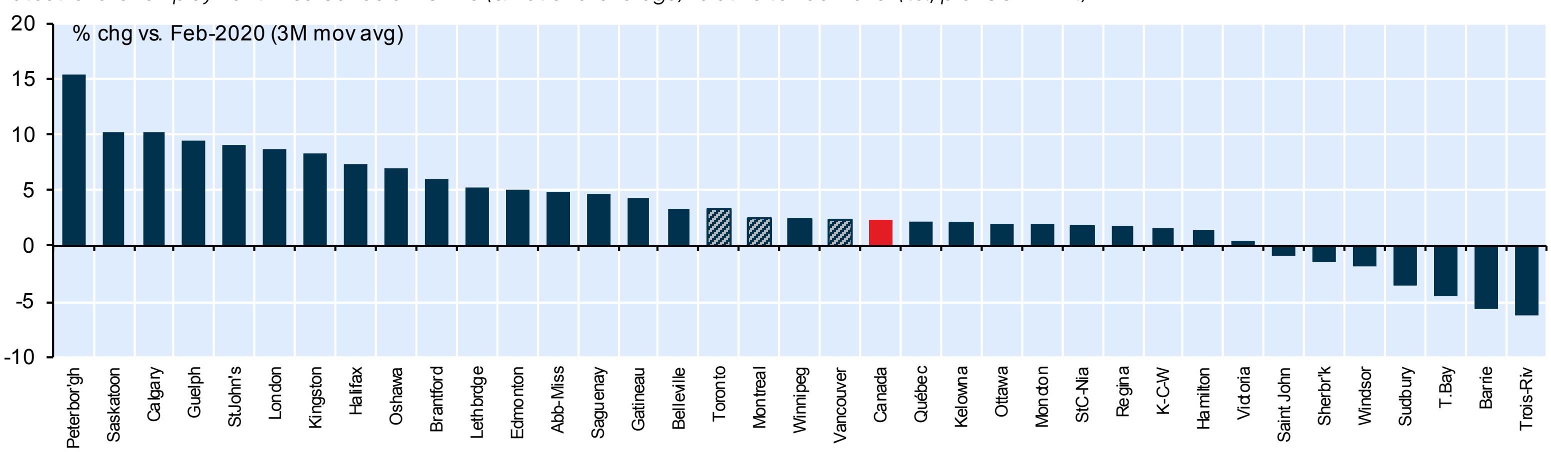


Source: NBF, StatCan | Note: As at Aug-2022; 25 CMAs in declining order of population

Demographics are something of a foundational element for municipal governments, where highly educated workforces continue to grow all across the largest census metropolitan areas (CMAs).

Chart 2: Most local labour markets have secured important recovery from short-lived pandemic hit

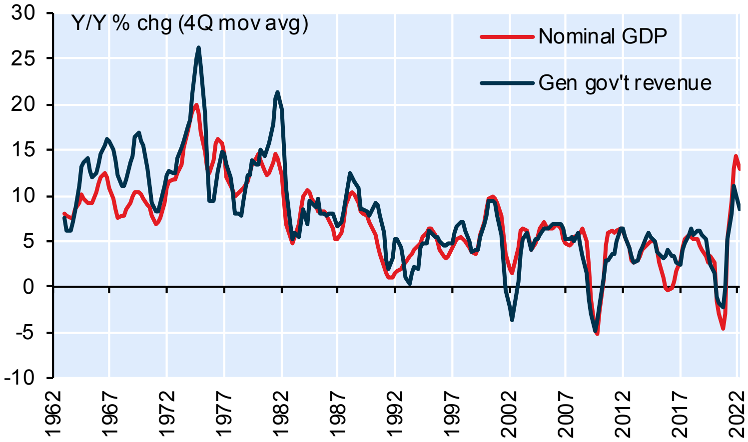
Latest level of employment in 36 Canadian CMAs (& national average) relative to Feb-2020 (i.e., pre-COVID hit)



Source: NBF, StatCan | Note: As at Aug-2022; cross-hatching denotes 3 largest CMAs (Toronto, Montreal, Vancouver), with national average included for comparison purposes

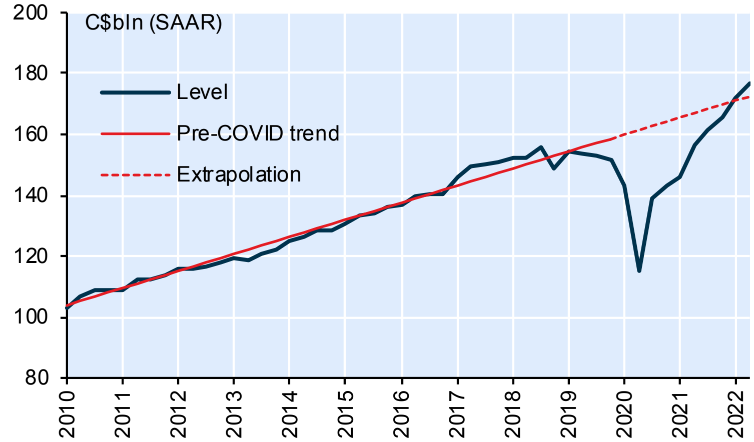
Notwithstanding some recent employment weakness in Canada, the country's largest cities have had considerable success integrating new entrants into the work force. Employment levels have staged a significant recovery following COVID-driven job losses. And as of August 2022, 28 of 36 Canadian CMAs had a jobless rate that was below the level observed prior to the pandemic.

Chart 3: Government revenue follows economy higher…
Growth in Cdn nominal GDP & general government revenue (i.e., all levels)



Source: NBF, StatCan | Note: Gov't revenue on national accounts basis to 2022:Q2

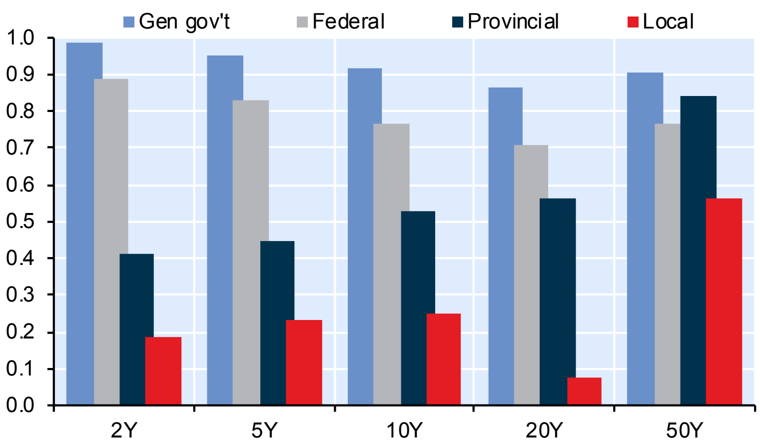
Chart 4: … with taxes staging particularly strong recovery…
Level of Cdn taxes less subsidies relative to pre-COVID trend



Source: NBF, StatCan | Note: Based on national income accounts to 2022:Q2

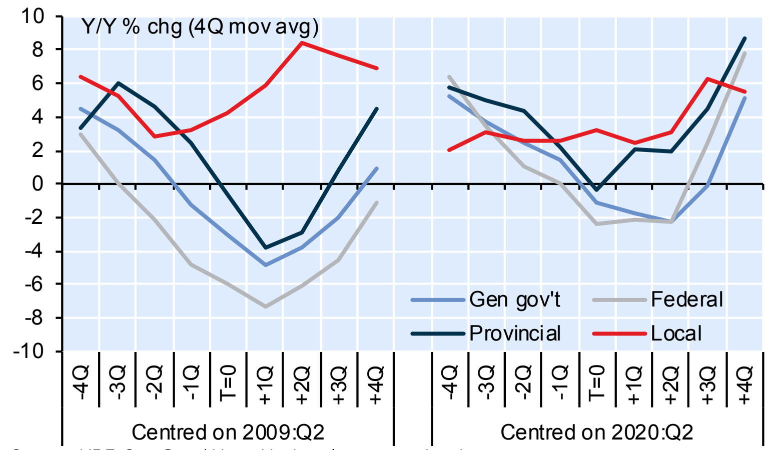
Economic resilience and robust nominal GDP growth has sparked a dramatic recovery in Canada's fiscal fortunes. In the general government sector (which includes all levels of government), tax revenue has vaulted higher, moving back above the pre-COVID trend. But Canada's local government sector remains unique, with key revenue streams more stable than at the federal-provincial level.

Chart 5: … but muni gov't revenue stable over time (by design)
Correlation btw gov't revenue growth & Cdn nominal GDP growth over time



Source: NBF, StatCan | Note: National accounts basis; smoothed data to 2022:Q2

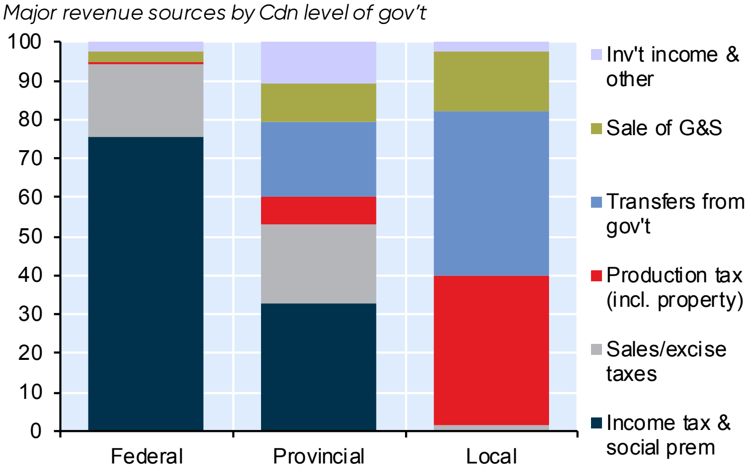
Chart 6: Local gov'ts much less impacted in downturns
Cdn gov't revenue growth during past two downturns/recessions



Source: NBF, StatCan | Note: National accounts basis

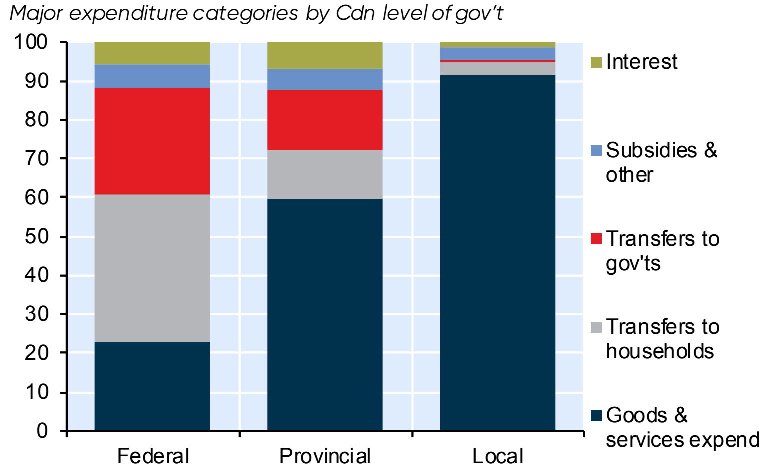
The relative stability of municipal government revenue is not a new story. Consider the largely non-existent correlation between Canadian nominal GDP growth and local government revenue growth. That might offer some comfort to those fearing an economic turn for the worse as rate hikes weigh. Looking back, munis suffered much less acute revenue pressure during past downturns.

Chart 7: Unique/stable revenue model for munis
Major revenue sources by Cdn level of gov't



Source: NBF, StatCan | Note: National accounts basis as at 2022:Q2

Chart 8: Nature of spending (& inflation exposure) also varied
Major expenditure categories by Cdn level of gov't

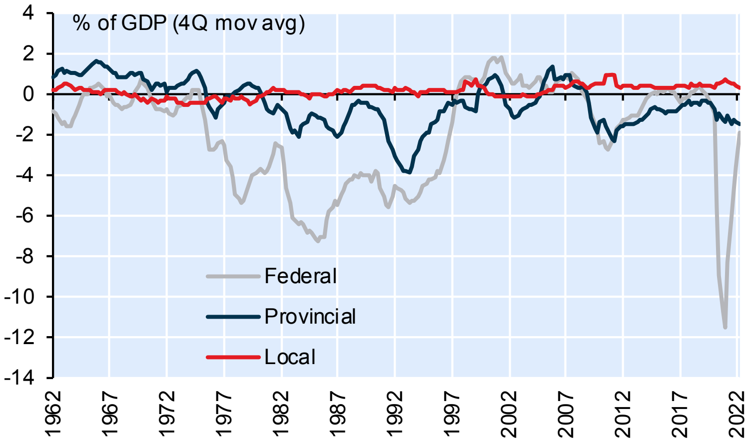


Source: NBF, StatCan | Note: National accounts basis as at 2022:Q2

It's not that municipal governments (and underlying tax bases) are impervious to the economic cycle. But the muni revenue model looks nothing like other levels of government. In select cases, there's direct (yet modest) leverage to housing, but a flexible mill rate protects vital property tax revenue even if assessed values were to decline. Government transfers have also lent additional stability.

Chart 9: A track record of muni fiscal stability (vs. fed/prov vol)

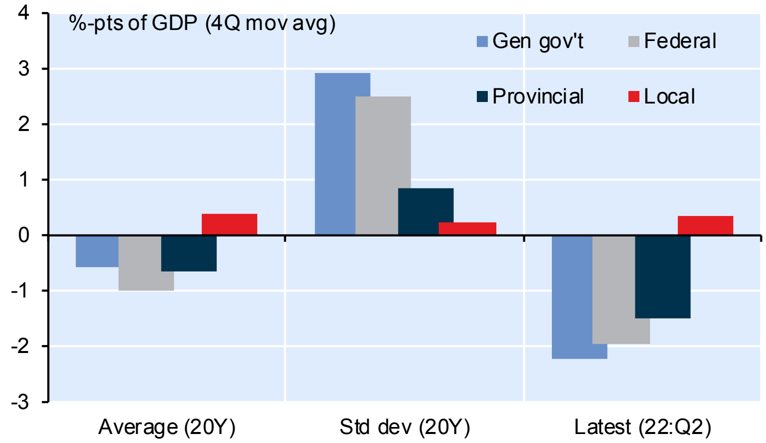
Budget balance by Cdn level of gov't



Source: NBF, StatCan | Note: National accounts basis to 2022:Q2

Chart 10: Further perspective on relative fiscal results/noise

Current & historical budget balance metrics by Cdn level of gov't

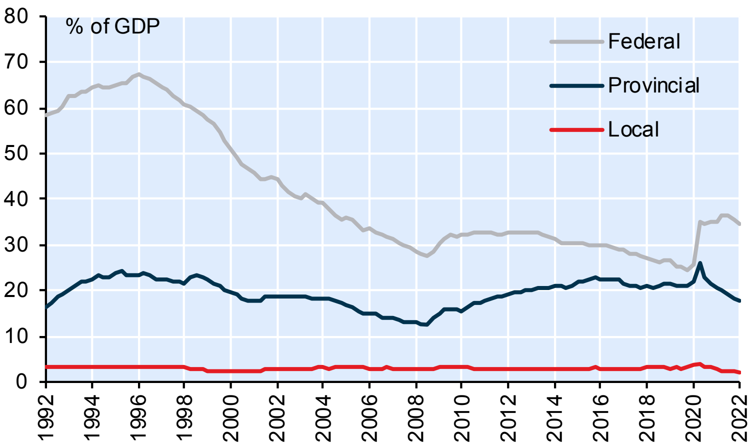


Source: NBF, StatCan | Note: National accounts basis as at 2022:Q2

Consistent with the stable revenue story outlined on the preceding page, local government budget balances have been inoculated against Canada's economic ups and downs. Again, this is very much by design, reflecting provincial legislative requirements for operational balance. It means budgetary volatility (for better or worse) is much more the domain of the feds and the provinces.

Chart 11: More constrained/controlled leverage…

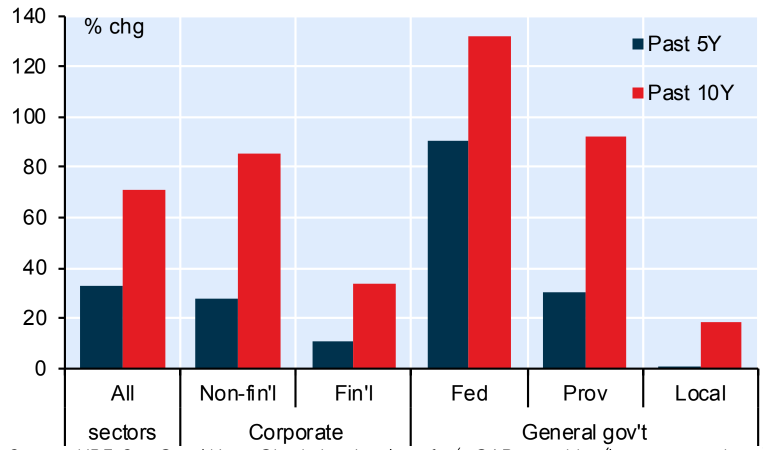
Net debt-to-GDP ratio by Cdn level of gov't



Source: NBF, StatCan | Note: National balance sheet accounts to 2022:Q1

Chart 12: … means limited growth in muni debt outstanding

Growth in domestic long-term debt securities by Cdn sector/level of gov't

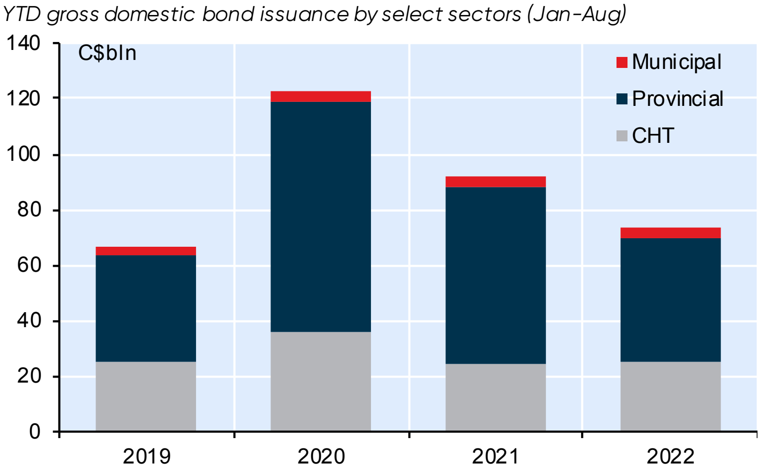


Source: NBF, StatCan | Note: Chg in book value of o/s CAD securities (long-term at issue)

Notwithstanding recent fiscal repair at the provincial level, the balanced operating budgets and long-standing limits on debt that characterize the municipal government sector make leverage a much less significant worry here. No other sector has held the line on new debt, there being effectively no growth in outstanding municipal bonds over the past half-decade.

Chart 13: Putting muni bond issuance in perspective

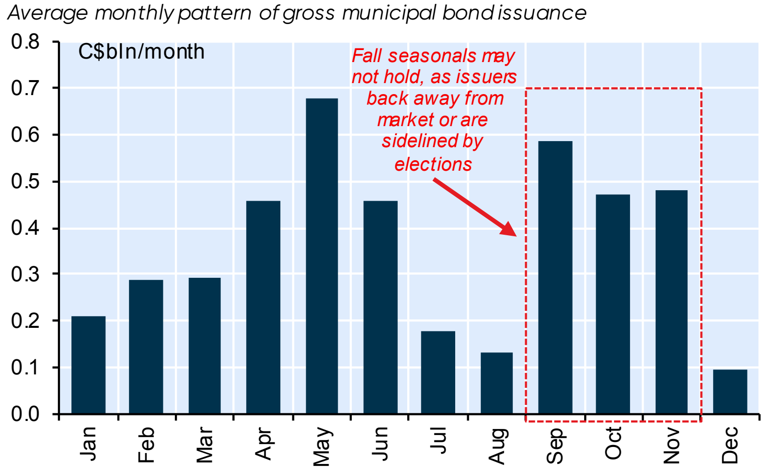
YTD gross domestic bond issuance by select sectors (Jan-Aug)



Source: NBF, IIROC, Bloomberg | Note: YTD supply based on Jan-Aug; CAD issues only

Chart 14: Fall seasonals may not hold in muni land

Average monthly pattern of gross municipal bond issuance

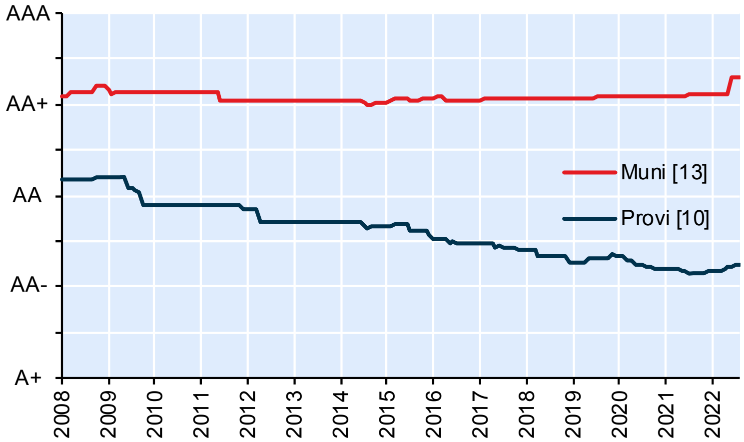


Source: NBF, Bloomberg | Note: Avg gross issues over 12Y period (2010-21)

Given restrictions/limitations on debt, no one is going to confuse the municipal bond market with provincials, crowns or Canadas. Year-to-date muni issuance (alongside secondary trading volumes) has receded in 2022. And we may not see the traditional seasonal pick up this fall. Higher borrowing rates and volatility have discourage some, while municipal elections look to sideline/delay others.

Chart 15: Muni ratings relatively strong(er) (with a bump in June)

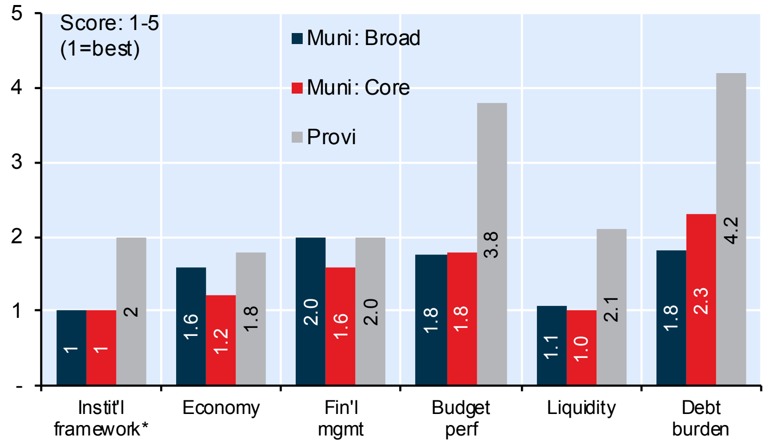
Average long-term credit rating: Select muni credits vs. prov'l average



Source: NBF, S&P, Moody's, DBRS | Note: Avg rating, controlling for +ve/-ve outlooks

Chart 16: A more detailed comparison of muni vs. provi risk

Average S&P credit rating factor score: Select muni credits vs. prov'l average

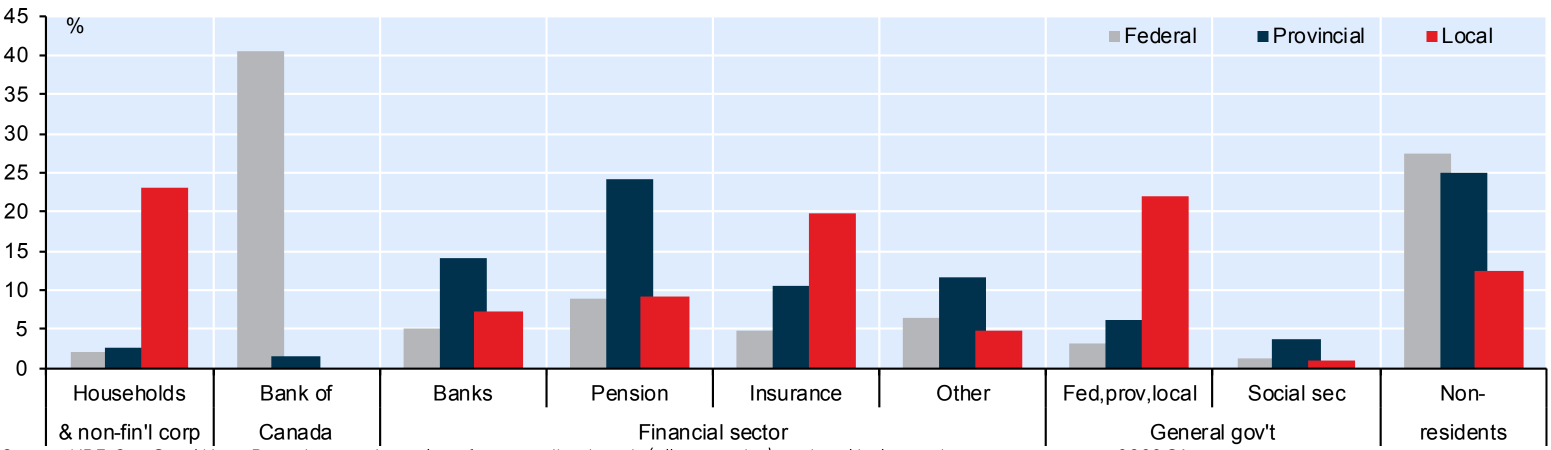


Source: NBF, S&P | Note: Avg score; instit'l framework applies across level of gov't

Municipal bonds are, on average, of a high credit quality (in absolute and relative terms). Budgetary stability begets ratings stability, a theme that's been in evidence since the GFC (if not longer). Note that S&P's enhanced view of the institutional framework governing Canadian munis led to some upgrades in June. At S&P, budgetary/debt scores compare particularly well to the average province.

Chart 17: Different buyer base for different levels of government in Canada (with GoC ownership shares notably distorted by BoC)

Distribution of bond ownership by Cdn level of gov't

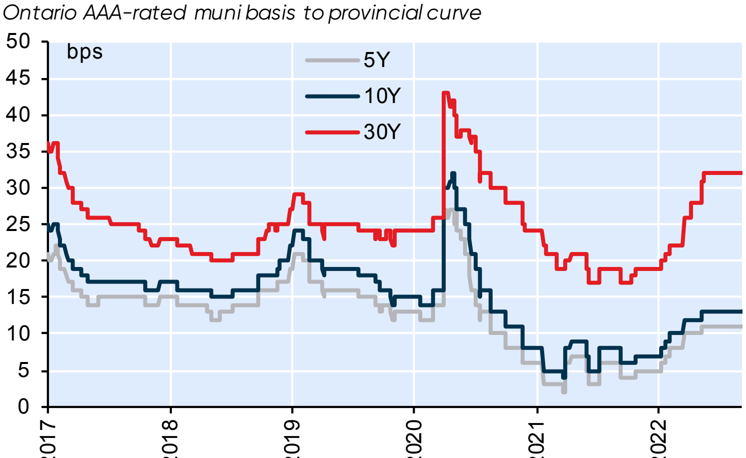


Source: NBF, StatCan | Note: Based on market value of outstanding bonds (all currencies); national balance sheet accounts as at 2022Q1

The buyer base has been another point of departure vs. provincial or federal bonds—ownership in the latter category (GoCs) influenced by central bank holdings. Historically, more muni bonds were steered to retail investors and/or other levels of government. Today, banks, pensions, insurers and other asset managers are actively involved, with non-residents having identifyied value in the past

Chart 18: Muni spreads not immune to broader anxiety

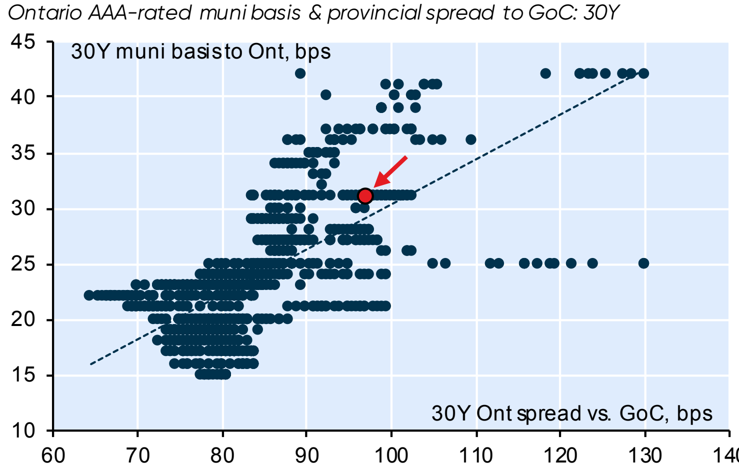
Ontario AAA-rated muni basis to provincial curve



Source: NBF | Note: Based on daily constant maturity indications to 9-Sep

Chart 19: Basis influenced by underlying spread backdrop

Ontario AAA-rated muni basis & provincial spread to GoC: 30Y



Source: NBF | Note: Based on daily constant maturity indications to 9-Sep (red dot)

Notwithstanding budgetary stability, credit rating uplift and limited net issuance, municipal bond spreads have spent much of 2022 on widening trend. That reflects a back-up in the underlying provincial curve on top of a wider basis. We're reluctant to call munis high(er) beta, but the muni basis to provis has shown a tendency to widen as financial stress rises and liquidity recedes. While we retain a degree of confidence in a 'soft landing' scenario, credit markets (including high-rated, fiscally sound munis) could remain on the defensive until the policy rate offensive shows signs of ending.

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