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.

Box: NBF’s 11th Annual Municipal Borrowers Conference

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

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

Chart 1: Generally solid growth in working age populations

Growth in working age population in Canada’s largest 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)
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.

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.

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.
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.

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.

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.
Market View
Economics and Strategy

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

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 2022:Q1

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 identified 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

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 bias. We’re reluctant to call munis higher 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.

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)

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