

## Industry Update

# Refuse and Recycling



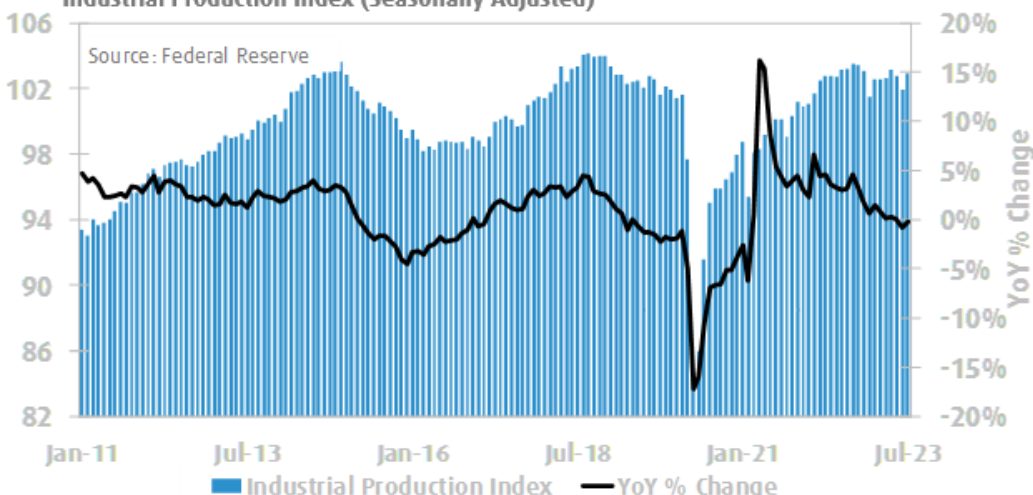
## Key Developments

- The EPA announced its **National Enforcement and Compliance** priorities for 2024-2027. The primary initiatives include increased compliance with drinking water standards, mitigating climate change via methane emission reduction, addressing exposure to PFAS "forever" chemicals, protecting over-burdened communities from coal ash contamination and hazardous air pollutants, and reducing chemical accident risk.
- According to the **Bureau of Labor Statistics**, the Waste Management and Remediation Services industry reached record-high employment at the end of June while regaining 47,100 jobs (+13%) since the pandemic low. Although peak wage increases are in the rearview, wage pressures are still elevated, with average hourly wages during the 2nd quarter increasing by 2.9% from the 1st quarter and 9.6% from a year earlier.
- Following a year-long collapse throughout 2022, the **BLS** Producer Price Index for corrugated recyclables has been on a steady uptrend while increasing 50% year-to-date through June. Conversely, the PPI for recycled plastics was flat year-to-date through June.
- Be sure to check out the latest perspectives from BMO economists on the macro outlook (page 4).

## Industry Fundamentals

Although past-peak, the carryover benefits from CPI-influenced pricing leverage and a robust M&A environment over the past couple of years continue to outpace more recent macro and industry-specific challenges to growth and profitability. Still, uneven recycling commodity pricing, less favorable collection pricing resets, volatile fuel expenses, stubbornly high labor costs, the consumer tilt toward services, structural changes to office utilization, and macro pressures on manufacturing and construction continue to challenge the industry's ability to expand volumes and margins. And if conditions continue to stiffen and warrant, the sector maintains proven cash flow preservation levers, including discretionary expense reductions, equipment optimization, automation efficiencies, and the postponement of capital outlays.

### Industrial Production Index (Seasonally Adjusted)

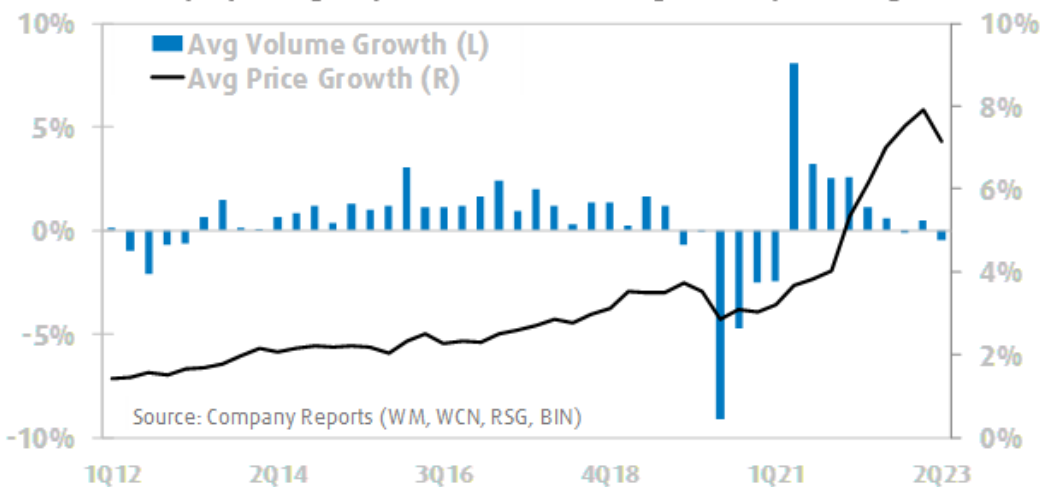


**U.S. industrial production** rebounded in July, rising a stronger-than-expected 1.0% month-over-month. However, the previous four months were revised lower, leaving total industrial output 0.2% lower than a year earlier.

Some of the headline surprise was powered by a strong month for utilities (+5.4%) amid the high temperatures in July. Output in the all-important manufacturing sector increased by 0.5%, driven by an ongoing rebound in motor vehicle and parts production, which jumped 5.2%. Excluding that sector, factory output managed only a 0.1% gain. Further, **manufacturing capacity utilization** slipped below the long-term average, which should keep downward pressure on goods prices.

## Business Indicators

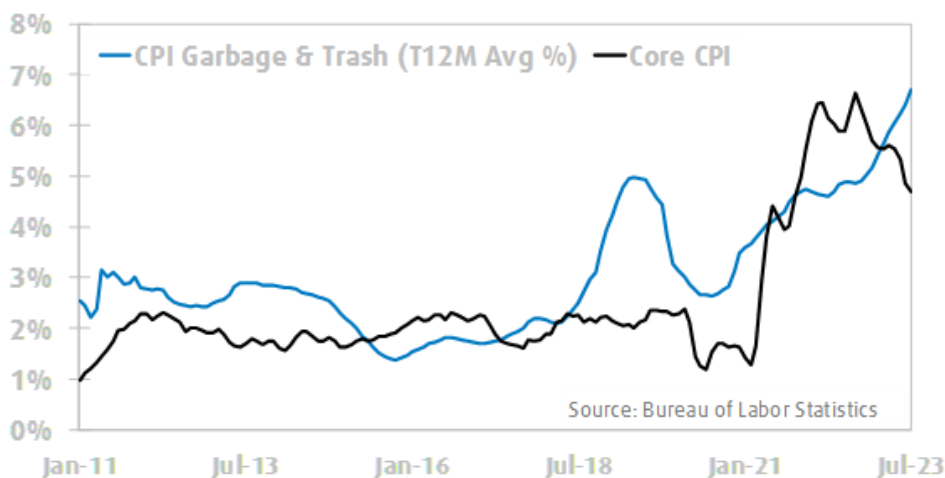
### Public Company Average Reported Volume and Pricing Growth Y/Y % Change



A sample group of public refuse haulers realized average year-over-year **pricing growth** of 7.2% during the 2nd quarter, down 70 basis points from the record high reached during the 1st quarter but well above the 5-year and 10-year averages of 4.4% and 3.3%, respectively. Although clearly past peak, the most recent pricing metrics reflect advantageous negotiating leverage within the still elevated inflationary backdrop.

Conversely, growth in **solid waste volumes** has shown a dramatic deceleration and, during the 2nd quarter, turned negative to be down 0.4% compared to a year earlier. Yearly comparisons have stiffened while inflation and higher interest rates have taken their toll on the industrial sector and C&D activity.

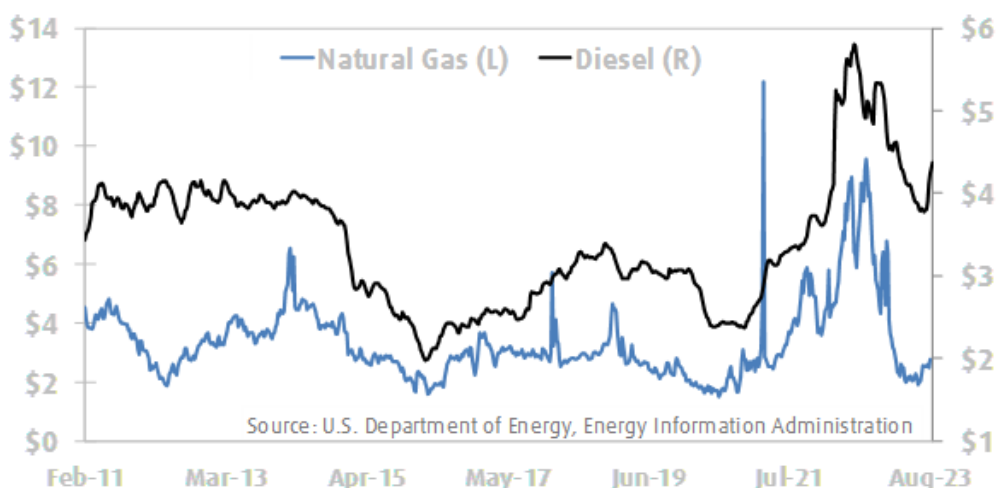
### Core CPI (All Items Excl. Food & Energy) vs. CPI Garbage & Trash Collection Y/Y % Change



U.S. consumer prices increased 0.2% month-over-month for a second straight month in July. It was the smallest 3-month annualized change (1.9%) in three years, although favorable year-ago comparisons pushed the yearly rate higher to 3.2%. Meantime, core CPI also rose 0.2%, trimming the annual rate to 4.7%. Although the supercore metric picked up a bit, the Fed may be relieved that overall price pressures are easing amid the highest interest rates in over two decades.

The **CPI index explicitly related to garbage and trash collection**, which is used frequently as a benchmark for contract service pricing, for the time being, continues to be extraordinarily “sticky” despite decelerating volume growth.

### Natural Gas Spot and On Highway Diesel Weekly Prices



Since the invasion of Ukraine, Diesel fuel prices have been on a high-altitude roller-coaster. Over the past year, mirroring a sharp decline from last fall and, more recently, a bounce in WTI crude prices, the national average weekly Diesel price of \$4.38 per gallon in mid-August had increased \$0.61 (+16%) from a recent low in early-July but was still down \$1.42 (-25%) from an all-time high last June.

The crude price increase over the past two months reflects improving odds of an economic soft landing coupled with Saudi Arabia’s unilateral decision to cut production by a hefty 1 million barrels per day. As such, the current BMO outlook for WTI suggests that crude prices will remain elevated during the 2nd half of the year before settling in to average \$80 per barrel during 2024.



BMO



Transportation Finance

### You can count on us.

Fueled by more than 40 years of experience, BMO Transportation Finance brings our waste management customers a locally based sales force, exceptional service and highly tailored financing solutions. Whatever your goals, we work to understand the way you work — and make it our business to know yours.

Visit [bmotf.com](http://bmotf.com) to learn more.

BMO Transportation Finance is a brand name used by BMO Harris Bank. © 2018 BMO Harris Bank N.A. Member FDIC



---

## “Voice of the BMO Economics Team”

With macro conditions outperforming most economists' expectations but with the lag of financial tightening not yet fully reckoned with, we thought checking in on the BMO Economics Team's latest perspective on the Fed and the future outlook for the U.S. economy would be helpful. For more: <https://economics.bmo.com/en/>

### **US Economy: Summer Breeze - Sal Guatieri, Senior Economist and Director Economics, August 18<sup>th</sup>, 2023**

The Fed can blame the weather, perhaps, for why the economy appears to have warmed up instead of cooled down as hoped for. Rather than hunkering down in air-conditioned homes, many Americans spent steamy July shopping in air-conditioned malls, stores and diners. Retail sales shot up 0.7% last month, and the control measure that the BEA uses to tally GDP jumped 1.0% even after hefty gains in the prior three months. Of course, apart from a large spike in food services, we don't know what happened to overall services spending. But weekly data on payment card use from the BEA and Affinity Solutions suggest it remained sturdy through early August.

Another '1.0' also highlighted the economy's resilience. Industrial production rose that much in July, though largely due to two special items: cranked A/C use and sped-up auto assemblies. The latter accounted for most of the 0.5% bounce in manufacturing, but has now returned to normal levels. Mixed data from the New York and Philadelphia Fed surveys suggest factory output will contract for the third time in four months in August. Meantime, the labor market remains healthy, with the trend in new and continuing jobless claims little changed in recent months after rising earlier this year.

The strong retail report warranted a half-point upward revision to our Q3 real GDP growth estimate to 2.5%. And, there's still upside risk, as the Atlanta Fed's Nowcast estimate has stormed to 5.8%. However, it's early days in the quarter and that metric has a history of starting off hot (or cold) before fading (or warming) by quarter's end. Walmart indicated that households are cutting back on discretionary items as they spend more on costly necessities, such as groceries. Moreover, construction spending on manufacturing facilities, which soared more than 80% in the past year due to earlier legislation to incent reshoring and climate change initiatives, cooled in May and June. The housing market is also under renewed pressure from 30-year mortgage rates topping 7%, the highest in 21 years. While starts popped in July, they retraced only a fraction of the prior month's decline and are little higher than a year ago. Stalled permits and a recent pullback in builder sentiment flag slower construction ahead.

**Bottom Line:** The U.S. economy likely picked up this summer, leading us to bump up our 2023 annual call to 2.2%. But we left the 2024 forecast unchanged at 1.0%, as it's likely just a matter of time before mounting headwinds—notably the lagged effect of tighter Fed policy and lending conditions—overwhelm fading tailwinds, such as excess savings and revenge spending.

### **North American Economy: Getting Really Real – Doug Porter, Chief Economist, August 18<sup>th</sup>, 2023**

Where are the serious economic and/or financial cracks going to first emerge? Some version of that has been the most common question we have fielded since the Fed and other central banks embarked on the intense tightening campaign of the past 18 months. Could the answer be China? It certainly felt that way this week, as deepening property woes and another raft of disappointing economic data from the world's second biggest economy sent shudders through global financial markets. It was nearly a full-on risk-off week, as the S&P 500 fell more than 2% (now down almost 5% for August), the U.S. dollar neared its high for the year, oil fell to \$80, and even bitcoin took a big step back in a tough week for financial markets.

---

## “Voice of the BMO Economics Team”

### Getting Really Real (Cont.)

One major market did not follow the risk-off script—government bonds. Instead of rallying in the face of stress, as they so often do, bonds joined in the selling parade, taking a variety of yields to multi-year highs. In fact, it may well be that the relentless back-up in long-term yields itself is the root cause of the market’s recent angst, moreso than China concerns. The benchmark 10-year Treasury yield pierced the 4.3% threshold this week, and saw its highest close—at that level—since November 2007. As recently as April, it was probing 3.3% in the wake of the regional banking squall. This abrupt rate rise has spilled over into mortgages, where the 30-year rate broke above 7% in the latest week, threatening to add a new down-leg to housing.

Perhaps of most concern for markets is what’s driving the steady rise in long-term yields. It’s not higher inflation expectations, as the 10-year breakeven rate has been locked in a relatively narrow range around 2.3% for a year now. Instead, the sell-off has been keyed by real interest rates, which are forging higher across the board. The real 10-year Treasury yield is now on the cusp of hitting 2% for the first time since 2009, while all other major maturities have long since broken through that threshold. To put today’s levels in perspective, the 10-year real yield was basically at zero just before the pandemic, and promptly dropped deeply negative for the next two years—at least until the Fed started tightening and engaging in QT.

Why are real yields on the march? The ball really got rolling in early 2022, when central banks and markets collectively realized how far policy had fallen behind the inflation curve, and tightening commenced. Instead of buying bonds, central banks are now busily reducing their massive holdings. Piling on has been Fitch’s downgrade (on Aug. 1) and a tidal wave of supply, juiced by a doubling of the U.S. budget deficit to more than \$2 trillion in the short space of a year. Geopolitics may be playing a small role, as Russia has essentially cut its holdings of Treasuries to nil and China is seemingly headed in that direction, steadily reducing its holdings by \$265 billion since the first quarter of 2021 to \$835 billion now (a 24% slice). Even Japan, again the largest holder of Treasuries, has trimmed its exposure by 10% in the past year to \$1.1 trillion, as domestic JGBs now offer a semi-respectable 0.63% 10-year yield.

The rise in real yields back to levels that were pretty much the norm prior to the Global Financial Crisis may be a clear signal that the long-term rate outlook has truly shifted. A return to solid positive real yields has a variety of important implications, and some are less than pleasant:

Gone are the easy days for public finances. Negative real rates were a godsend for governments, especially during the pandemic, allowing them to borrow heavily without sustaining serious damage to long-term finances. Positive real rates will ultimately impose much more discipline, a reality that perhaps not all policymakers have cottoned onto yet.

Household borrowers also had access to historically cheap credit for more than a decade, and saw persistent windfalls through renewals into lower mortgage rates. The latter will instead be a meaningful headwind for what looks like years to come.

Asset valuations will ultimately need to readjust to a different world for real interest rates—real estate (yes, including housing), equities (which arguably have already partially adjusted through last year’s bear market), and more speculative assets.

---

## “Voice of the BMO Economics Team”

### Getting Really Real (Cont.)

On the positive side of the ledger, the return to robust real rates is a boon for pension plans, as the long-term liabilities are much more heavily discounted. It's also good news for savers, who have been punished mercilessly for more than a decade of extremely low and even negative after-inflation rates.

Of course, if the economic outlook was particularly weak, real yields would likely not be making the upward move of the past few months. But adding to the advance has been a drumbeat of upward revisions to the near-term U.S. outlook by a wide variety of analysts—present company included. Perhaps most eye-popping is the early read on Q3 GDP growth by the Atlanta Fed's GDPNow of a towering 5.8%, which, you know, is a pretty long way from recession. The result popped higher on upside surprises in retail sales and industrial production, the latter of which revealed U.S. auto production was at its highest since pre-pandemic days.

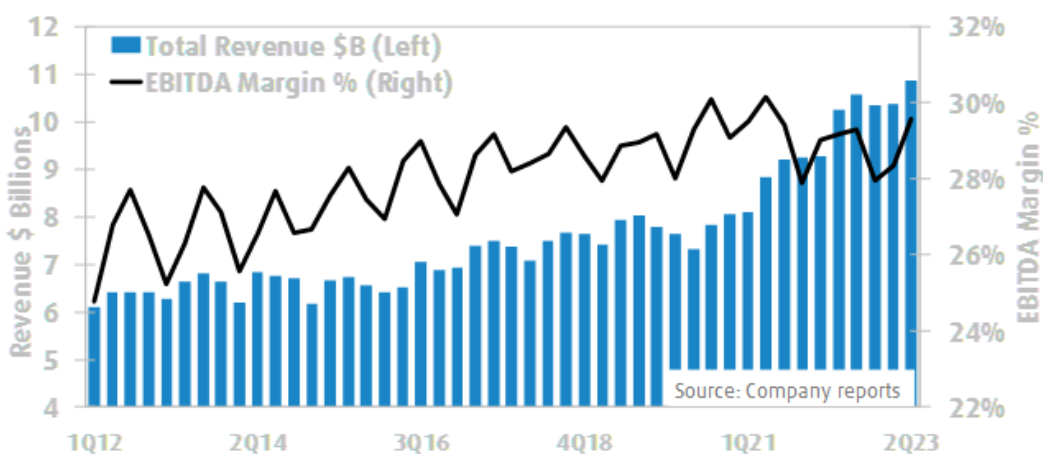
Amid the steep rise in yields, all eyes and ears will turn to next Friday's sermon from the Teton Mountains by Jay Powell (10 am, from Jackson Hole). Recall that last year's effort was a terse “there will be pain” lecture, presaging the 300 bps of additional tightening in the past year. Expectations are running high that the Chair may revisit the issue of the neutral or natural rate of interest (aka *r-star*), a topic he delved deeply into in 2018's speech, when real rates were still mired well below 1%. This is ultimately a much more important issue than whether the Fed will hike one more time this cycle—we and the market lean “no”—or when rate trims may commence. The bevy of solid data and the latest rise in yields suggest that day may be even further away than our call of late next spring.

Canada was certainly not left out of the selling pressure in bonds or stocks. In fact, the TSX had its worst day of the year on Tuesday, was down 3% on the week, and is now just hanging onto a slender gain for all of 2023. A high-side CPI result for July added to the sour mix—the 3.3% reading leaves Canada's inflation rate above that of the U.S. for the first time since pre-pandemic days in 2019. This put some additional pressure on domestic yields and nudged up the chances that the Bank of Canada goes back to the tightening well one more time. While market pricing doesn't yet see a move in September, it has almost fully baked in one more by year-end.

In turn, the key five-year bond yield has vaulted well above the 4% threshold for the first time since late 2007. Barely three months ago, that important yield was still below 3%, a nasty turn of events for the housing market. Our view is that these higher yields will thus do some of the dirty work for the Bank, and, along with a weakening job market, suggest that further rate hikes won't be necessary. However, keeping rates steady will mean the Bank will have to grit through what's likely to be another nasty rise in headline inflation next month to above 3½%.

## Business Indicators

### Waste Management Public Company Total Revenue and EBITDA Margin



**Total revenue** for a sample group of public waste management companies saw a typical uptick during the usually seasonally strong 2nd quarter. Still, the 4.7% sequential increase from the 1st quarter was below the average 6.1% seasonal uptick over the past dozen years. Nonetheless, despite pressure on volumes due to slowing manufacturing and construction activity, core pricing strength combined with contributions from M&A still resulted in the highest quarterly revenue total on record and year-over-year growth of nearly 6%.

**EBITDA margin** typically follows the direction of revenue due to increasing or decreasing asset utilization and operating leverage. However, in the abnormal climate of the past couple of years and despite strong revenue growth, the industry's profit margin has been diluted by unusually high and sticky internal cost inflation (labor, insurance, maintenance, etc.), acquisition integration inefficiencies, and deflationary recycling commodity prices. That said, in a quasi return to normalcy as internal cost inflation subsides, EBITDA margin of 29.6% during the 2nd quarter increased both sequentially and year-over-year yet was still 50 basis points lower than the record high 2nd quarter of 2021 despite 23% higher revenue.

### 2023 Outlook for Waste Management Public Companies

Company	Revenue Y/Y %	Adj. EPS Y/Y %	EBITDA Y/Y %
Waste Management	+3.9%	+5.9%	+5.7%
Republic Services	+9.8%	+9.5%	+11.1%
Waste Connections	+11.5%	+8.4%	+13.9%

Source: BMO Equity Research as of 8/21/23

## Refuse Financing Inquiries

Jim Roberts

[Jim.roberts@bmo.com](mailto:Jim.roberts@bmo.com)

972-819-2616

## Industry Research Contact

Michael Zimm, CFA

[Michael.zimm@bmo.com](mailto:Michael.zimm@bmo.com)

[bmotf.com](http://bmotf.com)

**IMPORTANT DISCLAIMER:** This newsletter provides general information and should not be used or taken as legal, regulatory, business, financial, tax, accounting or other advice, or relied upon in substitution for the exercise of your independent judgment or legal advice. For your specific situation or where otherwise required, expert advice should be sought. Although BMO Harris Bank N.A. believes that the information contained in this newsletter has been obtained from and is based upon sources BMO Harris Bank N.A. believes to be reliable, BMO Harris Bank N.A. does not guarantee its accuracy and it may be incomplete or condensed. BMO Harris Bank N.A. makes no representation or warranties of any kind whatsoever in respect of such information. BMO Harris Bank N.A. accepts no liability of any kind for loss arising from the use of the material presented in this newsletter.

Copyright © 2023 BMO Harris Bank N.A. All rights reserved. You may reprint or forward this presentation to others provided that it is reproduced or distributed in its entirety, including this disclaimer.