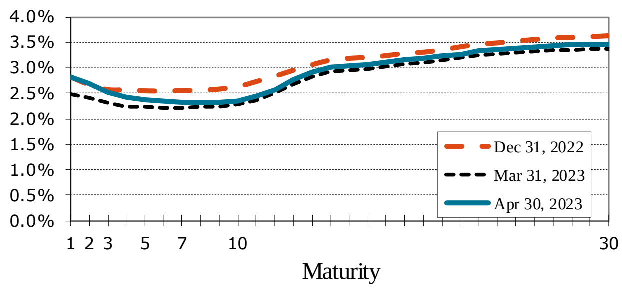
Baird Advisors
Municipal Fixed Income Market Commentary
April 2023

Municipal Yields Rise as the Curve Inverts Further in April

Tax-exempt rates rose modestly in a flattening trend in April as short-term rates rose more than intermediate- or long-term yields. The inverted posture of the municipal curve pushed even deeper into inverted territory as the 1–10-year yield spread increased from -19 bps in March to -47 bps at month end. The persistent inversion of the Treasury curve and expectations of another 25 bps rate hike by the Fed in May continues to influence the tax-exempt curve as well. Also, like the taxable market, where cash (T-bill) yields are higher than the rest of the Treasury curve, the same is true for municipals. The Sifma (cash) tax-exempt floating rate index, which closed the month at 3.86%, down slightly from 3.97% at its start, was higher than any yield along the rest of the tax-exempt curve. The pace of municipal fund outflows picked up last month, partly due to the April tax-payment cycle, which pushed YTD net redemptions to $6B, from -$1.7B at the end of Q1. Yet, demand, for still modest levels of new supply, remained more than sufficient. Although tax-exempt supply rose 1% YoY for April, YTD issuance is still off 17% from last year.

AAA Municipal Yields



Maturity	12/31/21	12/31/22	3/31/23	4/30/23	1Mo Δ	YTD Δ
1	0.19%	2.82%	2.47%	2.83%	0.36%	0.01%
2	0.25%	2.67%	2.41%	2.70%	0.29%	0.03%
3	0.34%	2.58%	2.30%	2.52%	0.22%	-0.06%
5	0.60%	2.56%	2.23%	2.37%	0.14%	-0.19%
7	0.85%	2.56%	2.22%	2.32%	0.10%	-0.24%
10	1.05%	2.64%	2.28%	2.36%	0.08%	-0.28%
30	1.54%	3.63%	3.38%	3.47%	0.09%	-0.16%

Illinois Upgraded and Well Received but Long-Term Challenges Remain

One of the most visible credits in the municipal market is the State of Illinois general obligation debt. In recent quarters, the financial picture for the state has noticeably improved with multiple ratings upgrades as evidence. From being on the verge of falling below investment grade in 2019, with a Baa3 rating from Moody's and BBB- from S&P, current ratings are now A3 and A-, respectively. In April, the state was able to easily issue nearly $2.5B of GO debt with reportedly over $8B in total orders. Total outstanding debt for the state GO credit is $26.3B, but debt service costs represent a manageable 5.9% of total annual appropriations and, importantly given the rise in short-term rates, all the debt is fixed rate. The backlog of unpaid bills, which was $8B in 2019 is now down to roughly the equivalent of 30 days of account payables (~$1.5B) and the state has repaid all its Covid-related borrowing from the federal government. In addition, a rainy-day fund of $1.1B has been established with plans to increase this to over $2B by the end of FY24. From a pension perspective, the state has made its statutorily required annual pension payments in recent years while also paying an additional $700M. While this is all good news, significant longer-term challenges remain. First, the funded ratio for the state pension funds remains very low at just 43.8% on a fair value basis just as state demographics enter a more challenging period. In addition, according to recently released IRS data on income migration, not only are more people leaving the state than entering but the income gap between the two was the highest in the nation in 2021 at $44,000. The average income of those leaving Illinois that year was $118,000 compared to annual income of $74,000 of new entrants. Illinois deserves credit for the recent improvement, but structural challenges may prevent the ratings on the state from rising further.

Modest Declines in April but Still Strong YTD Returns

Modestly negative returns occurred across the municipal market in April. Shorter maturities experienced most of the price volatility as the curve inverted further and long maturities outperformed. As a result, the shorter average maturity Pre-refunded sector also lagged the returns of both GOs and Revenue bond sectors. Lower-quality credits, especially High Yield tax-exempt issues, outperformed higher-quality issues in April given their excess carry and continue to hold the YTD performance lead as well.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	April	YTD	*Duration*	Bloomberg Quality	April	YTD	*Duration*
Municipal Bond Index	-0.23%	2.54%	*6.07*	AAA	-0.37%	2.12%	*5.46*
General Obligation bonds	-0.30%	2.28%	*5.71*	AA	-0.26%	2.38%	*6.13*
Revenue bonds	-0.18%	2.77%	*6.44*	A	-0.09%	2.91%	*6.09*
Prerefunded bonds	-0.50%	0.72%	*2.27*	BBB	-0.11%	3.60%	*7.60*
Long maturities (22+ yrs.)	-0.19%	4.07%	*10.31*	High Yield	0.58%	3.33%	*7.62*
Intermediate maturities (1 - 17 yrs.)	-0.28%	1.99%	*4.49*	HY, ex-Puerto Rico	0.18%	2.67%	*7.42*
Short maturities (1 - 5 yrs.)	-0.43%	0.93%	*2.32*				

Disclosures

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks such as interest rate risk, credit risk, inflation risk, and liquidity risk. In a rising interest rate environment, the value of fixed-income securities generally decline and conversely, in a falling interest rate environment, the value of fixed-income securities generally increase. High yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield.

The Bloomberg Municipal Bond Index is a broad-based, total-return index. The bonds are all investment-grade, tax-exempt, and fixed-rate securities with long-term maturities (greater than 2 years). They are selected from issues larger than $50 million. The components listed below the Municipal Bond Index (long maturities, intermediate maturities, short maturities, prefunded bonds, general obligation bonds and revenue bonds) are subsectors of the Bloomberg Municipal Bond Index and do not represent separate indices.

The Bloomberg High Yield Municipal Index includes bonds with a par value of at least $3 million and must be issued as part of a transaction of at least $20 million. The maximum rating for inclusion is Ba1/BB+/BB+ using the middle rating.

For more information about the Bloomberg Municipal Bond Index or Bloomberg High Yield Municipal Index, please visit https://index.barcap.com/Home/Guides_and_Factsheets.

Municipal securities investments are not appropriate for all investors, especially those taxed at lower rates. The alternative minimum tax (AMT) may be applicable, even for securities identified as tax exempt. Past performance is not a guarantee of future results.

Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment grade investments are those rated from highest down to BBB- or Baa3.

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