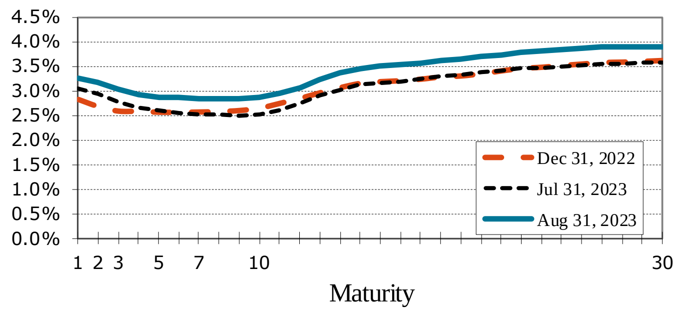
Baird Advisors
Municipal Fixed Income Market Commentary
August 2023

Yields Rose and the Inversion Lessened in August

Tax-exempt yields rose in August, following the lead of the Treasury market. But municipal yields rose more than Treasuries due to modest yet persistent fund outflows across the industry and surprisingly robust new issuance. Intermediate and long-term municipal yields rose over 30 bps in the month while short-term yields rose 21 bps, which steepened a still inverted curve. The 1-10yr curve ended August inverted by -38 bps, less than the -51 bps at the start of the month. The Sifma tax-exempt floating rate index traded in a nearly 150bp range in August, between 3.0% and 4.47%, before settling at 4.06% at month end. Driving the extreme volatility in tax-exempt floating rates is a lower supply of outstanding floating-rate debt and the rising cost of funds for dealers to hold inventory as the federal funds rate has risen, making dealers quick to adjust rates to meet shifting investor demand. Overall industry outflows from tax-exempt funds continued in August, with net redemptions of $805 million. Short-term funds, where the selling has been focused all year have now had thirty-one consecutive weeks of outflows, while longer-term fund flows are positive. Net fund redemptions YTD stand at -$7.6B. New supply was also relatively heavy with tax-exempt issuance of $35.3B in August, up 12.5% YoY. This was the highest issuance for August since 2016. YTD supply of tax-exempt debt is still down nearly 6% YoY while taxable municipal issuance is down 46% YoY.

AAA Municipal Yields



Maturity	12/31/22	7/31/23	8/31/23	1Mo Δ	YTD Δ
1	2.82%	3.04%	3.25%	0.21%	0.43%
2	2.67%	2.93%	3.16%	0.23%	0.49%
3	2.58%	2.77%	3.02%	0.25%	0.44%
5	2.56%	2.59%	2.88%	0.29%	0.32%
7	2.56%	2.51%	2.83%	0.32%	0.27%
10	2.64%	2.53%	2.87%	0.34%	0.23%
30	3.63%	3.57%	3.90%	0.33%	0.27%

US Government Downgrade's Impact on Municipal Ratings

A theoretical debate emerged in August after the US government credit rating was downgraded by Fitch to AA+ from AAA. Can/should state and local government debt be rated as high or higher than that of the sovereign? The US rating change had little direct impact on the municipal market as just over $5B of municipal debt was tied to the US rating out of a total market value of over $4 trillion. The downgraded municipal issues were primarily those backed by US government securities held in escrow (e.g., Pre-refunded or Escrowed to Maturity issues) and housing bonds guaranteed by federally enhanced mortgage-backed securities. After the US downgrade, Fitch continues to rate twelve states with the same AA+ rating as that of the US and sixteen states higher at AAA (not to mention the perhaps hundreds of local municipal credits with at least AA+ ratings). Some argue that since all states are dependent on federal revenues, typically ranging between 15% - 30% of total spending, the US rating should necessarily be higher. These federal funds help to maintain healthcare, welfare, and education services as well as infrastructure spending. There is also the massive federal support provided during and after major events, such as tropical storms, tornados, floods, and wildfires as well as the unprecedented support for the Covid pandemic. On the other hand, each of these highly rated state and local governments share important credit characteristics that support the high ratings, such as a strong and diverse source of tax revenues and relatively low debt burden. For most, this credit debate has little influence on their portfolio since repayment of debt from highly rated municipals or the US Treasury is perceived as nearly certain, which should be the primary concern of any bond investor.

Rising Yields Cause Negative August Returns, YTD Still Positive

Rising yields caused negative municipal returns in August, but YTD returns remain positive. Long maturities lagged other segments of the curve as the curve steepened. GOs marginally outperformed other market sectors while lower-quality issued lagged higher-quality for the month. YTD both longer maturities and lower-quality issues continue to be the most rewarding.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	August	YTD	*Duration*	Bloomberg Quality	August	YTD	*Duration*
Municipal Bond Index	-1.44%	1.59%	*6.19*	AAA	-1.34%	0.87%	*6.47*
General Obligation bonds	-1.39%	1.03%	*5.90*	AA	-1.46%	1.28%	*6.01*
Revenue bonds	-1.53%	1.89%	*6.51*	A	-1.38%	2.35%	*6.15*
Prerefunded bonds	-0.15%	0.81%	*2.20*	BBB	-1.79%	3.46%	*7.48*
Long maturities (22+ yrs.)	-2.54%	2.66%	*10.44*	High Yield	-1.52%	3.52%	*7.72*
Intermediate maturities (1 - 17 yrs.)	-1.01%	1.22%	*4.60*	HY, ex-Puerto Rico	-1.72%	2.43%	*7.53*
Short maturities (1 - 5 yrs.)	-0.22%	1.01%	*2.37*				

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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