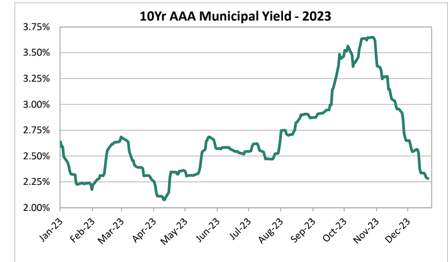
BAIRD

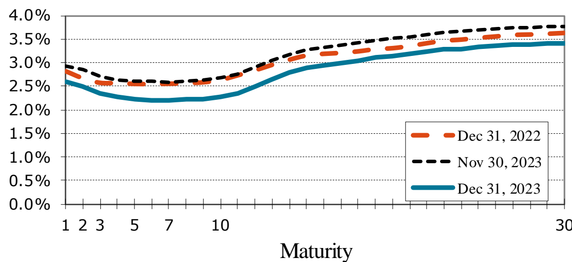
Baird Advisors
Municipal Fixed Income Market Commentary
2023 Review and 2024 Outlook

2023 Municipal Market Review

The tax-exempt market closed the year on a very strong tone, yields fell dramatically in Q4 which pushed them below year ago levels across the curve. For the year, intermediate yields fell the most as 7 – 10yr maturity yields declined by 37 bps. But the YoY perspective hides the significant intra-year volatility that occurred, as shown in the adjacent graph of the 10Yr AAA yield. After trading in a 50 – 60 bp range early in the year, yields began a steady, multi-month march higher. From the low of 2.08% in April, the 10yr yield rose 158 bps to peak at 3.65% in late-October. Then, one of the strongest rallies in decades occurred in November and December as the 10yr closed the year at 2.27%, down 138 bps from the peak. Other segments of the municipal curve underwent similar rate movements as the volatility in tax-exempt yields followed a similarly volatile Treasury market. Investors were on watch for signs of economic weakness/recession throughout the year, but few appeared. Instead, the Fed remained committed to fighting inflation, raising the federal funds rate by 100 bps in 2023. One of the catalysts for the Q4 rally was an acknowledgement by Fed Chair Powell that the outlook for further rate increases was now equally balanced with the possibility for rate cuts, which fueled market expectations that as many as six 25 bps rate cuts might occur in 2024; the median outlook of the Fed dot plots suggests three cuts are possible. Yet, economic growth remains quite resilient; the economy grew at a better than 2% rate in Q1 and Q2, 4.9% in Q3, with Q4 also expected above 2%. Slowing inflation offered investors and the Fed support as core PCE fell from a peak rate of 5.6% in February to 3.2% in November.



AAA Municipal Yields



Maturity	12/31/22	9/30/23	11/30/23	12/31/23	1Mo Δ	4Q Δ	2023 Δ
1	2.82%	3.73%	2.92%	2.59%	-0.33%	-1.14%	-0.23%
2	2.67%	3.65%	2.85%	2.50%	-0.35%	-1.15%	-0.17%
3	2.58%	3.51%	2.71%	2.35%	-0.36%	-1.16%	-0.23%
5	2.56%	3.38%	2.60%	2.22%	-0.38%	-1.16%	-0.34%
7	2.56%	3.38%	2.59%	2.19%	-0.40%	-1.19%	-0.37%
10	2.64%	3.44%	2.68%	2.27%	-0.41%	-1.17%	-0.37%
30	3.63%	4.42%	3.77%	3.40%	-0.37%	-1.02%	-0.23%

Even with the rate volatility in 2023, the municipal curve remained inverted between the 1 – 10yr segment throughout the year, from -18 bps at the start to -32 bps at year end. Contributing to the inversion in fixed rate issues was the elevated (and volatile) weekly floating-rate municipal index yield, SIFMA. The SIFMA Index ended the year at 3.87% (approximately 73% of the effective federal funds rate), up 21 bps from the start of the year, but 221 bps above its low in January of 1.66%. The opportunity to stay in short-term floating- or fixed-rate issues at similar or higher yields than intermediate maturities negatively impacted fund flows in 2023. Also impacting flows in Q4 was a challenging tax-loss harvesting period. A sharp sell-off in October triggered loss harvesting, but if investors went to cash to avoid the 31-day wash sale rule, they missed the massive year-end rally in November/December. If they invested in a different municipal investment, they now sit with a short-term capital gain. Nonetheless, 2023 was the second consecutive year of net redemptions from municipal funds across the industry, with $28.4B of outflows in year, but down significantly from the record $119.6B redemptions in 2022. Interestingly, most municipal fund outflows were from short-term funds as investors either went to cash or into long-term funds which had net inflows for the year. Despite the industry outflows, overall demand for the municipal sector was robust as evidenced by the outperformance of tax-exempt yields which fell more than comparable maturity Treasuries for the year. It helped that new municipal supply was modest in 2023 as total issuance fell 2% YoY; taxable issuance was off 36% YoY, from an already light base in the prior year, and tax-exempt supply rose just 5% YoY. Leading the supply was heavy issuance from Texas municipalities. To meet the significant infrastructure needs of a growing population, Texas sold more municipal debt than any other state in 2023, even more than the perennial leaders, California and New York. With more than nine million new residents moving to Texas since 2000, it now joins California as only the second state with more than thirty million residents.

SIFMA Floating-Rate Municipal Index - 2023

Source: Bloomberg

Credit Update

The backdrop for municipal credit was fundamentally strong throughout the year, with rating agency upgrades exceeding downgrades for all three rating agencies. Providing support for municipalities was the lingering post-Covid federal stimulus. S&P estimates that as of June 2023, state and local governments still had an estimated 55% of their pandemic relief unspent, and approximately 40% for local school districts. This means municipalities are well positioned for slowing tax revenue growth as is occurring in many locations. For example, the State of California, always among the most cyclical of states due to its heavy reliance on income tax (the top 1% of earners pay 40% of all income tax revenues), now projects a record combined deficit of $68B for

fiscal years 2023 and 2024. The lack of capital gains taxes following the equity market decline in 2022 is a contributing factor, but more favorable markets this year should help narrow next year's gap. Some spending adjustments will also be needed, but the state also has a record $38B in reserves available to help ease the adjustment. Other states, such as New York and New Jersey are also forecasting slowing tax revenue estimates for FY 2024 and beyond.

Away from state and local governments, stresses emerged in other municipal sectors, most notably Higher Education and Hospitals. By our count, twenty smaller, private not-for-profit liberal arts colleges either closed in 2023 or announced plans to do so in 2024, while others intend to merge with another college or university to survive. Beyond the now less-favorable demographic backdrop, as fewer high school graduates are causing acute enrollment challenges, many colleges also face elevated fixed costs for tenured faculty as well as imbalances between the majors offered and majors sought by employers. Students and families are also weighing the costs of a traditional, four-year college education against other education and career options. In contrast, aging demographics are supportive of the Hospital sector, even though many of the post-pandemic challenges remain. Although the nursing and staffing shortages have eased (but not gone away), labor costs are elevated while reimbursement levels are largely unchanged, squeezing operating margins. The pressure is most obvious among smaller, rural hospitals, but encouragingly there has been stabilization and modest improvement among many of the larger regional and national healthcare systems. Finally, the municipal Single-family Housing (SFH) sector is fundamentally strong, as the demand for down-payment assistance and/or below-market mortgage rates for first-time homebuyers is high. This led to a 50% YoY increase in SFH supply in 2023, which kept spreads wide in the sector, but offers a favorable risk/reward profile for tax-exempt investors.

Strong Q4 Rally Lifts 2023 Returns Into Solidly Positive Territory
The sharp decline in rates in Q4 pushed 2023 returns into positive territory across the curve. A consistent theme for both periods was that risk-taking was rewarded in the quarter and year. Longer maturities significantly outperformed both intermediate and short-term curve segments over each period. The Revenue sector also outperformed GOs and the shorter duration Prerefunded sector for the year. Finally, the risk theme was consistent across the credit spectrum as lower-quality municipals outperformed AAAs for the quarter and year; BBBs outperformed AAAs by 313 bps for all of 2023 as both carry and narrowing spreads helped.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	December	Q4	2023	2022	*Duration*	Bloomberg Quality	December	Q4	2023	2022	*Duration*
Municipal Bond Index	2.32%	7.89%	6.40%	-8.53%	*6.05*	AAA	2.21%	8.35%	5.80%	-7.93%	*6.21*
General Obligation bonds	2.15%	7.79%	5.62%	-7.74%	*5.72*	AA	2.25%	7.62%	5.92%	-7.97%	*5.90*
Revenue bonds	2.46%	8.15%	6.89%	-9.29%	*6.33*	A	2.52%	7.96%	7.34%	-9.06%	*5.99*
Prerefunded bonds	0.62%	3.03%	2.99%	-3.01%	*2.19*	BBB	2.61%	9.19%	8.93%	-11.63%	*7.26*
Long maturities (22+ yrs.)	3.45%	11.61%	9.35%	-15.58%	*10.01*	High Yield	3.00%	9.21%	9.21%	-13.10%	*7.06*
Intermediate maturities (1 - 17 yrs.)	1.89%	6.38%	5.26%	-4.84%	*4.54*	HY, ex-Puerto Rico	2.97%	8.75%	7.92%	-12.64%	*6.97*
Short maturities (1 - 5 yrs.)	0.95%	3.53%	3.58%	-3.17%	*2.36*						

2024 Outlook
The favorable backdrop for the municipal market should continue into 2024, helped by the expectation that mutual fund inflows will gradually return. Historically, municipal fund flows have been highly correlated with the slope of the tax-exempt curve, the more positive the slope the more positive the inflows. So, the outflows of the last two years against an inverted curve over much of the period is not surprising. However, if inflation continues toward the Fed's 2% target rate and more signs of slowing growth emerge in the US economy, it is likely that short-term rates will fall faster than long-term rates, resteepening the curve. Curve positioning in 2024 will continue to be important, as investors balance the desire to position for lower short-term rates against capturing the optimal roll-down in the 10- to 15-year segment of the curve.

More favorable fund flows will likely be met with only a modest pickup in supply. Perhaps underappreciated by many is the stable level of total outstanding municipal debt, which has remained near $4 trillion since 2008 while Treasury supply has exploded. Consensus estimates among municipal dealers is for supply in 2024 to increase only slightly since the federal stimulus funds continue to limit borrowing needs for many state and local governments. And with tax-exempt yields only back near their long-term average since the global financial crisis in 2008, little change in refunding activity is expected. The exception for issuance will be those states experiencing the fastest growth in population (e.g. Texas and Florida). Issuance among other municipal sectors, particularly Higher Education and Hospitals, should improve only modestly given their ongoing challenges. Housing supply should stay robust, but it is a relatively small sector of the total market.

Finally, because municipal credit spreads are relatively tight as we enter 2024, the best investment opportunities will likely be found among higher-quality issues. While most of our strategies will benefit from the additional yield that a modest credit overweight currently offers, patience on adding to the overweight will likely be rewarded later in the year. Instead, structural opportunities, including coupon, call and prepayment variations should offer additional yield with more favorable risk characteristics.

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.

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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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