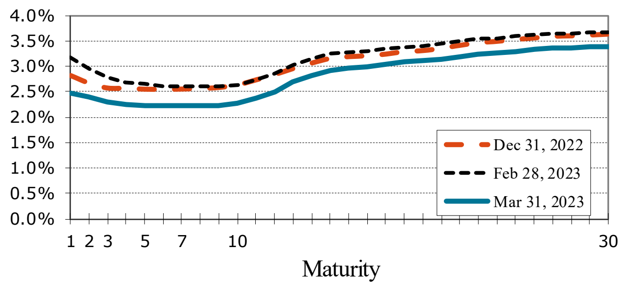
Baird Advisors
Municipal Fixed Income Market Commentary
March 2023

Municipal Yields Decline in Q1 Led by Sharply Lower Rates in March

Tax-exempt rates fell in the first quarter, driven by sharp yield declines in March particularly in short-term maturities. The emergence of concerns over bank balance sheets at a few select institutions caused the Fed to provide liquidity support in March which, given concerns over tighter credit conditions and slower growth, led to the sharpest drop in short-term Treasury rates since October 1987. Yet, the Fed was not deterred from its inflation-fighting efforts and raised the federal funds rate 25 bps, bringing the upper end of the Fed's target range to 5.0%. The short end of the tax-exempt curve continued to experience significant volatility as the Sifma weekly floating rate index fluctuated in a range of more than a 200 bps in March, from a low of 2.21% to a peak of 4.35%. The spike in the shortest tax-exempt rates left the curve inverted by 169 bps between the Sifma (cash) tax-exempt rate and 10yr AAA yields at quarter end, a disincentive for investors to extend out along the curve. The impact was evident in municipal fund flows which ended the quarter with seven consecutive weeks of net redemptions. Although YTD industry flows were negative in Q1, with $1.7B of net redemptions, this was much more manageable than the $21.9B of industry outflows in Q1 of last year. Supply was modest in the quarter with total issuance off 28% YoY as both tax-exempt borrowings (-23%) and taxable (-48%) fell.

AAA Municipal Yields



Maturity	12/31/21	12/31/22	2/28/23	3/31/23	1Mo Δ	Q1 Δ
1	0.19%	2.82%	3.17%	2.47%	-0.70%	-0.35%
2	0.25%	2.67%	2.95%	2.41%	-0.54%	-0.26%
3	0.34%	2.58%	2.78%	2.30%	-0.48%	-0.28%
5	0.60%	2.56%	2.65%	2.23%	-0.42%	-0.33%
7	0.85%	2.56%	2.60%	2.22%	-0.38%	-0.34%
10	1.05%	2.64%	2.64%	2.28%	-0.36%	-0.36%
30	1.54%	3.63%	3.66%	3.38%	-0.28%	-0.25%

Impact of Bank Balance Sheet Concerns on the Municipal Market

As deposits fled banks in March in search of higher yielding alternatives, the massive unrealized losses on the bonds held on bank balance sheets brought liquidity concerns to the surface. The Fed's emergency measures, which boosted both liquidity and confidence in the financial system, were well received. Although the most direct impact of the bank turmoil occurred in bank equity and bond prices, the municipal market was not immune to the bank challenges. For one, banks are the third largest holder of municipal debt, at 15% of the total outstanding, over half of which is held in the form of direct loans to municipalities. If banks tighten credit standards and reduce municipal lending, it would allow public debt issuance to rise, which would be a welcome event for the market. It is also possible that banks could sell a portion of their municipal holdings to meet liquidity needs, but given their ability to now borrow directly from the Bank Term Funding Program (BTFP), at the face value of Treasuries and Agency MBS collateral, any selling of municipal debt should be modest. Select banks also serve as guarantors of short-term municipal debt or liquidity providers on variable rate demand note (VRDNs). However, the extent of their involvement was greatly reduced following the 2008 financial crisis and is no longer a material component of these floating rate issues. Finally, the largest banks are also involved in the prepay gas sector of the municipal market. These issues provide advantages to municipalities through long-term gas purchase agreements at a predetermined discount to market prices. In these agreements, banks serve as the key counterparty by guaranteeing the delivery of gas. This necessarily ties the rating on each gas issue to that of the bank's credit quality. The top five banks involved in prepay gas issues are among the largest in the industry (Goldman Sachs, Morgan Stanley, RBC, Citi and Bank of America) and are all on the list of Global Systemically Important Banks (G-SIBs).

Strong March Returns Provide Positive YTD Results

The strong rally in March provided positive returns for the quarter across the municipal market. Longer maturities outperformed other curve segments by a wide margin as rates fell. The GO and Revenue sectors also handily outperformed Prefunded issues YTD. Within the credit spectrum, A and BBB rated issues outperformed both AAA and High Yield tax-exempt issues in Q1.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	March	YTD	*Duration*	Bloomberg Quality	March	YTD	*Duration*
Municipal Bond Index	2.22%	2.78%	*6.10*	AAA	2.23%	2.50%	*5.96*
General Obligation bonds	2.30%	2.59%	*5.72*	AA	2.22%	2.65%	*6.01*
Revenue bonds	2.23%	2.96%	*6.49*	A	2.13%	3.01%	*6.05*
Prerefunded bonds	1.48%	1.23%	*2.30*	BBB	2.47%	3.71%	*7.60*
Long maturities (22+ yrs.)	3.00%	4.27%	*10.34*	High Yield	1.55%	2.73%	*7.74*
Intermediate maturities (1 - 17 yrs.)	1.94%	2.27%	*4.52*	HY, ex-Puerto Rico	1.63%	2.48%	*7.52*
Short maturities (1 - 5 yrs.)	1.48%	1.37%	*2.35*				

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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