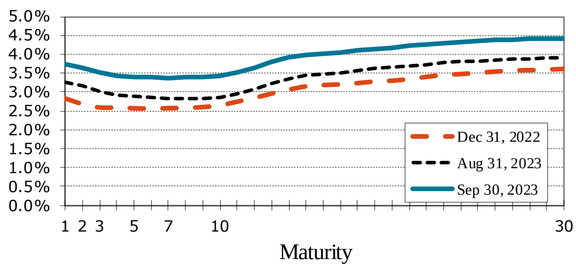
Baird Advisors
Municipal Fixed Income Market Commentary
September 2023

Yields Rise Sharply in September and Q3; Steepening Trend Reduces Curve Inversion

Tax-exempt rates followed Treasury yields higher in September and in the quarter as the Fed signaled an end of the hiking cycle was likely near, but also that rates would remain higher for longer than previously expected. Tax-exempt rates rose as much as 57 bps in the month and were from 72-89 bps higher in Q3. Long-term rates rose more than short which steepened the curve over the quarter, helping to reduce but not eliminate the inversion in the 1-10yr maturity segment. The municipal curve inversion narrowed from -47 bps at the start of the quarter to -29 bps at the end. The favorable summer seasonal period, where demand exceeded supply, faded in August and September as tax-exempt issuance increased while mutual fund outflows persisted across the industry. Tax-exempt supply rose 8% YoY in Q3, although it is still down 4% YTD relative to last year's pace. Issuance was particularly heavy in Texas as school districts, most of which benefit from the Permanent School Fund (PSF) credit support, borrowed heavily as did several Municipal Utility Districts (MUD), issuing to meet the infrastructure needs of the growing communities. On the demand side, modest industry outflows continued for municipal funds throughout the quarter, bringing YTD net fund redemptions to $12.0B. History suggests that the combination of rising tax-exempt yields, which should be increasingly appealing to investors – especially those in higher income tax brackets – and a steepening curve, which incentivizes investors to extend their average maturity exposure, will, in time, lead to more positive municipal fund flows across the market.

AAA Municipal Yields



Maturity	12/31/22	6/30/23	8/31/23	9/30/23	1Mo Δ	3Q Δ	YTD Δ
1	2.82%	3.01%	3.25%	3.73%	0.48%	0.72%	0.91%
2	2.67%	2.92%	3.16%	3.65%	0.49%	0.73%	0.98%
3	2.58%	2.77%	3.02%	3.51%	0.49%	0.74%	0.93%
5	2.56%	2.61%	2.88%	3.38%	0.50%	0.77%	0.82%
7	2.56%	2.54%	2.83%	3.38%	0.55%	0.84%	0.82%
10	2.64%	2.55%	2.87%	3.44%	0.57%	0.89%	0.80%
30	3.63%	3.57%	3.90%	4.42%	0.52%	0.85%	0.79%

Credit News

- A federal government shutdown was averted at quarter-end, the debate pushed out 45 days, but the impact on most municipalities and the municipal market regardless of what happens is relatively minimal. Most affected by a government shutdown would be states with a higher concentration of federal workers, such as DC, Virginia and Maryland. Unless a shutdown were to last for several weeks, the fiscal impact would be small.
- There has been a record $13.3B of prepaid gas bond issuance YTD, already exceeding the total 2022 volume of $10.3B. Prepay gas bonds offer municipalities a long-term, fixed supply of energy at a predetermined discount to spot natural gas prices. Large domestic and international banks are involved as counterparties, typically obligated to make monthly payments to the gas supplier. The banks can borrow at the more favorable tax-exempt rates and the heavy issuance is driven by relatively rich municipal-to-taxable valuations. Prepay gas bonds offer investors exposure to corporate-backed obligors at appealing tax-free yields relative to other similarly rated securities.
- State and local government tax revenues are slowing at the same time that the Covid pandemic aid is now largely spent. Not surprisingly, budget gaps are emerging, particularly among some of the largest municipalities. For example, Chicago is projecting a $538 million gap for FY2024. Mayor Brandon Johnson is weighing numerous options for additional revenue, including a "mansion tax" on homes worth over $1 million. New York City is also facing budget deficits and is appealing for state and federal aid to offset costs associated with caring for the nearly 60,000 migrants now in the city.

Higher Yields Push Q3 Returns Into Negative Territory

The sharp rise in tax-free rates in September drove municipal returns into negative territory for Q3 and YTD. Across maturities, short-term issues outperformed other curve segments. Similarly, the shorter duration Pre-refunded sector outperformed both GOs and Revenue bonds. For the quarter, 'A' rated issues outperformed both lower- and higher-quality issues. High Yield municipals have held in better than Investment Grade issues YTD.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	September	Q3	YTD	*Duration*	Bloomberg Quality	September	Q3	YTD	*Duration*
Municipal Bond Index	-2.93%	-3.95%	-1.38%	*6.37*	AAA	-3.19%	-4.34%	-2.35%	*6.61*
General Obligation bonds	-3.01%	-4.10%	-2.01%	*6.10*	AA	-2.83%	-3.89%	-1.58%	*6.19*
Revenue bonds	-3.00%	-4.04%	-1.16%	*6.69*	A	-2.86%	-3.69%	-0.58%	*6.34*
Prerefunded bonds	-0.84%	-0.86%	-0.04%	*2.15*	BBB	-3.57%	-4.49%	-0.24%	*7.66*
Long maturities (22+ yrs.)	-4.56%	-6.66%	-2.03%	*10.72*	High Yield	-3.40%	-4.24%	0.00%	*7.93*
Intermediate maturities (1 - 17 yrs.)	-2.25%	-2.85%	-1.05%	*4.72*	HY, ex-Puerto Rico	-3.12%	-4.07%	-0.77%	*7.73*
Short maturities (1 - 5 yrs.)	-0.95%	-0.94%	0.05%	*2.36*					

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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