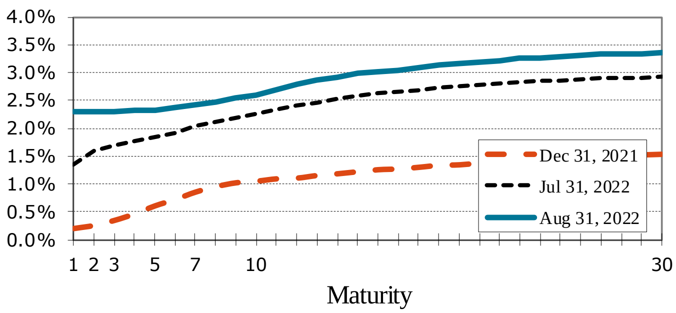
Baird Advisors
Municipal Fixed Income Market Commentary
August 2022

Municipal Rates Rise Led by Short-term Maturities, Flattening the Curve

Tax-exempt yields rose across the curve in August, led by a sharp rise in short-term rates which flattened the curve. Yields rose early in the month on the strong July employment report (+528k) and continued the upward trend, particularly after Fed Chair Powell's hawkish tone at the Jackson Hole Summit in late-August. Over the month, 1yr AAA yields rose 94 bps relative to a 34 bps rise in 10yr yields, leaving just 4 bps of slope between the 1 – 5-year segment of the municipal curve and just 32 bps out to 10-years. The flattening trend in municipals was influenced both by the inverted U.S. Treasury curve of -33 bps between the 1 – 10-year maturities as well as the need for municipal dealers to clear an overhang of short-term notes from July at market concessions. Curve inversions in the tax-exempt market are rare events as strong structural forces provide positive slope bias; in addition to the uncertainty of future income tax rates relative to what is known today, more fundamentally, investors prefer to invest short on the curve while municipalities want to borrow long to match the life of their projects. Demand for municipals was tepid in August despite it being a net negative supply month (i.e. more rolled-off or matured than was issued). Net redemptions from municipal funds pushed YTD industry outflows deeper into record territory at -$83.7B. Meanwhile, just $33.1B of tax-exempt supply was issued in August, off 11% relative to last August as YTD supply is now down 3% YoY. Taxable municipal supply has plummeted in 2022, off 43% YoY as the heavy refunding volume of 2021 has evaporated as interest rates have risen.

AAA Municipal Yields



Maturity	12/31/21	7/31/22	8/31/22	1Mo Δ	YTD Δ
1	0.19%	1.35%	2.29%	0.94%	2.10%
2	0.25%	1.60%	2.30%	0.70%	2.05%
3	0.34%	1.70%	2.31%	0.61%	1.97%
5	0.60%	1.84%	2.33%	0.49%	1.73%
7	0.85%	2.03%	2.42%	0.39%	1.57%
10	1.05%	2.27%	2.61%	0.34%	1.56%
30	1.54%	2.93%	3.35%	0.42%	1.81%

Hospital Credits – Healthy Today But Require Close Monitoring

The nonprofit hospital sector of the municipal market, like the patients they serve, requires close monitoring from a credit perspective. While defaults are rare, they have occurred more frequently among hospitals than in other municipal sectors. That said, despite the unprecedented challenges that Covid presented (and still presents), the hospital sector remains quite strong. A recent S&P sector report noted "remarkable improvement from FY20 despite the continued turmoil last year as providers managed through multiple surges of Covid-19 and significant labor pressure." We would agree, while acknowledging that rising costs and ongoing staffing challenges illustrate the need for close surveillance. Our hospital credit analysis focuses on three key areas, including: 1) market share, or the essentiality within the community/region it serves, 2) a history of consistent operating performance, and 3) a strong balance sheet. What the last few years have also reinforced is the critical service that hospitals provide in their respective communities, an essential need with an aging and increasingly vulnerable population in the U.S. Yet, there will continue to be differentiation among hospital credits, particularly as it relates to efficiency of operations. We expect that stronger operators will continue to improve and gain market share while weaker operators struggle, forced to look to cut costs or look for strategic alliances with stronger providers. Thankfully, more nonprofit hospitals are in the former camp than the latter, but this remains a sector where good fundamental analysis is necessary, allowing investors to benefit by identifying the winners and avoiding the losers in this challenging environment.

Spike in Rates Leads to Negative August Returns

The increase in rates drove returns into negative territory once again in August. Although short-term rates rose the most, the largest price declines occurred among longer maturities. This maturity impact carried through to sector performance as well where shorter duration Prerefunded issues outperformed both GOs and Revenue bonds. Along the credit spectrum, modest spread widening allowed higher-quality sectors to outperform lower-quality issues, fitting the YTD trend as well.

Total Returns of Selected Bloomberg Municipal Indices and Subsectors

Bloomberg Index/Sector	August	YTD	Duration	Bloomberg Quality	August	YTD	*Duration*
Municipal Bond Index	-2.19%	-8.62%	*6.83*	AAA	-2.19%	-8.24%	*6.55*
General Obligation bonds	-2.15%	-8.09%	*6.21*	AA	-2.22%	-8.28%	*6.64*
Revenue bonds	-2.28%	-9.27%	*7.38*	A	-2.04%	-8.92%	*7.01*
Prerefunded bonds	-1.31%	-3.31%	*2.52*	BBB	-2.48%	-10.62%	*8.11*
Long maturities (22+ yrs.)	-3.52%	-14.57%	*12.86*	High Yield	-2.22%	-10.51%	*10.29*
Intermediate maturities (1 - 17 yrs.)	-1.73%	-6.37%	*4.65*	HY, ex-Puerto Rico	-2.18%	-10.49%	*10.10*
Short maturities (1 - 5 yrs.)	-1.25%	-3.42%	*2.42*				

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.

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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