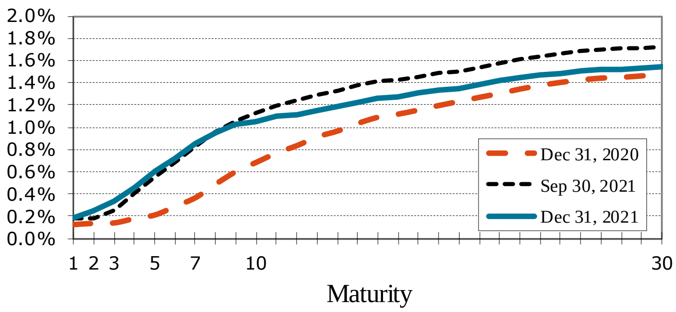
Baird Advisors
Municipal Fixed Income Market Commentary
2021 Review and 2022 Outlook

Key Municipal Events of 2021

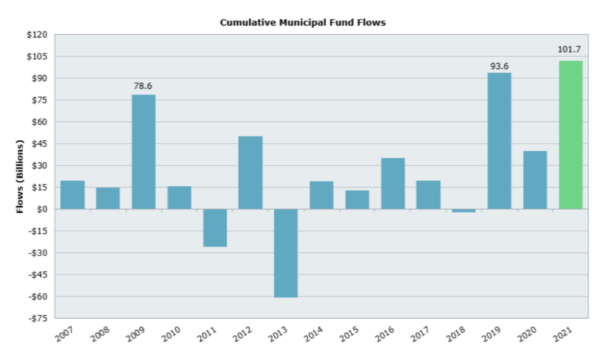
Two themes dominated the municipal market in 2021 – credit and cash inflows. Investors took comfort in the strong credit backdrop, as tax revenues rebounded sharply and were joined by unprecedented federal fiscal support. Generally, the more credit risk an investor accepted, the better the return they likely achieved. The record cash flows into tax-exempt funds were driven by expectations of higher tax rates and strong demographic support from baby boomers and others seeking safety and income. Together, these powerful forces largely insulated the municipal market from the volatility experienced in taxable fixed income sectors, leading to the outperformance of the tax-exempt market. These themes were not as evident at the start of the year, however, as tax-free yields rose and the curve steepened on expectations of strong growth, rising inflation and a Fed willing to let the economy run "hot." But things got a bit too hot too quickly as both growth and inflation rose to multi-decade highs. Rather than waiting until 2022 to begin tapering monthly asset purchases, as anticipated, the Fed began to trim purchases in November by $15B/month and then doubled the taper to $30B/month starting in January. The Fed pivot in Q4 pushed short-term tax-free rates marginally higher on expectations of three rate hikes in 2022. Long-term yields fell instead on expectations that the Fed will succeed in slowing growth and inflation in coming quarters. The result for tax-exempt yields was 20 bps of flattening in the curve between 1-30 years in Q4. Still, tax-free rates ended the year higher than where they began across all segments of the curve with the greatest upward adjustment in the intermediate maturity range (7yr) where rates rose 48 bps.

AAA Municipal Yields



Maturity	12/31/20	9/30/21	12/31/21	Q4 Δ	2021 Δ
1	0.13%	0.18%	0.19%	0.01%	0.06%
2	0.14%	0.18%	0.25%	0.07%	0.11%
3	0.14%	0.25%	0.34%	0.09%	0.20%
5	0.22%	0.55%	0.60%	0.05%	0.38%
7	0.37%	0.82%	0.85%	0.03%	0.48%
10	0.69%	1.13%	1.05%	-0.08%	0.36%
30	1.47%	1.73%	1.54%	-0.19%	0.07%

The strong demand mentioned above was most evident in the consistently positive flows into municipal mutual funds and ETFs throughout the year. Only one of the 52 weeks reported a net outflow and the cumulative net inflows in 2021 set a record of $101.7B, more than twice the $39.7B of inflows in 2020 and surpassing the previous high of $92.8B set in 2019. It is noteworthy that the two highest inflow years in the last twenty were in 2019 and 2021 when rates were relatively low by historical measures. In the past, low or rising yields often slowed the pace of new investments, or even caused outflows. But more recent history illustrates the demographic-driven desire by investors for municipal bonds, rightfully viewed as a higher-quality, income producing asset, particularly tax-free income in an environment with higher tax rate expectations. Certainly, the favorable long-term demographic trend of aging boomers retiring at an accelerated pace due to Covid played a role. The Federal Reserve of St. Louis estimates that 2.4 million "excess retirements" occurred due to Covid between the start of the pandemic and August 2021.



Unfortunately, Covid-19 remained an ever-present concern for investors throughout the year as the virus mutated to rapidly spreading Delta and Omicron variants. But the U.S. economy proved resilient with no widespread lockdowns this year unlike those in 2020. Supply chain bottlenecks were the major concern, which cut both ways for state and local governments. The supply constraints slowed activity across many industries and regions (e.g., travel, entertainment and manufacturing) and the Covid challenges were certainly disruptive for K-12 and higher educational institutions, but the inflation pressure that resulted also helped to boost state and local government tax revenues as income and sales tax revenue rose. State and local governments are running the largest budget surplus, measured as a percentage of GDP, in over 40 years. Strong stock market returns should lead to lucrative capital gain tax

Fiscal Support for Municipal Issuers

	$2.2T CARES Act (3/2020)	$900B Stimulus (12/2020)	$1.9T ARPA Stimulus (3/2021)	3 Phase Total
State & Local	$150B	$--	$350B	**$500B**
Hospitals	$100B	$63B	$100B	**$263B**
Transit	$25B	$25B	$30B	**$80B**
Higher Education	$14B	$20B	$40B	**$74B**
Primary Education	$14B	$54B	$126B	**$194B**
Airports	$10B	$--	$8B	**$18B**
Airlines	$25B	$15B	$14B	**$54B**
TOTAL	**$338B**	**$177B**	**$668B**	**$1,183B**

revenues in April of 2022 as well. These tax revenues, combined with the unprecedented fiscal support provided in the $1.9T American Rescue Plan Act (ARPA) funds, passed in Q1 (along with the other fiscal support in 2020) provided one of the strongest credit backdrops for state and local governments in recent memory. ARPA provided $350B to state and local governments, while also directing more than $300B to hospitals, public transit, airports and schools. In total, we estimate that municipal issuers received nearly $1.2T in federal support over the last two years.

Despite being flush with cash, new tax-exempt municipal borrowings in 2021 still rose YoY, even as taxable municipal issuance fell modestly. Total municipal supply of $484B was down 2% YoY, with tax-exempt supply up 10% and taxable issuance down 24%. Municipal issuers slowed their use of taxable borrowings to refinance tax-exempt debt for two reasons: 1) taxable rates rose more than tax-exempt yields, reducing the cost savings, and 2) they were awaiting the details of the infrastructure bill. Early versions of the bill included the reinstatement of advance refundings to the tax-exempt market. Ultimately, Congress was able to pass the $1.2T Infrastructure Investment and Jobs Act (IIJA) in Q4, which included $550B of new infrastructure spending that will be spread out over several years. But the advance refundings provision was dropped, as was the potential return of Build America Bonds to the taxable market. The top target for the new IIJA spending plan is roads, but funds are also directed to many other key needs, including the electric grid, rail, public transit and broadband expansion. The plan will distribute funds primarily through matching federal grants in which state and local governments share in a portion of the project's cost. The strong fiscal condition of most municipalities should allow for ready use of the funds when available, although the net fiscal impact in any single year is relatively modest.

Solid Q4 Adds to Strong Municipal Returns in 2021

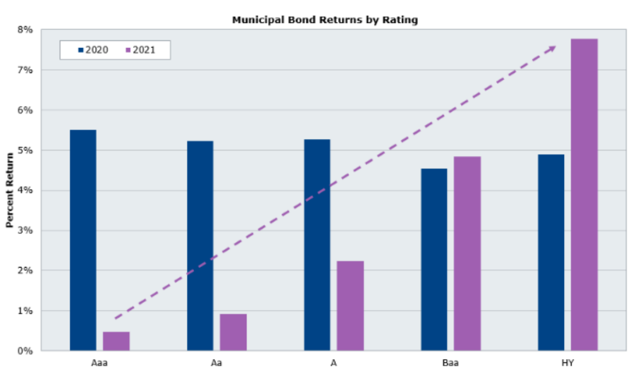
In Q4, short-term rates rose as the market priced in the first Fed rate hikes of 2022 while long-term yields fell. The flattening trend was reflected in returns as long maturities easily outperformed shorter maturities. A similar pattern of performance held for the full year as well; long issues outperformed short maturities by 281 bps. There was also a large performance divergence across the credit spectrum as lower-quality issues significantly outperformed higher-quality for the year. The narrowing of credit spreads, mentioned above, rewarded investors willing to take on a more aggressive risk posture – both on credit as well as along the curve. The Revenue sector provided the best performance for the quarter and full year relative to GOs, while Prerefunded issues lagged due both to their high-quality and exposure to the short end of the curve.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	December	4Q	2021	Bloomberg Quality	December	4Q	2021
Municipal Bond Index	0.16%	0.72%	1.52%	AAA	0.18%	0.82%	0.47%
General Obligation bonds	0.13%	0.71%	1.01%	AA	0.14%	0.69%	0.92%
Revenue bonds	0.18%	0.79%	1.86%	A	0.18%	0.69%	2.25%
Prerefunded bonds	0.03%	-0.05%	0.00%	BBB	0.22%	0.80%	4.85%
Long maturities (22+ yrs.)	0.22%	1.58%	3.17%	High Yield	0.26%	1.16%	7.77%
Intermediate maturities (1 - 17 yrs.)	0.14%	0.38%	0.86%	HY, ex-Puerto Rico	0.21%	1.06%	7.74%
Short maturities (1 - 5 yrs.)	0.04%	-0.05%	0.36%				

2022 Outlook and Opportunities

We foresee the strong fiscal position of municipalities continuing in 2022, supporting a solid credit backdrop. Even with growth expected to slow to a still accelerated pace of 3-4%, rising tax revenues and unspent federal monies should provide ample resources for municipal issuers. This expectation, however, is largely priced into current market evaluations as lower-quality issues significantly outperformed higher-quality issues in 2021 (see chart).



Unlike 2020, when there was little difference in performance across the credit spectrum, in 2021 BBBs provided 438 bps of excess return over AAAs, as credit spreads tightened to record levels. We expect the additional yield of lower-quality issues to continue to add value to a portfolio, but less so than in 2021 and with less carry advantage could lag higher-quality issues if spreads were to widen. Long-term pension funding challenges remain for many municipalities, and it will be important to monitor how municipalities utilize the abundant resources they currently have. Will they create new long-term spending programs? Or, preferably, view it as the one-time windfall it is and allocate the funds for similar one-time upgrades or expenditures? Security selection and structural opportunities among individual securities will continue to play a critical role in the new year. Whether it be sectors where cash flow analysis is required (e.g. housing) or unique coupon/call features that offer additional yield, we expect to lean increasingly toward structural opportunities over credit inefficiencies until credit spreads are more rewarding. Finally, with rates higher YoY and the yield curve steeper between short-term and intermediate-term maturities, the curve continues to offer appealing roll-down and total return potential. We find the best value currently in the 6 – 9-year segment of the curve and will look to optimize portfolio exposure in that part of the curve.

Disclosures

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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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