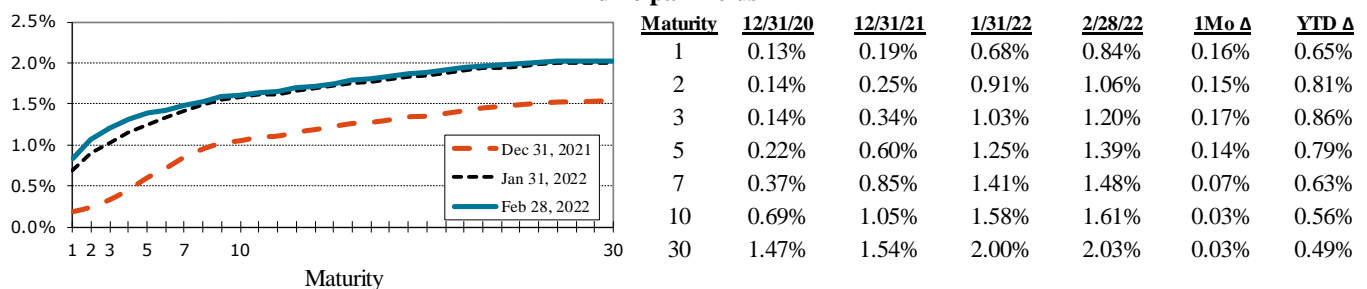


Baird Advisors
Municipal Fixed Income Market Commentary
February 2022

Rates Rise, Curve Flattens on Fed and Geopolitical Uncertainty

Tax-exempt rates rose across the curve in February but retreated from their mid-month peak as the Russian invasion of Ukraine began. For the full month, short-term municipal yields rose 17 bps while long-term yields were just 3 bps higher, continuing the flattening trend that began last October. The Fed minutes from the January FOMC meeting contributed to the flattening curve shift, which, along with select Fed governors, suggested a faster pace of rate hikes was more likely than previously expected. Strong economic data early in the month, including employment and inflation reports, also supported the move. However, the rising rate trend ended, and tax-free rates fell once Russia launched a full invasion into Ukraine on February 24th. Nonetheless, heightened volatility has led to seven consecutive weeks of municipal fund outflows and total YTD redemptions of \$8.3B. Tax-exempt supply has been quietly strong, up 14% YoY even with total municipal issuance down 9% YoY due to a collapse of taxable volume as refunding activity has all but disappeared. While the YTD volatility in municipal rates can be unsettling, evidenced by the industry outflows, the meaningfully higher yields, especially among short- to intermediate-term maturities which are up as much as 86 bps in two months, enhances the return potential for investors. For much of 2021, there was little advantage from a yield perspective to extend into short maturities from cash equivalents, now that same move offers investors a yield pickup of 100 bps, or more.

AAA Municipal Yields



Municipal Credit Strength Limits Spread Widening, So Far

The fundamental backdrop for municipal credit remains quite strong and is a key reason why municipal credit spreads have been relatively stable amid the market volatility. Last year, 73% of Moody's municipal rating changes were upgrades compared to just 27% downgrades. More telling was that the par value of Moody's upgrades exceeded that of downgrades by nearly six times (5.9:1). And the strong economic backdrop continues to boost tax state and local revenues. The most recent data for the 39 states that have reported (through January) show a median YoY state revenue increase of 19% and up 23% from pre-pandemic levels in January 2020. It's not surprising, therefore, that municipal credit spreads have widened just 5 bps since year end. It also helps that the revenue stream for municipalities is domestic focused, offering investors a relative safe haven from the international geopolitical turmoil. Also, inflation tends to benefit municipal revenues since incomes, goods/services and properties are all taxed on their nominal value which rises during inflationary periods. Given the strong fiscal position of states, it's not surprising that several are looking to reduce tax rates. Currently eight states have no income tax and as many as another dozen are discussing or taking steps to move in that direction. In addition, seventeen states are also proposing temporary cuts to gasoline and grocery taxes to help minimize the impact of rising prices on their residents.

Negative Returns in February on Rising Rates; Lower-Quality Underperforms

Rising rates pushed February returns into negative territory, with short maturities outperforming longer-term bonds; the shorter average duration of the Prerefunded sector also led to the outperformance of that sector relative to others this month. The modest widening of municipal credit spreads mentioned above led to the underperformance of lower-rated issues, as BBBs lagged AAAs in February by 34 bps, and 52 bps YTD. However, the emergence of Puerto Rico from its long bankruptcy process helped the High Yield municipal sector outperform both A and BBB rated debt in February.

Total Returns of Selected Barclays Municipal Indices and Subsectors

<u>Bloomberg Index/Sector</u>	<u>February</u>	<u>YTD</u>	<u>Duration</u>	<u>Bloomberg Quality</u>	<u>February</u>	<u>YTD</u>	<u>Duration</u>
Municipal Bond Index	-0.36%	-3.09%	5.14	AAA	-0.26%	-3.04%	5.24
General Obligation bonds	-0.29%	-3.07%	5.00	AA	-0.30%	-3.01%	5.07
Revenue bonds	-0.40%	-3.21%	5.42	A	-0.47%	-3.12%	5.03
Prerefunded bonds	-0.17%	-1.69%	2.54	BBB	-0.60%	-3.56%	5.77
Long maturities (22+ yrs.)	-0.52%	-4.04%	8.01	High Yield	-0.23%	-3.02%	7.09
Intermediate maturities (1 - 17 yrs.)	-0.31%	-2.75%	4.16	HY, ex-Puerto Rico	-0.33%	-3.06%	7.32
Short maturities (1 - 5 yrs.)	-0.27%	-1.80%	2.43				

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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