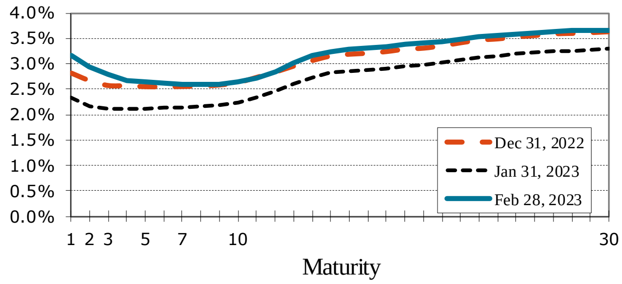
Baird Advisors
Municipal Fixed Income Market Commentary
February 2023

Tax-exempt Rates Rose in February, Reversing the January Decline

Tax-exempt rates rose sharply in February on strong economic news and higher/stickier inflation data, more than reversing January's decline in yields. Cash and near-cash yields were the most volatile segment of the tax-exempt curve in February, rising more than long-term rates which pushed the curve to an even more deeply inverted slope. The volatility in short rates was most evident in the Sifma Weekly Floating-Rate Index, which rose to a 3.98% peak in February, up from a low of 1.66% in late-January. The high cash rates – as well as the strong cross-market influence of the deeply inverted Treasury curve – drove the inversion between the 1 – 10yr maturities to -53 bps from -18 bps at year end and -10 bps in January. Even with the rise in yields, however, tax-exempt rates remain on the richer side of historic valuations relative to Treasuries, particularly on the shorter end. For example, the 2yr AAA tax-exempt yield to 2yr Treasury yield ratio was just 62% at month end, compared to an average ratio of 87% over the last ten years. Not surprisingly, the appeal of cash/floating-rate yields and the relative richness of tax-exempts led to modest outflows in February; net redemptions YTD totaled $1.1B. New supply continued to disappoint as total YTD issuance is off 27% YoY. This was led by a 73% decline in taxable supply with tax-exempt issuance off 17% YoY.

AAA Municipal Yields



Maturity	12/31/21	12/31/22	1/31/23	2/28/23	1Mo Δ	YTD Δ
1	0.19%	2.82%	2.34%	3.17%	0.83%	0.35%
2	0.25%	2.67%	2.17%	2.95%	0.78%	0.28%
3	0.34%	2.58%	2.12%	2.78%	0.66%	0.20%
5	0.60%	2.56%	2.12%	2.65%	0.53%	0.09%
7	0.85%	2.56%	2.14%	2.60%	0.46%	0.04%
10	1.05%	2.64%	2.24%	2.64%	0.40%	0.00%
30	1.54%	3.63%	3.29%	3.66%	0.37%	0.03%

State Tax Policy and Revenue on Diverging Paths

Calendar year 2022 was a banner year for state tax collections as strong revenues produced higher spending while still allowing states to boost reserves to record levels (now nearly 12% of general fund spending). Those reserves will help offset the slowing revenues we expect in coming quarters. Yet, performance among states will vary as each has their own unique tax structure and revenue sources. States that are heavily dependent on energy production and sales (e.g., ND and AK) typically have the most revenue volatility but performed well in 2022 and may continue to do so. Tax structure matters and eight states implement no income tax but rely instead more heavily on sales taxes. Among those states with an income tax, eleven have a flat income tax rate and more are moving in that direction. States with no income tax, or a flat tax have benefited from in migration as tax policy plays a role in resident location. The flat-tax states also tend to have less revenue volatility and should have a smoother ride as growth slows than states with a highly progressive tax structure. California, for example, has not only an above average reliance on income taxes but also a very progressive tax structure (rates vary from 1% - 12.3%), placing a heavy reliance on the wealthiest residents. In the 2019 tax year, the top 1% of California taxpayers provided approximately 40% of the total tax revenue, leaving the state vulnerable to outmigration of its highest earners. California revenues are already slowing, with January collections off 42% from the same month last year (income taxes were off 50%), and twelve-month revenues off 2% YoY. April tax payments may also disappoint given lower capital gains taxes from weak financial markets last year. The key for investors is to track each state as to their specific revenue and spending trend, hoping they are not overly complacent given the recent strength they have enjoyed.

February Partially Reverses the Strong January Returns, But Still Positive YTD

After one of the strongest January rallies in nearly thirty years this was the worst February return since 2008. Short maturities outperformed intermediate and long maturities this month, which translated to outperformance of the Prerefunded sector over the longer duration GO and Revenue sectors. There was little performance differentiation this month across the Investment Grade credit spectrum, but the High Yield municipal category lagged.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	February	YTD	*Duration*	Bloomberg Quality	February	YTD	*Duration*
Municipal Bond Index	-2.26%	0.55%	*6.15*	AAA	-2.31%	0.26%	*6.00*
General Obligation bonds	-2.28%	0.29%	*5.77*	AA	-2.27%	0.41%	*6.04*
Revenue bonds	-2.31%	0.71%	*6.56*	A	-2.16%	0.86%	*6.21*
Prerefunded bonds	-1.30%	-0.24%	*2.30*	BBB	-2.46%	1.21%	*7.28*
Long maturities (22+ yrs.)	-3.33%	1.23%	*10.47*	High Yield	-3.14%	1.16%	*7.78*
Intermediate maturities (1 - 17 yrs.)	-1.88%	0.32%	*4.57*	HY, ex-Puerto Rico	-2.87%	0.84%	*7.59*
Short maturities (1 - 5 yrs.)	-1.43%	-0.11%	*2.38*				

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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