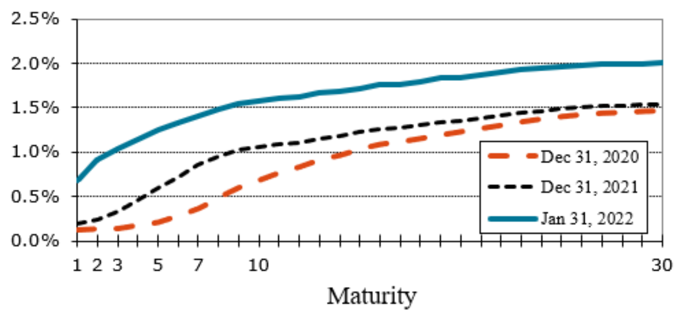
Baird Advisors
Municipal Fixed Income Market Commentary
January 2022

Liquidity Fades on Selling Pressure Driving Municipal Yields Sharply Higher

A sharp rise in Treasury yields to start the year also led to heavy selling pressure in the municipal market, pushing tax-exempt rates meaningfully higher. Municipal funds/ETFs experienced $1.1B of net outflows in January, the first sustained redemptions since March/April 2020. The abundant market liquidity of last year quickly evaporated in 2022 as dealers reduced inventory on the higher volatility, adding to the downward pressure on prices. In addition, new tax-exempt issuance also rose 17% YoY in January. The result of the above influences was higher tax-exempt yields and a flatter curve as short-term rates rose 69 bps while long-term yields rose 46 bps. The yield adjustments in municipals were significantly more than the rise in comparable maturity Treasury yields, bringing the municipal-to-Treasury cross-market relationship back in line with long-term norms. For example, the 2yr AAA municipal-to-Treasury yield ratio rose from just 33% at year end to 76% at the end of January and a similar upward adjustment in valuations occurred across the curve. Importantly, the municipal sell-off was **not** driven by credit concerns. In fact, state budgets are experiencing impressive revenue gains both on a YoY basis and relative to pre-pandemic levels. Pension funding levels also improved in 2021 on strong stock market returns and higher market rates. The pension consulting firm Milliman reported the average funded ratio of the 100 largest public pension funds rose to 85% at year end, up from 71% in mid- 2020.

AAA Municipal Yields



Maturity	12/31/20	9/30/21	12/31/21	1/31/22	1Mo Δ
1	0.13%	0.18%	0.19%	0.68%	0.49%
2	0.14%	0.18%	0.25%	0.91%	0.66%
3	0.14%	0.25%	0.34%	1.03%	0.69%
5	0.22%	0.55%	0.60%	1.25%	0.65%
7	0.37%	0.82%	0.85%	1.41%	0.56%
10	0.69%	1.13%	1.05%	1.58%	0.53%
30	1.47%	1.73%	1.54%	2.00%	0.46%

Puerto Rico Exits Bankruptcy

After five (long) years, the largest municipal bankruptcy in history has finally come to an end. Last month, Judge Laura Swain approved the plan of adjustment which reduces Puerto Rico's debt burden and provides the Commonwealth a path to long-term fiscal stability. Operating under the oversight of the federally appointed PROMESA fiscal control board, Puerto Rico was able to suspend roughly $20B of island debt payments during the bankruptcy period. In addition, taxpayer supported debt was cut from $33.2B to $7.4B. Bondholders will receive approximately $7B in cash plus a contingent value instrument (CVI) that pays out if island sales taxes exceed projected levels. While GO bondholders will recover between 69 – 82% of the face value of their holdings (more subordinate claims saw much bigger cuts), most pensioners were largely unaffected. The 28% of all pensioners that receive a monthly pension benefit over $1,500/month will have their payment level frozen. Also, a separate pension reserve fund was established that should gradually reduce the unfunded pension liability. If scheduled deposits are made, the funded ratio will reach 50% by FY2039. The PROMESA board will remain in place until Puerto Rico achieves four consecutive years of balanced budgets. They will also monitor debt management controls included in the plan which restrict both the amount and purpose for future borrowings. Finally, the island will receive a total of $43B in federal aid for Covid relief and another $2.3B as part of the recent infrastructure bill. For the first time in a very long time Puerto Rico and its citizens now have a good chance to not just meet their obligations but to also participate in the U.S. economic recovery more fully.

Sharply Negative Returns to Start 2022

Returns across the municipal market were sharply negative in January. For the broad Bloomberg Municipal Index, this was the worst start to any year since 1981, and only the seventh January with a negative return in the last 40 years. Although short rates rose the most, that maturity segment still outperformed other parts of the curve. For example, the shorter maturity Pre-refunded sector outperformed on the month relative to both GOs or Revenue bonds. There was little difference in performance this month across the quality spectrum; A-rated issues marginally outperformed other categories.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	2021	January	Duration	Bloomberg Quality	2021	January	Duration
Municipal Bond Index	*1.52%*	-2.74%	5.14	AAA	*0.47%*	-2.79%	5.24
General Obligation bonds	*1.01%*	-2.79%	5.01	AA	*0.92%*	-2.72%	5.07
Revenue bonds	*1.86%*	-2.82%	5.41	A	*2.25%*	-2.66%	5.03
Prerefunded bonds	*0.00%*	-1.53%	2.56	BBB	*4.85%*	-2.98%	5.62
Long maturities (22+ yrs.)	*3.17%*	-3.54%	7.92	High Yield	*7.77%*	-2.80%	7.14
Intermediate maturities (1 - 17 yrs.)	*0.86%*	-2.44%	4.18	HY, ex-Puerto Rico	*7.74%*	-2.74%	7.28
Short maturities (1 - 5 yrs.)	*0.36%*	-1.54%	2.45				

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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