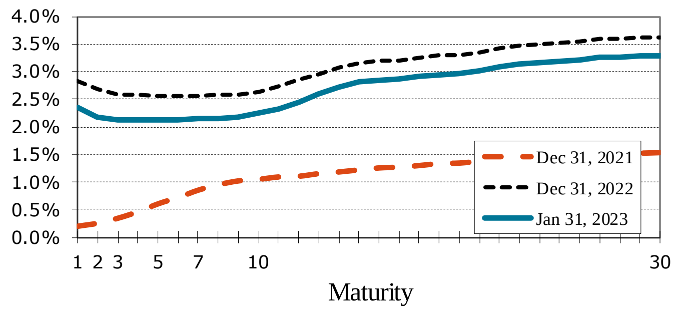
Baird Advisors
Municipal Fixed Income Market Commentary
January 2023

Favorable Supply/Demand Backdrop Provides Strong Start for Municipals in 2023

The reemergence of investor demand combined with moderate supply pushed municipal yields sharply lower in January. Short-term rates fell the most, steepening the curve, yet the 1-10 yr. curve segment remained inverted (-10 bps). Impressively, the 48 bp decline in 1yr AAA tax-exempt yields far exceeded the 1yr Treasury rate decline (-2 bps), richening the cross-market valuation for short-term municipals. To illustrate, the volatile Sifma floating-rate tax-exempt index fell 200 bps in January to 1.66%. Relative to the 4.30% yield on the taxable Secured Overnight Finance Rate (SOFR) this implies a breakeven tax rate of over 60%. Municipal outperformance was driven by a very favorable supply/demand backdrop. After the record fund outflows in 2022, flows turned positive in the last two weeks of January (~ $3B). Heavy tax-loss selling ended at the close of the year just as more investors came to recognize the improved value of bonds. From a supply perspective, new issuance is off to a slow start; tax-exempt issuance fell 7% YoY in January with expectations for light supply in February as well. Between the unspent federal money that state and local governments still hold (now with greater spending flexibility provided by the recent $1.7T omnibus spending bill), and still strong, although slowing, tax revenues there is simply less need to borrow currently. We are beginning to see, however, diverging tax revenue reports across the country which may lead to additional issuance. For example, California now expects a $22.5B deficit in its current fiscal year while Texas (with a very different tax structure) is projecting a $32.7B budget surplus.

AAA Municipal Yields



Maturity	12/31/21	9/30/22	12/31/22	1/31/23	1Mo Δ
1	0.19%	3.04%	2.82%	2.34%	-0.48%
2	0.25%	3.07%	2.67%	2.17%	-0.50%
3	0.34%	3.09%	2.58%	2.12%	-0.46%
5	0.60%	3.13%	2.56%	2.12%	-0.44%
7	0.85%	3.14%	2.56%	2.14%	-0.42%
10	1.05%	3.26%	2.64%	2.24%	-0.40%
30	1.54%	3.95%	3.63%	3.29%	-0.34%

Hospital Sector Overview – Opportunities Amid the Challenges

The not-for-profit Hospital sector of the municipal market has faced some of its most difficult challenges ever in the last three years. When Covid-19 entered the US in early-2020, hospitals were forced to rapidly adapt, altering care delivery strategies, address staff burnout while revenues fell as profitable elective surgeries were halted. Thankfully, significant federal support provided a necessary bridge, but the challenges continue, particularly the ability to attract and retain qualified workers as rising labor costs squeeze operating margins. Understandably, some municipal investors avoid the Hospital sector altogether. Yet, while we acknowledge the headwinds are likely to persist for most of 2023, we also see opportunity, dependent upon diligent fundamental credit research. Recent financial reports indicate that many hospitals are successfully managing through the difficulties with particularly strong balance sheets as security. The Hospital sector represents just over 9% of the Bloomberg Municipal Bond Index, with 38% and 50% in S&P's AA- and A-rated categories, respectively. Also, credit spreads have widened in recent months, helping to sufficiently compensate for the additional risk. We prefer larger hospital systems with academic partnerships that provide strong brand recognition and an established pipeline of talent; particularly relative to smaller, stand-alone hospitals subject to prolonged industry stress. That said, the healthcare industry will continue to rapidly evolve, with investments in more consumer-centric delivery options, such as: telehealth, in-home in-patient care, clinics, ambulatory surgery centers and micro-hospitals. Aging demographics make this an essential service sector that will continue to grow and present opportunities for investors.

Impressive Rally Boosts January Returns

A strong rally to start the year provided positive returns in January. There was a risk-on tone throughout the month as longer maturities outperformed short-term bonds (by 338 bps) and lower-quality (BBBs) outperformed higher-quality (AAA) issues by 113 bps. A similar theme prevailed across market sectors as the longer duration Revenue sector led both Prerefunded and GOs.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	2022	January	*Duration*	Bloomberg Quality	2022	January	*Duration*
Municipal Bond Index	-8.53%	2.87%	*6.09*	AAA	-7.93%	2.63%	*5.89*
General Obligation bonds	-7.74%	2.63%	*5.69*	AA	-7.97%	2.74%	*5.97*
Revenue bonds	-9.29%	3.09%	*6.49*	A	-9.06%	3.09%	*6.18*
Prerefunded bonds	-3.01%	1.07%	*2.34*	BBB	-11.63%	3.76%	*7.23*
Long maturities (22+ yrs.)	-15.58%	4.71%	*10.31*	High Yield	-13.10%	4.44%	*7.67*
Intermediate maturities (1 - 17 yrs.)	-4.84%	2.25%	*4.53*	HY, ex-Puerto Rico	-12.64%	3.82%	*7.49*
Short maturities (1 - 5 yrs.)	-3.17%	1.33%	*2.39*				

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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