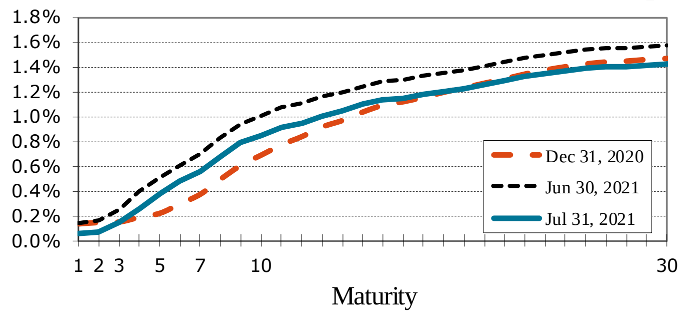
Baird Advisors
Municipal Fixed Income Market Commentary
July 2021

Trend of Lower Rates and Flatter Curve Continues in July

Tax-free rates extended the rally from Q2 into July as long-term rates fell 14 bps while short rates fell 8 bps, flattening the curve. Investors, flush with cash from heavy seasonal reinvestment needs, continued to purchase municipal funds at a record pace. Through July, YTD inflows of $69.5B already qualify as the third highest full year amount with five months left on the calendar. The strong demand is likely to continue through August, the largest reinvestment month of the year with an estimated $59B of principal and interest payments expected. Supply, on the other hand, was very light in July with just $36B of total issuance, down 25% YoY. Although total supply YTD is still marginally ahead of last year's pace, up 4% to $273B vs. $263B, 28% has been taxable. This favorable supply/demand backdrop for the market not only helped to push tax-free rates lower in July, but also to narrow credit spreads on lower-quality issues relative to high-grades as investors stretched for additional yield.

AAA Municipal Yields



Maturity	12/31/20	6/30/21	7/31/21	1Mo Δ	YTD Δ
1	0.13%	0.14%	0.06%	-0.08%	-0.07%
2	0.14%	0.16%	0.06%	-0.10%	-0.08%
3	0.14%	0.25%	0.14%	-0.11%	0.00%
5	0.22%	0.51%	0.37%	-0.14%	0.15%
7	0.37%	0.70%	0.56%	-0.14%	0.19%
10	0.69%	1.00%	0.85%	-0.15%	0.16%
30	1.47%	1.57%	1.43%	-0.14%	-0.04%

Bipartisan Infrastructure Progress

One reason for the heightened investor focus on the municipal market this year is the ongoing debate over infrastructure spending and possible tax increases. To that end, an agreement was reached in the Senate in late July on the Bipartisan Infrastructure Investment and Jobs Act (BIIJA). Importantly, enough Republicans joined with Democratic leaders in the Senate to reach a filibuster-proof margin on the agreement. The bipartisan plan would provide $548B of new spending over five years on physical infrastructure needs. While it covers a broad range of needs, the largest allocations are targeted for: roads and bridges ($110B), the electric grid ($73B), rail ($66B), broadband expansion ($65B) and water system needs ($55B). No planned tax increases are associated with this bill, instead the cost is offset, primarily, from unused Covid relief funds ($205B), unused unemployment benefits ($53B) and recouping fraudulently paid claims ($50B). Disappointing to municipal participants, however, is the lack of inclusion (at least so far) of direct-pay bonds (like the Build America Bonds from 2009/10) in this bill. While there is a cost to the federal budget from direct-pay subsidies, they proved an effective and relatively efficient financing method after the Great Financial Crisis and could be helpful once again. If this bill is approved in the Senate in early August, as expected, it will then move to the House for consideration. It is uncertain if Speaker Pelosi would take up the bill on its own, or perhaps pair it with a much larger budget reconciliation resolution with a proposed target of $3.5T in spending. The reconciliation bill would have to pass on a partisan basis as it is focused on top Democratic priorities, such as immigration reform, expanding Medicare and combating climate change. The ultimate size of the reconciliation bill will likely be determined by the aggregate size of the personal and corporate tax increases that can be agreed upon in this process. Many estimate the size will be reduced from $3.5T to $1 - $2T when completed.

Risk-on Positioning Continued to Set the Performance Pace

Risk taking continued to be rewarded in July as longer maturities and lower-quality issues outperformed other segments of the market. The flattening curve provided the best performance in intermediate and long maturities relative to shorter maturities. Lower-quality outperformance was evident in the 46 bps of excess return provided by BBBs relative to AAAs in July, padding their relative YTD lead to 436 bps. There was little differentiation across market sectors this month, but Revenue issues remain the YTD leader.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	July	YTD	Bloomberg Barclays Quality	July	YTD
Municipal Bond Index	0.83%	1.90%	AAA	0.80%	0.86%
General Obligation bonds	0.82%	1.38%	AA	0.78%	1.29%
Revenue bonds	0.88%	2.26%	A	0.81%	2.67%
Prerefunded bonds	0.26%	0.32%	BBB	1.26%	5.22%
Long maturities (22+ yrs.)	1.06%	3.42%	High Yield	1.20%	7.40%
Intermediate maturities (1 - 17 yrs.)	0.73%	1.31%	HY, ex-Puerto Rico	1.20%	7.53%
Short maturities (1 - 5 yrs.)	0.33%	0.67%			

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 Barclays 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 Barclays Municipal Bond Index and do not represent separate indices.

The Bloomberg Barclays 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 Barclays Municipal Bond Index or Bloomberg Barclays 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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