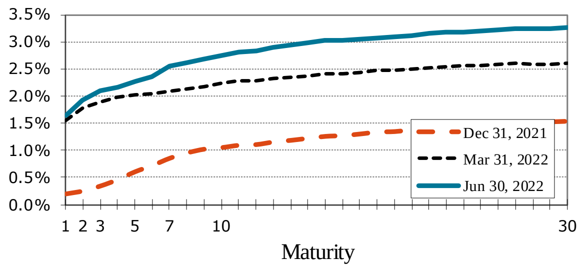
Baird Advisors
Municipal Fixed Income Market Commentary
June 2022

Higher Rate Trend Continues in Q2, Municipal Curve Steepens

Tax-exempt rates rose in June and for the full quarter, extending the YTD rising rate trend. Although the curve steepened this quarter, with long-term rates rising more than short, over the six-month period ending in June yields have risen in a nearly parallel manner with 2's, 10's and 30's all up approximately 170 bps. Elevated and lingering inflation remains the primary cause as June's CPI of 8.6% YoY was the third consecutive month over 8%. The Fed aggressively responded to the data by first telegraphing a 75 bp rate hike just days before the June FOMC meeting and then acted on their strong signal. Liquidity in the municipal market has been challenged due to record tax-exempt fund redemptions, exaggerated by heavy tax-loss selling (much of it spurred perhaps by the $102B of record fund *inflows* in 2021 at much lower rates), which has caused the underperformance of municipals relative to Treasuries at various points along the curve, most notably longer maturities. The $76B of net fund outflows YTD exceeds both the $48B during the 2020 pandemic and the $70B in the 2013 taper tantrum. Yet, even with the heavy selling, investors have absorbed the same level of new tax-exempt supply this year (up 1% YoY) compared to last year when, as noted above, fund flows were strongly positive. Total municipal issuance, however, is still off 10% YoY due to a nearly 40% decline in taxable municipal supply as refunding activity disappeared.

AAA Municipal Yields



Maturity	12/31/21	3/31/22	5/31/22	6/30/22	1Mo Δ	Q2 Δ	YTD Δ
1	0.19%	1.54%	1.58%	1.64%	0.06%	0.10%	1.45%
2	0.25%	1.78%	1.86%	1.93%	0.07%	0.15%	1.68%
3	0.34%	1.89%	2.02%	2.09%	0.07%	0.20%	1.75%
5	0.60%	2.03%	2.19%	2.27%	0.08%	0.24%	1.67%
7	0.85%	2.09%	2.33%	2.55%	0.22%	0.46%	1.70%
10	1.05%	2.23%	2.50%	2.75%	0.25%	0.52%	1.70%
30	1.54%	2.60%	2.88%	3.25%	0.37%	0.65%	1.71%

Municipal Credit Quality Peaking

As strong as the fundamental backdrop for municipalities is currently, credit strength is likely peaking as signs of a slowing, if not contracting, U.S. economy emerge. For most municipalities, the unprecedented fiscal support provided during the pandemic more than offset Covid-related expenses and tax revenue declines. In addition, the strong economic and financial market rebound boosted all sources of tax revenues, leaving states flush with cash and budget surpluses an unusually common occurrence across the country. Most states have acted prudently with their windfall, setting aside record reserves for the future. It appears that future may be rapidly approaching as sharply higher rates (in the U.S. and globally) are having the dampening economic effect the Fed (and other central banks) desires to tame inflation. Q1 growth was negative (-1.6%) and current estimates are that Q2 may be very low, if not also negative. Since municipal revenues are procyclical – they rise and fall with the economy and the financial markets – it is likely that tax revenue growth will slow, broadly speaking, in 2023. Markets often anticipate an economic turn, and that has been true this year as municipal credit spreads have already widened from last year's record tights (importantly, the move is back to more normal, longer-term averages, so far). For example, BBB – AAA tax-free yield spreads have risen from 55 bps in August 2021 to 115 bps in June, approaching the 119 bps average spread since 2015. In time, we would expect further widening to occur, both due to the slowing economy but also in response to the wider corporate credit spreads YTD, which tend to lead municipal spreads by a quarter or more. Given the very strong fundamental backdrop for state and local governments, however, we would view any meaningful spread widening as an opportunity to add lower-quality exposure to portfolios. Even if a recession were to occur, every expectation currently is that it would be relatively mild as labor markets are tight and the lofty reserves municipalities have set aside would help to cushion the anticipated softening in tax revenues.

Q2 Negative Returns Push YTD Returns Lower

The rise in yields in June and Q2 pushed returns deeper into negative territory YTD. Given the steepening curve, longer maturities underperformed both intermediate and short maturity segments for the month and quarter. With only a modest rise in short-term maturities in Q2, the shorter-duration Prerefunded sector outperformed both GOs and Revenue issues. Given the widening credit spreads mentioned above, higher-quality issues outperformed lower-quality issues across all time frames in 2022.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	June	Q2	YTD	Bloomberg Quality	June	Q2	YTD
Municipal Bond Index	-1.64%	-2.94%	-8.98%	AAA	-1.52%	-2.52%	-8.51%
General Obligation bonds	-1.36%	-2.51%	-8.43%	AA	-1.50%	-2.65%	-8.57%
Revenue bonds	-1.87%	-3.37%	-9.68%	A	-1.77%	-3.29%	-9.37%
Prerefunded bonds	-0.22%	0.20%	-3.06%	BBB	-2.37%	-4.52%	-11.33%
Long maturities (22+ yrs.)	-3.80%	-6.59%	-14.66%	High Yield	-3.19%	-5.61%	-11.77%
Intermediate maturities (1 - 17 yrs.)	-0.84%	-1.55%	-6.80%	HY, ex-Puerto Rico	-2.99%	-5.43%	-11.63%
Short maturities (1 - 5 yrs.)	-0.10%	0.08%	-3.25%				

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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