Baird Advisors
Municipal Fixed Income Market Commentary
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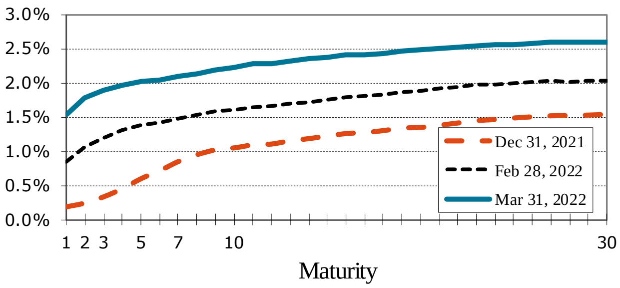
Sharp Rate Rise, Curve Flattening Significantly Improves Tax-exempt Income and Valuations

Higher inflation and Russia's invasion of Ukraine led to a significant reset of the expected rate path by the Fed, pushing tax-exempt rates dramatically higher all along the curve. Unfortunately, as rates rose and bond prices fell, the low year-end starting yields provided too little protection to soften the negative returns; yet the pain was not equally distributed along the curve. Short-term rates rose the most, with 2-year yields up 153 bps while long-term yields rose 106 bps, leading to a flatter curve. The most severe price declines, however, occurred among the longest maturities, beyond 20-years. Not surprisingly, the heightened market volatility led to persistent outflows from municipal funds, totaling $21B for the quarter (roughly one-fifth of the $102B that came into municipal funds in all of 2021). Total supply was modest, falling 5.1% YoY as a decline in refunding activity led to a 30% YoY drop in taxable municipal issuance. Tax-exempt issuance rose 6%YoY, as a focus on infrastructure spending lifted new money borrowings. As rough as this quarter was for investors, not since the early-1980s has the municipal market experienced similar negative returns, the good news is that investors immediately begin to earn the new, higher income levels. The rapid reset of tax-exempt rates, which was even more pronounced than in most Treasury maturities, means that any reinvestment of coupons/dividends, or any new allocations to the asset class, will occur at much more attractive valuations. Also, a more aggressive Fed rate path is now factored into current yield levels. Market prices now reflect another 200 bps of Fed rate hikes in 2022, in addition to the 25 bp increase that occurred in March. The pace and magnitude of rate hikes will, of course, depend both on domestic and geopolitical developments, most importantly the current trend and future expectations of inflation.

AAA Municipal Yields



Maturity	12/31/20	12/31/21	2/28/22	3/31/22	1Mo Δ	YTD Δ
1	0.13%	0.19%	0.84%	1.54%	0.70%	1.35%
2	0.14%	0.25%	1.06%	1.78%	0.72%	1.53%
3	0.14%	0.34%	1.20%	1.89%	0.69%	1.55%
5	0.22%	0.60%	1.39%	2.03%	0.64%	1.43%
7	0.37%	0.85%	1.48%	2.09%	0.61%	1.24%
10	0.69%	1.05%	1.61%	2.23%	0.62%	1.18%
30	1.47%	1.54%	2.03%	2.60%	0.57%	1.06%

Municipal Credits Continue to Strengthen

By any measure, municipal credits are strong and improving. Tax revenues continued to rise for state and local governments in Q1, on top of the 14% YoY increase in 2021. Not since 1941 have states reported a similar budget surplus as a percent of GDP (+1.2%) as they did last year. Tax revenues, personal and corporate, as well as sales taxes are rising thanks to what has so far been a strong, post-pandemic recovery. Property taxes have also risen along with real estate values, particularly in the residential segment. Record federal support has played a key role, providing 34% of total state/local spending in 2021. Even if the economy slows in coming quarters, reserve levels are at record highs which will cushion any declines. The rating agencies continue to reward this fundamental strength with an upward rating trend, even among the lowest rates states; Illinois and New Jersey each received rating upgrades in Q1. The commodity-rich states are especially benefiting from rising energy and mineral prices. Alaska, for example, recently raised its two-year oil revenue forecast by $3.6B on updated oil price estimates. This fundamental strength has led many states to consider tax cuts, some temporary and others permanent. Connecticut, Georgia and Maryland, for example, have temporarily suspended the state gas tax while several other states are considering the same move. Other states are on a path to lower state income tax rates for competitive reasons, to attract business and residents from higher tax states. Mississippi is the most recent example, having agreed in March to gradually reduce the top individual income tax rate to 4% from 5% by 2026.

Rate Rise Drives Negative Quarterly Returns

Sharply higher yields across the curve led to the worst quarterly return for the Bloomberg Municipal Bond Index since Q3 1980. Even though short rates rose more than long, the longest maturities suffered the largest price decline of any curve segment. The Revenue sector, with its longer average duration, was the worst performing sector while Prerefunded bonds held in the best. For the quarter, BBBs underperformed AAAs by 99 bps given their longer duration and the modest widening of credit spreads.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	March	YTD	*Duration*	Bloomberg Quality	March	YTD	*Duration*
Municipal Bond Index	-3.24%	-6.23%	*5.55*	AAA	-3.20%	-6.14%	*5.56*
General Obligation bonds	-3.10%	-6.07%	*5.31*	AA	-3.17%	-6.08%	*5.48*
Revenue bonds	-3.44%	-6.54%	*5.90*	A	-3.27%	-6.29%	*5.45*
Prerefunded bonds	-1.58%	-3.25%	*2.50*	BBB	-3.70%	-7.13%	*6.25*
Long maturities (22+ yrs.)	-4.80%	-8.65%	*9.32*	High Yield	-3.61%	-6.53%	*8.05*
Intermediate maturities (1 - 17 yrs.)	-2.66%	-5.33%	*4.24*	HY, ex-Puerto Rico	-3.61%	-6.56%	*8.10*
Short maturities (1 - 5 yrs.)	-1.56%	-3.33%	*2.41*				

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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