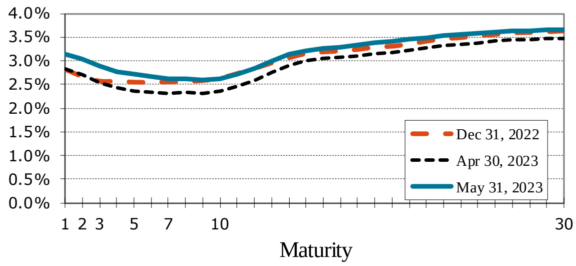
Baird Advisors
Municipal Fixed Income Market Commentary
May 2023

Tax-exempt Yields Rise and the Curve Flattens in May

Tax-exempt rates rose for the second month in a row, driven higher in May by several factors, including: concern over the federal debt ceiling, continued strength in the labor market and a modest supply overhang from the sale of municipal securities by the FDIC. Short-term rates rose more than long-term yields shifting the curve in a bear-flattening trend. The curve inversion deepened between the 1–10-year maturity segments, increasing to -52 bps from -47 bps over the month. Although tax-exempt *cash* yields moved lower in May, with the SIFMA floating-rate index falling to 3.56% from 3.86% in April, the unusual condition in which tax-exempt cash yields more than all but the longest end of the curve remains and continues to negatively impact municipal fund flows. Net fund redemptions continued in May as YTD industry outflows extended to $7.7B from $6.0B in the prior month. From a supply perspective, new tax-exempt issuance was down 6.5% from the same month last year and YTD supply is off 14% YoY, but there was modest pressure in the secondary market which helped to push up yields. The FDIC recently acquired $7.0B of municipal securities from the failed SVB Bank and last month sold roughly $1.4B. The portfolio is comprised of below-market coupon securities which trade at deep discounts to par. Yet, despite market anxiety over the persistent sales, demand was solid for the items which largely traded at or better than market valuations. The FDIC sales are occurring at an advantageous time for investors since yields have risen over the last two months and seasonal supply/demand conditions, in which cash rolling-off will exceed new supply, are improving. Citi Research estimates, for example, that there will be $60B of municipal cash to reinvest in June, from maturing and called bonds as well as coupon payments, compared to just $37B of expected gross issuance.

AAA Municipal Yields



Maturity	12/31/22	3/31/23	4/30/23	5/31/23	1Mo Δ	QTD Δ	YTD Δ
1	2.82%	2.47%	2.83%	3.14%	0.31%	0.67%	0.32%
2	2.67%	2.41%	2.70%	3.03%	0.33%	0.62%	0.36%
3	2.58%	2.30%	2.52%	2.88%	0.36%	0.58%	0.30%
5	2.56%	2.23%	2.37%	2.71%	0.34%	0.48%	0.15%
7	2.56%	2.22%	2.32%	2.63%	0.31%	0.41%	0.07%
10	2.64%	2.28%	2.36%	2.62%	0.26%	0.34%	-0.02%
30	3.63%	3.38%	3.47%	3.64%	0.17%	0.26%	0.01%

Texas Permanent School Fund Guarantee Capacity Raised

Although uncertainty over the U.S Treasury debt ceiling garnered most of the market attention in May, a much smaller and less well-known debt ceiling was also recently reached in the municipal market. The Texas Permanent School Fund (PSF), which was established in 1854 with a $2 million deposit, grew steadily and in 1983 was granted the ability to leverage its assets to guarantee the debt of local Texas school districts. Since then, the PSF has backstopped the debt of over nine hundred school districts with total outstanding debt of over $117B. Texas school district debt backed by the AAA rating of the PSF is a favored municipal credit by both Texans and national investors alike. But the amount of debt the PSF is allowed to backstop is limited by both the cost basis of the PSF assets as well as IRS and state of Texas imposed limits. As the PSF reached its borrowing capacity earlier this year investors worried about the lack of new supply while Texas districts were concerned that their borrowing costs would rise without the strong credit backstop. In May, Texas Representative Lloyd Doggett introduced legislation that increased the IRS capacity limit for the PSF. With $56.8B in fund assets at fiscal year-end 2022 (8/31/22) the new PSF guarantee limit is now $218B, providing significant additional capacity for the growing needs of many Texas communities. Notably, no Texas school district has ever defaulted since the program began adding to the credibility of the process and the guarantee.

Rate Rise Produces Negative Returns in May, But Still Positive YTD

Rising rates in May led to negative returns across the municipal market, but YTD returns remain in positive territory. Shorter maturities held in the best with both intermediate and longer maturities lagging for the month. This translated into the shorter average maturity Pre-refunded sector also outperforming both GOs and Revenue issues. Also, thanks to the additional income they offer, lower-quality issues marginally outperformed higher-quality securities in May.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	May	YTD	*Duration*	Bloomberg Quality	May	YTD	*Duration*
Municipal Bond Index	-0.87%	1.65%	*6.08*	AAA	-0.88%	1.22%	*5.42*
General Obligation bonds	-0.96%	1.30%	*5.72*	AA	-0.93%	1.42%	*6.14*
Revenue bonds	-0.85%	1.90%	*6.45*	A	-0.76%	2.13%	*6.12*
Prerefunded bonds	-0.49%	0.23%	*2.22*	BBB	-0.67%	2.90%	*7.57*
Long maturities (22+ yrs.)	-0.81%	3.22%	*10.31*	High Yield	-0.69%	2.61%	*7.65*
Intermediate maturities (1 - 17 yrs.)	-0.88%	1.09%	*4.51*	HY, ex-Puerto Rico	-0.76%	1.89%	*7.47*
Short maturities (1 - 5 yrs.)	-0.53%	0.40%	*2.31*				

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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