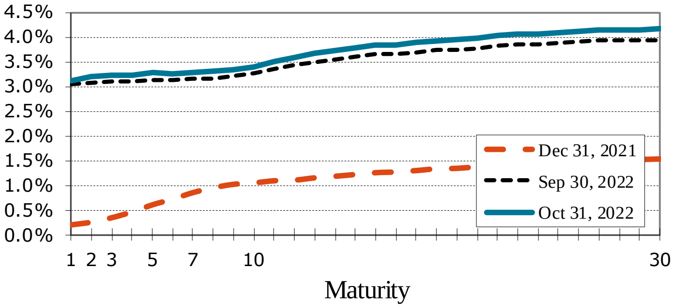
Baird Advisors
Municipal Fixed Income Market Commentary
October 2022

Rates March Higher with a Steepening Bias

Tax-exempt rates rose modestly across the curve in October with a slight steepening bias as long rates rose more than short. Municipal yields were surprisingly stable over the first two weeks of the month, even falling as much as 8 bps, but the ongoing upward pressure on Treasury yields and relentless redemptions from municipal funds proved to be too much. Rates reversed course and rose sharply to finish October with yields up 13 – 22 bps across the curve. Tax-loss harvesting activity remained the driving force behind the steady stream of fund redemptions across the industry, pushing net YTD outflows further into record territory of $104.8B. The YTD net redemptions now exceed the record *inflows* of $102B in 2021, which, ironically, occurred when rates were near their lowest point. To put the magnitude of the municipal outflows this year in perspective, they represent more than one-third of **all** fixed income fund net redemptions of $289B, including both taxable and tax-exempt – yet the municipal market represents less than 10% of total fixed income assets outstanding. The tax-loss harvesting may continue until year end, but we expect the higher yields now available to eventually provide stability to the market and make for a more favorable back drop for investors in 2023. Fortunately, new supply continues to be modest. Through October, total YTD tax-exempt supply of $276B is off 5% YoY while taxable supply remains extremely light at $55B YTD, off 52% YoY.

AAA Municipal Yields



Maturity	12/31/21	9/30/22	10/31/22	1Mo Δ	YTD Δ
1	0.19%	3.04%	3.12%	0.08%	2.93%
2	0.25%	3.07%	3.20%	0.13%	2.95%
3	0.34%	3.09%	3.23%	0.14%	2.89%
5	0.60%	3.13%	3.27%	0.14%	2.67%
7	0.85%	3.14%	3.28%	0.14%	2.43%
10	1.05%	3.26%	3.40%	0.14%	2.35%
30	1.54%	3.95%	4.17%	0.22%	2.63%

Strong Local Governments, Well Prepared for Economic Slowing

The recently released 2022 *City Fiscal Conditions* report from the National League of Cities, highlighted both the significant challenges cities, towns and villages have experienced over the last two fiscal years, including the pandemic and inflationary pressures, but also the resiliency of these local governmental entities. The report confirmed how "crucial" the federal support received from the American Rescue Plan Act (ARPA) was, allowing them to address critical community needs while preventing significant belt tightening otherwise required. Also, the passage last year of the Infrastructure Investment and Jobs Act provides federal grants to help meet their infrastructure goals. While they expect economic conditions to slow, including the growing risk of recession, the combination of healthy reserves and the lagged nature of the primary source of revenue for most – property taxes – allows for a favorable outlook. In fact, 9 of 10 financial officers expressed optimism to meet their fiscal needs in FY22-23. The cities and towns more reliant on sales tax revenues know they will be more sensitive and quicker to see revenue declines but have a more than ample cushion of coverage to allow for this cyclicality. Away from the report, it is also understood that credit ratings tend to lag the economic cycle – falling early in a recovery phase and rising late in the cycle. We have witnessed that pattern recently, with rating upgrades exceeding downgrades, but understand that may change in coming quarters. We would expect any downgrades to be modest in this market sector given the strong starting position cities find themselves in currently.

Long-term Bonds Led the Negative Returns in October

Short-term bonds outperformed other segments of the curve in October with longer-term bond prices falling the most as the curve steepened. The relative stability of short-term rates also led to the outperformance of Prerefunded issues over both GO and Revenue market sectors. Higher-quality issues held their value better than lower-rated issues in October, as they have all year as credit spreads continue to leak modestly wider.

Total Returns of Selected Bloomberg Municipal Indices and Subsectors

Bloomberg Index/Sector	October	YTD	Duration	Bloomberg Quality	October	YTD	*Duration*
Municipal Bond Index	-0.83%	-12.86%	*7.34*	AAA	-0.47%	-12.13%	*6.91*
General Obligation bonds	-0.51%	-11.91%	*6.66*	AA	-0.65%	-12.20%	*7.13*
Revenue bonds	-1.03%	-13.85%	*7.97*	A	-1.23%	-13.62%	*7.71*
Prerefunded bonds	0.09%	-4.91%	*2.44*	BBB	-1.72%	-16.40%	*8.80*
Long maturities (22+ yrs.)	-2.17%	-21.48%	*13.69*	High Yield	-2.05%	-17.75%	*10.68*
Intermediate maturities (1 - 17 yrs.)	-0.38%	-9.56%	*4.98*	HY, ex-Puerto Rico	-1.96%	-17.28%	*10.48*
Short maturities (1 - 5 yrs.)	-0.01%	-5.08%	*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.

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.

Robert W. Baird & Co. Incorporated.

This is not a complete analysis of every material fact regarding any company, industry or security. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. Indices are unmanaged and are not available for direct investment.