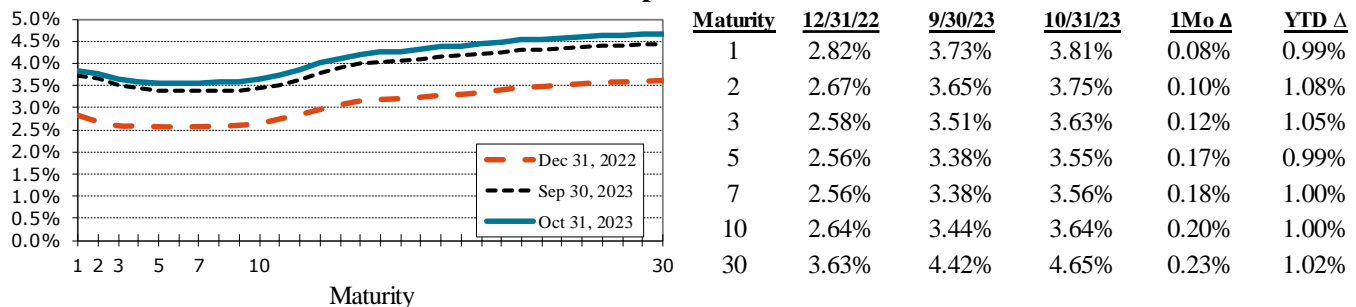


Baird Advisors
Municipal Fixed Income Market Commentary
October 2023

Yields Trend Higher and Curve Steepens Led by Rise in Long-term Rates

Tax-exempt rates rose in October, following a similar upward trend in Treasury yields. Long-term municipal yields rose more than short-term, with the steepening helping to narrow the 1s10s curve inversion to -17 bps from -29 bps the prior month. AAA-rated tax-exempt yields rose to the highest levels since before the financial crisis in 2008. Contributing to the higher municipal yields was robust new tax-exempt supply which increased 40% relative to the same month last year. Yet, YTD supply is still only even with last year's pace. Secondary market trading was also active, reaching the highest level of the year on a par basis as investors once again engaged in tax-loss harvesting prior to the year-end deadline. Demand for municipals was generally solid but varied by bond structure. Institutional investors emphasized new issues, where higher coupons and better call protection (convexity) is available, while retail is necessarily secondary market focused. Mutual fund redemptions continued across the industry, extending the outflow streak to thirteen consecutive weeks. Total outflows YTD have reached \$19.8B compared to the record \$105B of outflows at this point in 2022. The inverted curve, which allows investors to earn higher yields in cash or cash-like vehicles with little to no duration risk, continues to negatively impact fund flows. If the curve continues to steepen, as it did in October, investors will increasingly be incentivized to extend maturities to lock in the higher tax-exempt rates for longer. For investors in the higher marginal income tax rates, the tax-adjusted yields now available are particularly compelling, even relative to other asset classes.

AAA Municipal Yields



Higher Credit Quality Now the Prudent Focus

As yields have increased in recent months, credit spreads on lower-quality issues relative to higher-quality have narrowed, encouraging investors to move up in credit quality. The yield spread between BBB and AAA tax-exempt yields has fallen to 110 bps from 151 bps in April, reducing the reward investors receive in lower-rated issues. Put differently, the yield of the AAA municipal index now provides investors 80% of the yield of the BBB index, among the highest percentage it has offered in over five years. Driving credit spreads tighter are strong credit fundamentals across the municipal market and dearth of lower-quality supply. Yet, we believe credit conditions have peaked and will gradually decline as the full impact of tighter monetary conditions unfold. For example, New York now expects state tax revenue to fall \$9.6B in the current fiscal year relative to last, an 8.5% drop. California is facing an even larger decline. Fortunately, both states have healthy reserves from which to draw as needed. Recent data from the National Association of State Budget Officers (NASBO) shows that total state reserves peaked at \$399B (37% of expenditures) and have fallen to \$274B (23% of expenditures), still well above the \$66B average reserve level (9% of expenditures) between 2009 and 2018. Cities are also in solid shape thanks to elevated residential real estate values which drive property taxes, but office property assessments will need to be monitored as firms reconsider their changing workforce needs.

Steepening Curve Reflected in October Returns

The steepening of the municipal curve was evident in the returns at each respective maturity segment in October. Short maturities had a positive return, outperforming both intermediate and long-term issues for the month. The same trend was also reflected in the outperformance of the Pre-refunded sector, a sector with a shorter average maturity, relative to both GOs and Revenue issues. Higher-quality issues outperformed lower-quality securities for the month but remain behind YTD.

Total Returns of Selected Barclays Municipal Indices and Subsectors

<u>Bloomberg Index/Sector</u>	<u>October</u>	<u>YTD</u>	<u>Duration</u>	<u>Bloomberg Quality</u>	<u>October</u>	<u>YTD</u>	<u>Duration</u>
Municipal Bond Index	-0.85%	-2.22%	6.48	AAA	-0.60%	-2.93%	6.65
General Obligation bonds	-0.66%	-2.65%	6.15	AA	-0.80%	-2.36%	6.31
Revenue bonds	-0.98%	-2.13%	6.81	A	-1.02%	-1.59%	6.50
Prerefunded bonds	0.15%	0.11%	2.18	BBB	-1.41%	-1.64%	7.81
Long maturities (22+ yrs.)	-1.98%	-3.96%	10.85	High Yield	-1.60%	-1.60%	8.01
Intermediate maturities (1 - 17 yrs.)	-0.41%	-1.46%	4.80	HY, ex-Puerto Rico	-1.50%	-2.26%	7.81
Short maturities (1 - 5 yrs.)	0.13%	0.17%	2.36				

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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