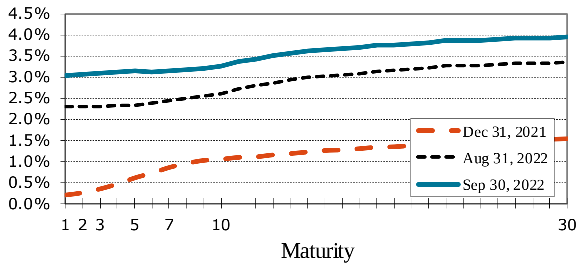
Baird Advisors
Municipal Fixed Income Market Commentary
September 2022

Rates Higher and Curve Flatter in Q3 on Committed Fed

Rates rose sharply in September and in Q3 with a flattening bias as short rates rose more than intermediate or longer maturities. Short term yields rose 140 bps this quarter and 10yr yields were up 51 bps, narrowing the yield spread between the 2yr and 10yr segments to just 19 bps – still steeper than the -44 bp inversion in the Treasury curve. Pushing rates higher in September was a clear and consistent message from the Fed, which is on a mission to bring inflation back to their 2% target and willing to accept the "likely economic pain" it may cause. The Fed boosted rates by 75 bps in September, the third such move in as many meetings, with another 125 bps signaled by year end. The ongoing rate volatility extended the selling of municipal funds across the industry, pushing net fund redemptions deeper into negative territory at -$91.5B YTD. The positive aspect for investors is that tax-exempt yields have risen to their highest level in over a decade; the 4.04% yield of the Bloomberg Municipal Index at quarter end is higher than any time since 2009. The rate rise has occurred even with modest new issuance. Total municipal volume YTD is down 16% YoY, with tax-exempt issuance off 4% and taxable supply plummeting by 49% on less refunding volume.

AAA Municipal Yields



Maturity	12/31/21	6/30/22	8/31/22	9/30/22	1Mo Δ	Q3 Δ	YTD Δ
1	0.19%	1.64%	2.29%	3.04%	0.75%	1.40%	2.85%
2	0.25%	1.93%	2.30%	3.07%	0.77%	1.14%	2.82%
3	0.34%	2.09%	2.31%	3.09%	0.78%	1.00%	2.75%
5	0.60%	2.27%	2.33%	3.13%	0.80%	0.86%	2.53%
7	0.85%	2.55%	2.42%	3.14%	0.72%	0.59%	2.29%
10	1.05%	2.75%	2.61%	3.26%	0.65%	0.51%	2.21%
30	1.54%	3.25%	3.35%	3.95%	0.60%	0.70%	2.41%

Hurricanes Fiona and Ian Strike the U.S.

Hurricane Fiona hit Puerto Rico on September 17th, dropping more than thirty inches of rainfall on the southern part of the island, causing severe flooding and mudslides. The entire island was without power for a time, exposing the fragile nature of the electric grid, which is structurally weak from years of under investment. Then, on September 28th, Hurricane Ian struck the southwest coast of Florida as Category 4 storm, with sustained winds of more than 125 mph accompanied by heavy rainfall. Ian slowly progressed in a northeasterly direction across the state, then moved out into the Atlantic before turning back into the Carolina coast. In Florida, the Ft. Myers Beach area was among the hardest hit areas but flooding and damage occurred all along Ian's path. Although too soon for accurate damage estimates, the cumulative cost of repair will be significant, easily tens of billions. President Biden declared Puerto Rico and a growing list of Florida counties disaster areas which helps to expedite federal aid. While natural disasters such as these are always unwanted, particularly given the loss of life that often occurs, these happened when Florida and Puerto Rico are in positions of relative fiscal strength. Puerto Rico is at its strongest financial position in the last decade with still unspent federal aid from Hurricane Maria in 2017 and lower fixed costs following recent bankruptcy settlements. The State of Florida and the many local governments affected by Ian may be in their strongest fiscal condition ever, with post-Covid federal support and strong tax revenues adding to already healthy reserves. Florida ended FY 2022 with a budget surplus of $21.8B and total reserves of $19B, or 43% of General Revenues. In addition, the state-supported insurance entity, Citizen's Property Insurance Corporation, as well its reinsurer, the Florida Hurricane Catastrophe Fund, are each in solid condition, with ample resources, the ability to levy surcharges and additional borrowing capacity, if needed. Municipal credits in each case will need to be closely monitored during the recovery efforts, but history is on the side of a favorable outcome for those holding investment grade municipal debt.

Persistent Rate Rise Drives Negative Quarterly and YTD Municipal Returns

The shorter segment of the yield curve outperformed both intermediate and longer-term issues this quarter and YTD. This held true across market sectors as the shorter average duration Pre-refunded sector outperformed both the GO and Revenue sectors. Widening credit spreads continued to help higher-quality issues outperform lower-rated issues. For the quarter and YTD, AAAs outperformed BBBs by 57 bps and 322 bps, respectively.

Total Returns of Selected Bloomberg Municipal Indices and Subsectors

Bloomberg Index/Sector	September	Q3	YTD	Duration
Municipal Bond Index	-3.84%	-3.46%	-12.13%	*7.15*
General Obligation bonds	-3.66%	-3.30%	-11.45%	*6.54*
Revenue bonds	-4.06%	-3.62%	-12.96%	*7.76*
Prerefunded bonds	-1.74%	-1.99%	-5.00%	*2.47*
Long maturities (22+ yrs.)	-6.06%	-5.95%	-19.74%	*13.32*
Intermediate maturities (1 - 17 yrs.)	-3.03%	-2.58%	-9.21%	*4.87*
Short maturities (1 - 5 yrs.)	-1.71%	-1.88%	-5.07%	*2.40*

Bloomberg Quality	September	Q3	YTD	*Duration*
AAA	-3.78%	-3.50%	-11.71%	*6.79*
AA	-3.65%	-3.34%	-11.62%	*6.96*
A	-3.98%	-3.51%	-12.55%	*7.44*
BBB	-4.83%	-4.07%	-14.93%	*8.57*
High Yield	-6.16%	-4.83%	-16.03%	*10.58*
HY, ex-Puerto Rico	-5.73%	-4.51%	-15.62%	*10.36*

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.

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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