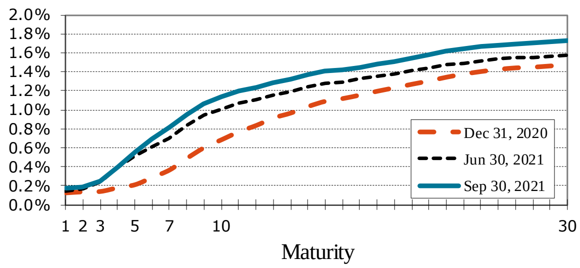
Baird Advisors
Municipal Fixed Income Market Commentary
September 2021

Municipal Yields Rise and Curve Steepens in Q3

Tax-exempt yields rose sharply in September which led to higher rates and a steeper yield curve in Q3. While short rates remained anchored by a steady Fed rate policy and strong short-term demand, long-term yields rose 16 bps for the month and quarter. The rise in long-term tax-exempt yields this quarter exceeded the yield rise in comparable maturity Treasuries, which helped to improve the cross-market valuation of municipals. The supply/demand backdrop for municipals remained favorable throughout the quarter as the modest increase in tax-exempt supply (+3% YoY) was more than offset by very strong demand. This was evident in the consistently positive municipal fund inflows each week of the quarter adding to the YTD record demand. Total fund inflows through September are $88.5B, which already qualifies 2021 as the second-highest calendar year since records began in 1992. Expectations of higher tax rates accompanied by a strong credit backdrop for municipalities has heightened interest in the market. While tax-exempt supply was up marginally, taxable municipal issuance, on the other hand, fell sharply (-42%) in the quarter relative to last year. There has been less use of taxable issuance in 2021 to advance refund tax-exempt supply, in part due to the hope that advance refundings in the tax-exempt market would return (see below). In addition, municipalities are flush with cash, both from the strong rebound in tax revenues as the economy reopened and the abundant federal stimulus, so the near-term need to borrow has been reduced on the margin.

AAA Municipal Yields



Maturity	12/31/20	6/30/21	8/31/21	9/30/21	1Mo Δ	Q3 Δ	YTD Δ
1	0.13%	0.14%	0.09%	0.18%	0.09%	0.04%	0.05%
2	0.14%	0.16%	0.09%	0.18%	0.09%	0.02%	0.04%
3	0.14%	0.25%	0.16%	0.25%	0.09%	0.00%	0.11%
5	0.22%	0.51%	0.42%	0.55%	0.13%	0.04%	0.33%
7	0.37%	0.70%	0.63%	0.82%	0.19%	0.12%	0.45%
10	0.69%	1.00%	0.94%	1.13%	0.19%	0.13%	0.44%
30	1.47%	1.57%	1.57%	1.73%	0.16%	0.16%	0.26%

Key Municipal Revisions Included in Biden's Infrastructure Draft

Market participants were pleased (and surprised) that a few key municipal provisions were included in the legislative draft of President Biden's Build Back Better infrastructure plan. Included in the House Ways and Means Committee's release was the restoration of advance refundings in the tax-exempt market and a return of Direct-Pay bonds (similar to the Build America Bonds (BABs) of 2009-10). Tax-exempt advance refundings were eliminated in the 2017 tax bill, forcing municipalities to consider alternative means of refinancing outstanding debt prior to a stated call date. If this provision survives through the House and Senate negotiations, there are hundreds of millions of tax-exempt debt that could be refunded over the next several years, assuming market rates remain relatively low. At the same time, the use of Direct-Pay taxable municipals to finance infrastructure projects, enhanced by the appeal of a federal subsidy on the interest cost (starting at 35% and declining to 28% over time), could, by some estimates lead to the issuance of over one trillion of BAB-like debt over the next several years. The Joint Committee on Taxation released a report estimating the cost to the federal budget of each provision. Their estimate is that Direct-Pay bonds would cost the federal government $22.5B over 10 years and the advance refunding cost would be $14.9B. Relative to what is likely to be a multi-trillion-dollar boost in federal spending, the cost of these provisions would be small. Yet, they would provide significant flexibility to municipalities at a time when there is bipartisan support for additional infrastructure investment. Market views are mixed as to the probability either or both provisions survive Congressional negotiations, but if they do, it could be a game-changer in terms of the supply outlook for both the tax-exempt and taxable municipal markets. At a time of rising taxes and an aging investor base searching for safe, supplemental income, the demand for municipals should remain strong.

Shorter and Lower-Quality Led Performance in Q3

Short-term maturities outperformed longer curve segments in the quarter as the yield curve steepened. At the same time, lower-quality issues outperformed higher-quality credits in Q3 on strong demand for additional yield and an improving credit backdrop. Across the sectors, the shorter average duration of Pre-refunded issues outpaced longer duration sectors of the market.

Total Returns of Selected Bloomberg Municipal Indices and Subsectors

Bloomberg Index/Sector	September	3Q	YTD
Municipal Bond Index	-0.72%	-0.27%	0.79%
General Obligation bonds	-0.73%	-0.25%	0.30%
Revenue bonds	-0.76%	-0.29%	1.07%
Prerefunded bonds	-0.21%	0.00%	0.05%
Long maturities (22+ yrs.)	-1.00%	-0.74%	1.57%
Intermediate maturities (1 - 17 yrs.)	-0.61%	-0.09%	0.48%
Short maturities (1 - 5 yrs.)	-0.22%	0.08%	0.41%

Bloomberg Quality	September	3Q	YTD
AAA	-0.80%	-0.41%	-0.35%
AA	-0.70%	-0.28%	0.23%
A	-0.69%	-0.28%	1.55%
BBB	-0.78%	0.11%	4.02%
High Yield	-0.65%	0.38%	6.53%
HY, ex-Puerto Rico	-0.70%	0.34%	6.61%

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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