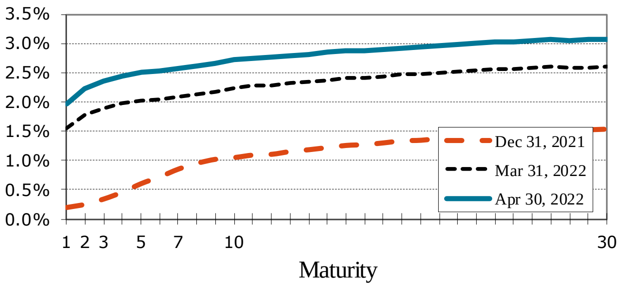
Baird Advisors
Municipal Fixed Income Market Commentary
April 2022

Inflation and Outflows Cause Parallel Shift Higher in Municipal Curve

Tax-exempt rates shifted higher in a near-parallel manner in April, with yields rising more than 45 bps across most of the curve. A rise of this magnitude in any month is certainly notable on its own but coming on the heels of the big move in rates in Q1 makes this four-month yield increase quite rare. The causes of the YTD rate pressure are clear – elevated inflation, with the March CPI reported at 8.5% YoY, and persistent municipal fund redemptions. The Fed is moving aggressively to tackle the inflation problem, but the ensuing rate volatility has led to investor selling. Net fund redemptions in April of $20B, inflated by selling for tax payments as well tax-loss harvesting, contributed to net YTD outflows of $41.5B. For perspective, this pace of outflows exactly matches the $41.5B of *inflows* to the municipal market to this date last year. It is also the largest fund redemptions since the Covid-driven selling in March and April of 2020, when $47B of redemptions occurred in just a two-month span. That episode was credit-driven due to the uncertainty and fear of Covid-19. The current episode is driven instead by rate fears which has allowed this bear market trading environment to be more orderly by comparison. Dealers are understandably cautious to add inventory, yet rate risks can be hedged, albeit not perfectly. Therefore, secondary trading activity has remained robust even if bidding depth has declined. New issue volume for tax-exempt bonds, even with higher yields, has also been impressive, up 7% YoY, whereas as taxable municipal volume has fallen sharply, down 33% YoY. Fortunately, we are also entering a more favorable seasonal period. From May – August, BofA Research expects coupon payments and principal roll-off to exceed new debt issuance by an estimated $39B.

AAA Municipal Yields



Maturity	12/31/20	12/31/21	3/31/22	4/30/22	1Mo Δ	YTD Δ
1	0.13%	0.19%	1.54%	1.96%	0.42%	1.77%
2	0.14%	0.25%	1.78%	2.22%	0.44%	1.97%
3	0.14%	0.34%	1.89%	2.35%	0.46%	2.01%
5	0.22%	0.60%	2.03%	2.50%	0.47%	1.90%
7	0.37%	0.85%	2.09%	2.57%	0.48%	1.72%
10	0.69%	1.05%	2.23%	2.72%	0.49%	1.67%
30	1.47%	1.54%	2.60%	3.07%	0.47%	1.53%

Improving (Relative) Value and Curve Considerations

While no one can know when or at what level rates may peak, as noted above the upward move in rates YTD has been impressive, both in magnitude and speed. Short-term tax-exempt rates are up ~200 bps since year end while long-term yields are more than 150 bps higher leading to a flatter yield curve. Short tax-exempt rates have closely tracked the movement in short Treasury yields, as each has priced in a more aggressive Fed rate path, while long municipal yields have risen more than Treasuries, up 150 bps vs. 109 bps. Not only are municipal investors now able to earn higher nominal yields, but the relative value of tax-exempt yields to taxables has also improved. For example, 5yr AAA Municipal yields offered just 48% of 5yr Treasury yields at year end, but they now provide 85%, and the cross-market valuations only improve as you move out the yield curve. At current valuations, most tax paying investors could benefit from the tax-exemption. As to where an investor might focus along the curve? This depends upon one's tolerance for risk, investing timeframe and market outlook. Some investors will find that the significant yield pickup moving from money market yields into short- or intermediate-term maturities is sufficiently rewarding for the risk. Investors are now able to receive 80% of the maximum yield along the curve in the 5yr maturity and nearly 90% at the 10yr point. While the flatter curve provides less yield incentive to extend into longer maturities, with rates up and recession risks rising, doing so locks in the higher yields for longer and greater return if the economy slows and rates decline. Tax-exempt yields on many higher-quality (AA) municipals now yield 4% or more in the 20yr maturity range. While the significant increase in rates has produced negative returns YTD, much better value has also been created for those reviewing the asset class as a part of their investment portfolio.

Negative Returns YTD Across the Curve

Higher rates in April added to the already negative total returns in Q1. The parallel shift in yields along the curve allowed shorter maturities to outperform longer-dated issues. This pattern also allowed the shorter duration Prerefunded sector to outperform both GOs and Revenue bonds in this month. Also, lower quality credits lagged higher quality, both in April and YTD.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	April	YTD	*Duration*	Bloomberg Quality	April	YTD	*Duration*
Municipal Bond Index	-2.77%	-8.82%	*6.08*	AAA	-2.58%	-8.56%	*5.93*
General Obligation bonds	-2.67%	-8.58%	*5.68*	AA	-2.77%	-8.68%	*5.97*
Revenue bonds	-2.96%	-9.30%	*6.54*	A	-2.76%	-8.87%	*6.09*
Prerefunded bonds	-0.93%	-4.15%	*2.47*	BBB	-3.12%	-10.03%	*7.01*
Long maturities (22+ yrs.)	-4.62%	-12.87%	*10.80*	High Yield	-3.55%	-9.85%	*9.20*
Intermediate maturities (1 - 17 yrs.)	-2.10%	-7.32%	*4.42*	HY, ex-Puerto Rico	-3.55%	-9.88%	*9.19*
Short maturities (1 - 5 yrs.)	-0.96%	-4.26%	*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.

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