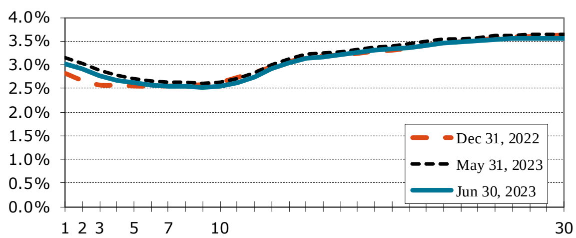
Baird Advisors
Municipal Fixed Income Market Commentary
June 2023

Curve Inversion Persists as Rates Rise in Q2

Although tax-exempt rates fell in June on light supply and strong reinvestment demand, yields were still higher for the quarter. The municipal curve continued its flattening trend in Q2 and YTD as short-term yields rose more than intermediate and longer maturities, allowing the historic inversion of the 1–10-year segment of the municipal curve to persist. Total municipal issuance was modest, falling behind year-ago levels for both the quarter (-6%) and YTD (-17%). As many municipalities utilize remaining American Rescue Plan Act (ARPA) funds for capital needs, issuers have shown both less need to borrow and a reluctance to do so at the higher rates. As a result, dealer estimates of full year supply have fallen to approximately $350B from $400B or more at the start of the year and below the $373B issued in 2022. Demand, on the other hand, was stronger than the $8.1B of YTD net outflows would suggest. Not only was the market able to rally in June into the secondary market sale of $7B of bonds acquired by the FDIC after the SVB Bank takeover, but virtually all the industry outflows were from short-term municipal funds. Presumably, investors were opting for either high-yielding money market funds or to extend along the curve, as both intermediate and long-term fund flows were positive. Heavy reinvestment demand from maturing and called bonds, as well as coupon payments, helps explain the market's solid tone, a trend which should continue in both July and August.

AAA Municipal Yields



Maturity	12/31/22	3/31/23	5/31/23	6/30/23	1Mo Δ	Q2 Δ	YTD Δ
1	2.82%	2.47%	3.14%	3.01%	-0.13%	0.54%	0.19%
2	2.67%	2.41%	3.03%	2.92%	-0.11%	0.51%	0.25%
3	2.58%	2.30%	2.88%	2.77%	-0.11%	0.47%	0.19%
5	2.56%	2.23%	2.71%	2.61%	-0.10%	0.38%	0.05%
7	2.56%	2.22%	2.63%	2.54%	-0.09%	0.32%	-0.02%
10	2.64%	2.28%	2.62%	2.55%	-0.07%	0.27%	-0.09%
30	3.63%	3.38%	3.64%	3.57%	-0.07%	0.19%	-0.06%

Secular Changes and Late-Cycle Signals Provide Credit Opportunities

Tracking rating agency upgrade/downgrade ratios, which remain very favorable from both a par value as well as number of credits, masks the credit and structural opportunities gradually emerging in the municipal market. For example, a divergence is occurring in state tax revenues across the country; collections are slowing in most states, a typical late-cycle economic signal, but still rising in others. California and New York are among the most cyclical tax revenue states, and each are projecting sizable budget deficits that will need to be addressed in coming quarters. BofA Global Research noted that of the 42 states that reported May revenues, median collections fell 4.2% YoY led by a decline in personal income taxes. Yet, as noted by Bloomberg, a dozen states, notably including Florida and Texas which are heavily dependent upon sales taxes, reported average YoY revenue gains of 5%. At the local level, property tax collections are stable due to strong residential real estate values, which have so far offset gradually declining valuations in office properties as the work-from-home transition impacts vacancy rates. While this will remain a drag on office properties, the revaluations will occur over several years giving municipalities time to adjust. Similarly, significant secular changes are also occurring in other areas of the municipal market, particularly Healthcare and Higher Education, two sectors that warrant closer attention but also offer opportunities. Consolidations and closings will continue as weaker providers in each sector face difficult choices, but those with a competitive edge should survive and gain market share. Housing is another sector with attractive valuations. Overall credit quality remains strong but uncertainty over prepayment speeds has risen. Older vintage single-family mortgage pools with lower average mortgage rates will prepay at a slower pace than newer, higher mortgage rate deals. Those with the ability to model each variety of mortgage pool should be well rewarded through excess return over time.

June Rally Minimizes Negative Q2 Returns; YTD Returns Positive Across the Market

Falling rates in June provided positive returns, helping to minimize the overall decline in Q2. For the quarter, longer maturities outperformed short and intermediate curve segments as the curve continued the flattening trend. YTD, longer maturities are the clear winner. Revenue bonds outperformed other sectors for the quarter and YTD and the same was true for lower-quality credits relative to higher-quality. The additional yield of riskier sectors/credits more than offset the detrimental impact of wider credit spreads.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	June	Q2	YTD	*Duration*	Bloomberg Quality	June	Q2	YTD	*Duration*
Municipal Bond Index	1.00%	-0.10%	2.67%	*6.06*	AAA	0.85%	-0.41%	2.08%	*5.46*
General Obligation bonds	0.87%	-0.41%	2.18%	*5.71*	AA	0.97%	-0.23%	2.41%	*6.11*
Revenue bonds	1.08%	0.04%	3.00%	*6.41*	A	1.08%	0.22%	3.24%	*6.10*
Prerefunded bonds	0.59%	-0.40%	0.83%	*2.22*	BBB	1.51%	0.72%	4.45%	*7.47*
Long maturities (22+ yrs.)	1.68%	0.67%	4.96%	*10.18*	High Yield	1.77%	1.65%	4.43%	*7.57*
Intermediate maturities (1 - 17 yrs.)	0.75%	-0.41%	1.85%	*4.51*	HY, ex-Puerto Rico	1.53%	0.94%	3.44%	*7.38*
Short maturities (1 - 5 yrs.)	0.60%	-0.37%	1.00%	*2.33*					

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.

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