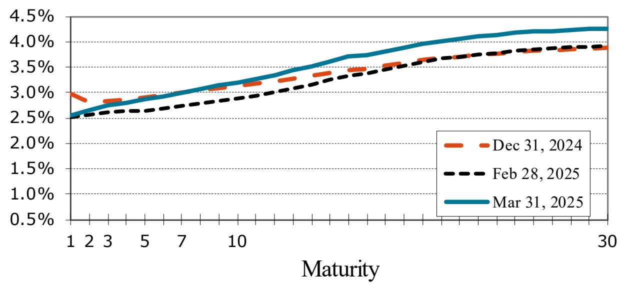
Baird Advisors
Municipal Fixed Income Market Commentary
March 2025

Municipal Yields Rise in Q1 Amid Heavy Supply

Tax-exempt rates climbed in March, led by the long end of the curve. For the quarter, however, municipal yields pivoted around the 7yr maturity, with short-term rates falling 41 bps while long-term rates rose by 40 bps, significantly steepening the curve. At quarter end, the yield spread between the 10Yr (3.20%) and 1Yr (2.56%) maturities was +64 bps, up from just +16 bps at the start of the year. This steepening was apparently incentive enough for investors to extend from cash-equivalents out along the curve, seeking to lock in higher yields and enhance their roll-down benefit as municipal funds had positive flows in 9 out of 12 weeks of the quarter; total net fund inflows are $9.8B YTD. Also, noteworthy this quarter was the divergence between municipals and Treasuries. While long tax-exempt yields rose, long-term Treasury yields fell, cheapening the cross-sector relationship. The AAA Municipal/Treasury yield ratio rose from 81% to 93% in the 30Yr maturity during the quarter, making municipals very appealing for tax paying investors. The primary cause for the lag in municipals was due to continued heavy new issuance. In Q1, total tax-exempt supply rose 19% YoY, well ahead of last year's record pace. A secondary factor was uncertainty surrounding the tax policy debate and what impact, if any, there may be on the municipal market. More information is needed before investors can make an informed judgement, but any meaningful impact on the municipal market seems unlikely, given the significant infrastructure borrowing needs (see below) and the efficiency the municipal market offers issuers, both large and small, to access needed capital.

AAA Municipal Yields



Maturity	12/31/23	12/31/24	2/28/25	3/31/25	1Mo Chg	Q1 Δ
1	2.59%	2.97%	2.51%	2.56%	0.05%	-0.41%
2	2.50%	2.82%	2.56%	2.66%	0.10%	-0.16%
3	2.35%	2.83%	2.60%	2.74%	0.14%	-0.09%
5	2.22%	2.90%	2.65%	2.87%	0.22%	-0.03%
7	2.19%	3.00%	2.74%	3.00%	0.26%	0.00%
10	2.27%	3.13%	2.88%	3.20%	0.32%	0.07%
30	3.40%	3.87%	3.92%	4.27%	0.35%	0.40%

State Budget Update

Federal efforts to cut costs have been garnering a lot of headlines since the Trump Administration took office, and states have taken notice as well. Several states, including two of the largest municipal issuers, Texas and Florida, are establishing their own committees and task forces designed to cut costs and make government operations more efficient. The cost-cutting measures come as governors seek to balance state budgets without the support of Federal pandemic aid. According to data from the National Association of State Budget Officers, FY25 enacted budgets indicate state general fund spending will *decrease* 0.3% as states cut back on one-time spending programs even as revenues continue to grow. According to Bank of America, of the 41 states that have reported February tax collections the median YoY growth rate was 6.9%. Beyond the projected state operating needs, a 2025 report card from the American Society of Civil Engineers (ASCE) emphasized the ongoing capital needs for the nation's infrastructure. ASCE assigned the US infrastructure a cumulative grade of C, which is an improvement from the C- grade received in the 2021 report. This year they noted a projected $3.7T funding gap over the next ten years beyond currently anticipated spending levels. Any cost-cutting efforts at the state and local level will need to consider these critical needs, particularly given the risk that federal spending cuts push a greater burden to the states. Still, state rainy day fund balances remain high, and state finances are in an advantageous position to weather any near-term challenges.

Negative Returns in March

Returns were negative in March, due to the rise in municipal yields, which pushed Q1 returns into negative territory as well for the Municipal Bond Index. Longer maturities lagged returns of intermediate and short maturities, each of which remain positive YTD. Not surprisingly, lower-quality bonds outperformed for the quarter, as AAAs tend to be more price sensitive to changes in rates. From a sector perspective, Prerefunded issues, with their shorter duration, outperformed other sectors for the quarter.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	March	YTD	*Duration*	Bloomberg Quality	March	YTD	*Duration*
Municipal Bond Index	-1.69%	-0.22%	*6.51*	AAA	-1.88%	-0.34%	*6.70*
General Obligation bonds	-1.73%	-0.29%	*6.15*	AA	-1.69%	-0.30%	*6.36*
Revenue bonds	-1.71%	-0.22%	*6.72*	A	-1.58%	-0.03%	*6.50*
Prerefunded bonds	-0.24%	0.92%	*2.43*	BBB	-1.67%	0.13%	*7.39*
Long maturities (22+ yrs.)	-2.50%	-1.46%	*10.48*	High Yield	-1.18%	0.82%	*7.12*
Intermediate maturities (1 - 17 yrs.)	-1.26%	0.39%	*4.90*	HY, ex-Puerto Rico	-1.11%	0.88%	*7.06*
Short maturities (1 - 5 yrs.)	-0.15%	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.

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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