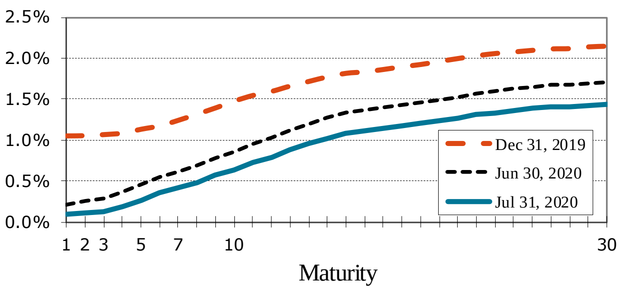
Baird Advisors
Municipal Fixed Income Market Commentary
July 2020

Curve Flattens as Yields Decline

Led by the long end, where yields declined 26 bps and short rates slipped 11 bps, the tax-free curve flattened in July as rates fell across all maturities. The rally pushed yields to record lows at most points along the curve on higher-quality bonds, following the record low U.S. Treasury yields. Heavy investor reinvestment demand from coupon payments and maturities led to consistently positive fund inflows across the municipal industry last month. Impressively, YTD fund flows are now positive once again (+$3B) after falling into deeply negative territory during the record redemption period of March and early April. Issuers are now rightly taking advantage of the low nominal rates with robust new borrowing. Nearly $43B of new municipal debt was issued in July, up 41% from the same month last year, making this the heaviest July since at least 1986. YTD total supply is 21% ahead of 2019's pace thanks to heavy taxable municipal borrowing, both new money and refundings, although for tax-free investors the abundant supply data is misleading. While total taxable volume of $69B is nearly 3X last year's pace, and taxable volume YTD nearly matches the $71B taxable total for all of 2019, tax-exempt supply is virtually unchanged YoY. Where possible, municipal issuers are opting for the taxable market given the relatively small cost difference between the two at the current low rates, and there is greater flexibility in the use of taxable bond proceeds without the rigid IRS guidelines for tax-exempt borrowings.

AAA Municipal Yields



Maturity	12/31/19	3/31/20	6/30/20	7/31/20	1Mo Δ	YTD Δ
1	1.06%	1.07%	0.21%	0.10%	-0.11%	-0.96%
2	1.06%	1.09%	0.26%	0.12%	-0.14%	-0.94%
3	1.07%	1.12%	0.29%	0.13%	-0.16%	-0.94%
5	1.14%	1.17%	0.46%	0.26%	-0.20%	-0.88%
7	1.25%	1.28%	0.61%	0.41%	-0.20%	-0.84%
10	1.48%	1.44%	0.86%	0.64%	-0.22%	-0.84%
30	2.15%	2.08%	1.70%	1.44%	-0.26%	-0.71%

Phase 4 Stimulus Negotiations Continue, Market and Rating Agencies Await Outcome

Negotiations continue on a Phase 4 fiscal package, but it appears that a significant gap remains between the GOP-led Senate's $1 trillion HEALs Act and the $3 trillion HEROES Act passed in the Democrat-led House. Beyond simply the $2 trillion dollar difference in fiscal support, among other key items for debate include Senate leaders demanding liability protection against Covid-related claims as workers return and Democratic leaders insisting on more aid to state and local governments. While policymakers negotiate a compromise, the rating agencies have been surprisingly patient before making significant changes in their ratings, awaiting details on additional federal support and giving municipalities a chance to respond to the fiscal decline. Nearly every state has enacted budget cuts, in most cases across the board cuts of 5% or more. Not surprisingly, municipal defaults have picked up modestly, with 47 reported YTD through June 30th, according to Municipal Market Data, on pace to approach the 108 that occurred in 2012. Nearly all defaults this year have been in predictably risky, High Yield sectors of the market; for example: Senior Care (21), Corporate-backed (6), Land-development (6) and Charter Schools (3). While much of the municipal market has a "negative outlook" by the rating agencies given the uncertain backdrop, a wave of downgrades has not occurred. Justification came from a Moody's spokesperson who recently stated, "The classic strengths of rated state and local governments, in particular the ability to disconnect spending from revenues, their broadly stable revenue structures, typically ample reserves, and good coverage for even narrow special tax pledges, enable us to reasonably look beyond the current crisis."

Longer Maturities Outperform as Curve Flattens; Lower Quality Outperforms as Credit Spreads Narrow

Risk-seeking strategies were rewarded in July. A flattening curve enabled longer maturities to outperform intermediate and short maturities by 96 bps and 176 bps, respectively. Across the quality spectrum, BBBs outperformed AAAs by 191 bps in July. Revenue bonds outperformed other sectors last month, but GOs remain the performance leader YTD.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	July	YTD	Bloomberg Barclays Quality	July	YTD
Municipal Bond Index	1.68%	3.80%	AAA	1.40%	4.86%
General Obligation bonds	1.60%	4.63%	AA	1.46%	4.23%
Revenue bonds	1.82%	3.54%	A	1.81%	3.19%
Prerefunded bonds	0.40%	2.65%	BBB	3.31%	1.19%
Long maturities (22+ yrs.)	2.36%	4.10%	High Yield	2.72%	0.00%
Intermediate maturities (1 - 17 yrs.)	1.40%	3.62%	HY, ex-Puerto Rico	2.67%	-0.79%
Short maturities (1 - 5 yrs.)	0.60%	2.38%			

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 Barclays 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 Barclays Municipal Bond Index and do not represent separate indices.

The Bloomberg Barclays 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 Barclays Municipal Bond Index or Bloomberg Barclays 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.