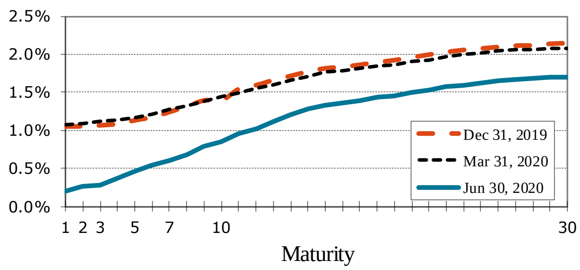
Baird Advisors
Municipal Fixed Income Market Commentary
June 2020

Rebound in Demand Drives Yields Lower in Q2 and Steepens Curve

Changes in tax-free yields were modest in June, but rates fell sharply in the quarter. In Q2, the curve steepened as short rates fell 86 bps and long yields declined by 38 bps. Investor demand stabilized early in the quarter, after the pandemic-driven redemptions in March, and finished strongly with eight consecutive weeks of tax-free fund inflows. Unlike the heavy influence of the Fed purchases in the taxable market, only one municipal issuer has utilized the Fed’s Municipal Liquidity Facility so far, as the State of Illinois borrowed $1.2B for a one-year term. Banks, however, have stepped up their involvement as the FDIC reported that municipal holdings in bank portfolios grew by $17.9B in Q1, the largest quarterly increase since at least 2003. In addition, the number of new bank loans to municipalities has more than doubled in recent months based; borrowing notices for bank loans jumped from 195 in February to 472 in May. June also kicked-off a summer season of heavy reinvestment demand as an estimated $46B of bonds rolled off due to maturities or early calls, and July is assumed to be at a similar level. Fortunately, new supply also improved in June and nearly matched the roll-off amount with $45.3B of issuance, 23% above the same month last year. Total YTD municipal supply is up 14% from last year’s pace, but the data is a bit overstated for tax-free issues alone where volume is off 3% YoY. Instead, taxable issuance has more than tripled relative to last year ($52.8B vs. $15.9B) with it now representing nearly 30% of total municipal issuance YTD.

AAA Municipal Yields



Maturity	12/31/19	3/31/20	5/31/20	6/30/20	1Mo Δ	Q2 Δ	YTD Δ
1	1.06%	1.07%	0.08%	0.21%	0.13%	-0.86%	-0.85%
2	1.06%	1.09%	0.14%	0.26%	0.12%	-0.83%	-0.80%
3	1.07%	1.12%	0.21%	0.29%	0.08%	-0.83%	-0.78%
5	1.14%	1.17%	0.42%	0.46%	0.04%	-0.71%	-0.68%
7	1.25%	1.28%	0.55%	0.61%	0.06%	-0.67%	-0.64%
10	1.48%	1.44%	0.82%	0.86%	0.04%	-0.58%	-0.62%
30	2.15%	2.08%	1.74%	1.70%	-0.04%	-0.38%	-0.45%

Market Awaits Additional Fiscal Stimulus as Austerity Measures Begin

The typical challenges municipalities face in a recession are becoming evident in the current economic backdrop. Tax revenues have fallen and demand for services has risen, forcing state and local governments to draw on reserves while they await federal fiscal support. Unlike the federal government, which can and does run large budget deficits, state and local governments are required to balance their budgets so, not surprisingly, austerity measures are underway. To date, 1.4 million public sector workers (7% of the total government payroll) have been laid off or furloughed, exceeding the 3.3% government job losses during the Great Recession. A survey by the National League of Cities reports that 65% of cities are either delaying or canceling planned infrastructure projects. Also, reportedly 70% of cities have yet to receive any of the $150B CARES Act funding. Although first time defaults on municipal debt are rising, Municipal Market Advisors reported 36 first time payment defaults YTD, the highest pace since 2012. Defaults have been focused on below investment grade issues, particularly among retirement facilities. Not surprisingly, investors anxiously await additional federal support, with hopes that a compromise can be reached by month end. GOP demands for Covid-related liability protection for companies as employees return to work appears to be necessary for a deal to be reached. The size of the total package under consideration is currently estimated at approximately $1 trillion, with significant funds directed toward state and local governments, but sentiment is divided both on the size and timing of another package.

Long End Outperforms in June; High Quality Significantly Outperforms Lower Quality in Q2

Municipal investors were rewarded in Q2 following the extreme volatility in March. Although the longest maturities outperformed other curve segments in June and the quarter, the intermediate segment has provided the best YTD return. Credit spreads narrowed last month as investors sought the additional yield of lower quality issues, but lower quality issues have lagged significantly YTD; AAA issues outperformed BBBs by 547 bps for the six months through June and High Yield issues were even further behind.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	June	Q2	YTD
Municipal Bond Index	0.82%	2.72%	2.08%
General Obligation bonds	0.37%	2.86%	2.98%
Revenue bonds	1.10%	2.73%	1.69%
Prerefunded bonds	-0.16%	1.94%	2.24%
Long maturities (22+ yrs.)	1.49%	2.93%	1.70%
Intermediate maturities (1 - 17 yrs.)	0.58%	2.69%	2.18%
Short maturities (1 - 5 yrs.)	0.20%	2.19%	1.77%

Bloomberg Barclays Quality	June	Q2	YTD
AAA	0.03%	2.86%	3.42%
AA	0.38%	2.69%	2.73%
A	1.49%	2.70%	1.36%
BBB	3.28%	2.79%	-2.05%
High Yield	3.96%	4.55%	-2.64%
HY, ex-Puerto Rico	3.63%	3.73%	-3.38%

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.