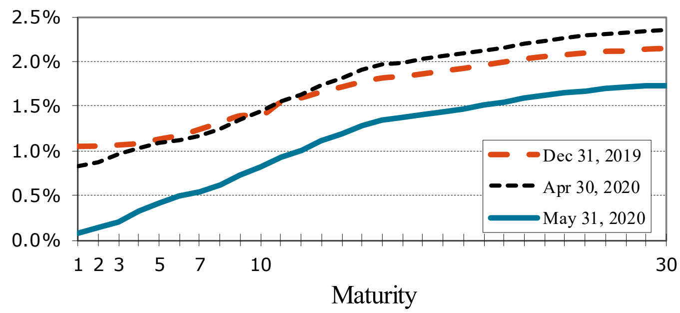
Baird Advisors
Municipal Fixed Income Market Commentary
May 2020

Yields Plummet, Curve Steepens as Municipal Market Rebounds

Tax-free rates fell sharply in May on strong investor demand and moderate new supply. Short-term rates fell the most (-75 bps), ending the month with 1yr AAA yields of just 0.08%, not far from the lower bound of the Fed's 0% - 0.25% fed funds target range. Intermediate and long-term yields also fell (-60 bps), although less than short rates, which steepened the yield curve. At month end, all yields across the AAA tax-free curve were lower than at the start of the year, something that seemed very unlikely at the height of the liquidity crisis in mid-March. Expectations of ongoing monetary and fiscal support encouraged investors to return to the market and tax-free fund cashflows turned positive in the last three weeks of May. YTD fund flows are still deeply negative, at -$18.8B, but that is an improvement from -$21.7B at the end of April. Regardless of the outlook for fund flows, strong reinvestment demand is expected over the favorable summer seasonal period. In June, an estimated $45B of principal will roll off from maturities and early calls, and there will be more than $120B rolling off from June through August. Add $46B of expected coupon payments over the summer and there is a high probability that demand will exceed supply over the next few months.

AAA Municipal Yields



Maturity	12/31/19	4/30/20	5/31/20	1Mo Δ	YTD Δ
1	1.06%	0.83%	0.08%	-0.75%	-0.98%
2	1.06%	0.88%	0.14%	-0.74%	-0.92%
3	1.07%	0.96%	0.21%	-0.75%	-0.86%
5	1.14%	1.09%	0.42%	-0.67%	-0.72%
7	1.25%	1.17%	0.55%	-0.62%	-0.70%
10	1.48%	1.44%	0.82%	-0.62%	-0.66%
30	2.15%	2.35%	1.74%	-0.61%	-0.41%

Credit Spreads Widen Even as States Reopen; Significant Credit Uncertainty Remains

Tax-free credit spreads widened in May despite the strong market tone and all 50 states in some stage of reopening. For example, the yield difference between BBBs and AAAs rose 19 bps last month (+270 bps from +251 bps) and has gapped wider by 200 bps since the end of February. Investors are rightly pricing in greater uncertainty as the credit impact of the economic stop, required to slow the spread of Covid-19, has, to varying degrees, impacted every sector of the municipal market. Approximately one million public sector workers have already been laid off; more than the 600,000 public jobs lost between 2008 and 2011 in the aftermath the Great Recession. Additional fiscal support is expected, but size and timing is unclear, suggesting more austerity measures are likely. Last month, the Democratic-controlled House passed the $3 trillion HEROES Act, which would provide $1 trillion to municipalities, but in the Senate, Mitch McConnell declared it "dead on arrival." There is a bipartisan effort by some senators to craft a plan that would provide $500B to state and local governments, but it is in the early stages. There was additional clarification in May on the Fed's Municipal Liquidity Facility (MLF), which allows the Fed to buy up to $500B of debt directly from the largest municipal issuers. Although the rates at which the Fed is willing to lend are relatively punitive, particularly for higher quality issuers (e.g. at the Overnight Index Swap (OIS) rate +150 bps for AAA rated municipalities), for lower quality issuers it may be an attractive alternative relative to the public markets.

Strong Rally in May Boosted YTD Returns Into Positive Territory

The strong rally last month produced positive returns across the municipal market and pulled YTD returns into positive territory as well. Not surprisingly, on an absolute basis, long maturities outperformed short-term issues given the magnitude of the rate decline. The General Obligation sector outpaced Revenue bonds, while the short-term nature of the Prerefunded sector lagged. Widening credit spreads caused the BBB category to lag AAA items, although High Yield had a strong month. YTD, however, higher quality issues have significantly outperformed lower quality tax-free debt because of the uncertain economic environment.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	May	YTD	Bloomberg Barclays Quality	May	YTD
Municipal Bond Index	3.18%	1.24%	AAA	3.22%	3.38%
General Obligation bonds	3.46%	2.60%	AA	3.26%	2.34%
Revenue bonds	3.19%	0.58%	A	3.02%	-0.13%
Prerefunded bonds	1.69%	2.40%	BBB	3.09%	-5.17%
Long maturities (22+ yrs.)	4.16%	0.21%	High Yield	4.08%	-6.35%
Intermediate maturities (1 - 17 yrs.)	2.84%	1.60%	HY, ex-Puerto Rico	3.82%	-6.76%
Short maturities (1 - 5 yrs.)	1.85%	1.57%			

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.