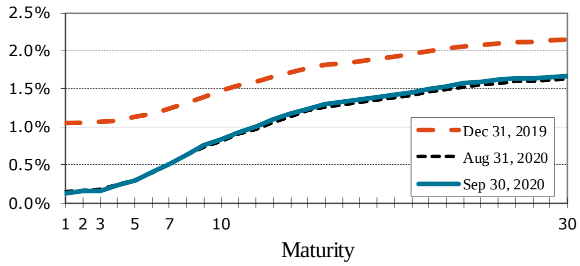
Baird Advisors
Municipal Fixed Income Market Commentary
September 2020

Volatility Declines and Curve Steepens as Yields Fall in Q3

Tax-free rates were little changed in September but fell for the quarter. The curve steepened in Q3 as short- and intermediate-term rates declined, led by a drop in the 5yr yield of 17 bps, while longer yields fell 3 bps. As the quarter progressed, market volatility fell, with yields unchanged for several days in September despite ongoing uncertainty over additional fiscal stimulus and the looming November elections. Investor demand for municipals was strong and consistent against modest levels of tax-exempt supply. Flows into municipal funds across the market were positive in all but the final week in Q3 bringing total YTD flows to $20B. The supply picture remains inflated by the heavy issuance of taxable municipals. While total municipal supply through September was 32% ahead of last year's pace, more than one-third (36%) has been taxable (historically taxable municipals have represented 10 – 15% of annual supply). Taxable issuance has more than tripled ($132B vs. $38B) while tax-exempt supply has *fallen* by 3% YoY. It is easy to see why yield volatility fell in September, given the already low level of rates, the strong supply/demand technical backdrop and a monetary policy intent on holding short-term rates near zero until inflation runs above 2% for some undefined period. It is an environment in which optimizing roll opportunities along the curve becomes particularly important while at the same time prudently seeking safe-yield opportunities in the market.

AAA Municipal Yields



Maturity	12/31/19	6/30/20	8/31/20	9/30/20	1Mo Δ	Q3 Δ	YTD Δ
1	1.06%	0.21%	0.15%	0.13%	-0.02%	-0.08%	-0.93%
2	1.06%	0.26%	0.17%	0.15%	-0.02%	-0.11%	-0.91%
3	1.07%	0.29%	0.18%	0.16%	-0.02%	-0.13%	-0.91%
5	1.14%	0.46%	0.31%	0.29%	-0.02%	-0.17%	-0.85%
7	1.25%	0.61%	0.50%	0.51%	0.01%	-0.10%	-0.74%
10	1.48%	0.86%	0.81%	0.84%	0.03%	-0.02%	-0.64%
30	2.15%	1.70%	1.62%	1.67%	0.05%	-0.03%	-0.48%

Tax Revenues Better Than Expected; Municipalities Nonetheless Take Action

State and local tax revenues have fallen less than initially feared. Headline declines of 25% or more for second quarter tax revenues are misleading since April tax payments were pushed back to July. Recent data that adjusts for the filing extension show that the average YTD state tax decline has averaged just 2.5% for the 47 states that have reported. Not surprisingly, state tax revenues are closely aligned with the GDP and a strong initial "V" shaped recovery in Q3 (est. ~ 30% GDP annualized growth) has propelled the recent tax revenue improvement. Average local tax revenues have performed similarly, with most benefiting from of a stable property tax base (so far) which offsets greater fluctuations in sales and income taxes. Moody's recently lowered their estimate of total tax loss for state and local governments to $450B (from $500B) through FY22. While large, when the $182B from the CARES Act is added back, plus an assumed draw of $72B from reserves is considered, the remaining funding gap declines to $196B. This amount is in line with the range of recent stimulus discussions between the House ($436B) and the Trump Administration ($250B). Not waiting on the stimulus, municipalities across the country are taking steps to address the deficits. Some are raising taxes – New Jersey raised the income tax rate on millionaires while also boosting both gas tax and toll rates. Across the board budget cuts, including worker furloughs/layoffs, are common. Many municipalities have bought additional time for the economy to recover through short-term borrowing or refinancing and extended principal payments on existing debt – a strategy often referred to as "scoop and toss." In the past this approach was viewed negatively by both the rating agencies and market participants, but in the current environment it is considered a prudent fiscal move. Until tax revenues fully recover, whenever that may be, municipalities will continue to lobby for federal support even as they take appropriate measures to close budget deficits.

Riskier Strategies Outperform – Longer Maturities and Lower Quality Set the Pace in Q3

Although price and yield changes in September were muted, returns were positive across all market and curve segments in Q3. Longer maturities outperformed other segments of the curve and, not surprisingly, the shorter-duration Prerefunded sector lagged the longer-duration Revenue and GO sector returns. Lower quality credit categories also outperformed higher quality as credit spreads between BBB and AAA rated issues narrowed by 42 bps during the quarter.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	September	Q3	YTD
Municipal Bond Index	0.02%	1.23%	3.33%
General Obligation bonds	-0.07%	0.92%	3.92%
Revenue bonds	0.05%	1.43%	3.14%
Prerefunded bonds	0.11%	0.38%	2.63%
Long maturities (22+ yrs.)	-0.14%	1.41%	3.14%
Intermediate maturities (1 - 17 yrs.)	0.08%	1.15%	3.35%
Short maturities (1 - 5 yrs.)	0.12%	0.70%	2.49%

Bloomberg Barclays Quality	September	Q3	YTD
AAA	0.04%	0.80%	4.24%
AA	0.05%	0.96%	3.71%
A	0.00%	1.45%	2.83%
BBB	-0.15%	3.11%	0.99%
High Yield	0.10%	3.09%	0.37%
HY, ex-Puerto Rico	0.20%	3.25%	-0.24%

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.