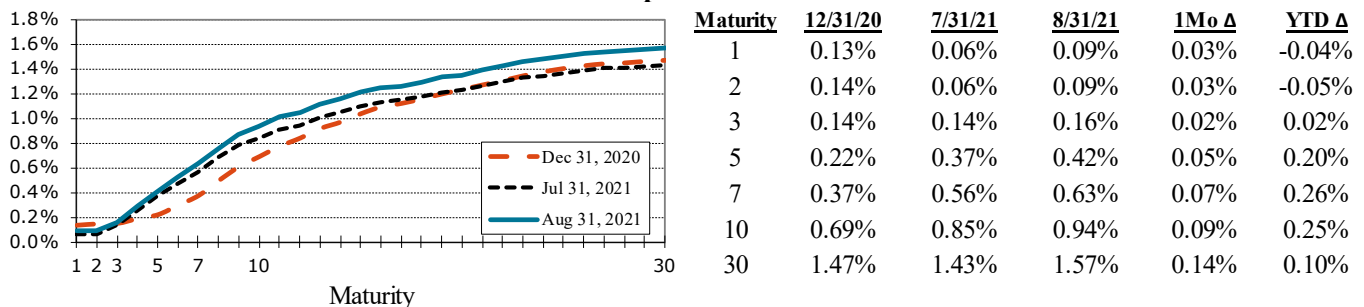


Baird Advisors
Municipal Fixed Income Market Commentary
August 2021

Municipal Yields Rise and Curve Steepens

Municipal yields rose in August and the yield curve steepened modestly. The current slope of the curve from 2 – 30 years roughly matches the average slope observed over the past 1- and 5-year periods, providing valuable roll down opportunities, particularly in the intermediate maturity range. August was another month of light secondary market trading, in fact trading volume YTD is the lowest it has been in 20 years. The lack of selling/swapping activity is driven primarily by the record YTD fund inflows of \$80.8B as investors are focused on simply getting new cash invested. There has been less need, therefore, to sell existing holdings, which also helps to minimize unwanted capital gains. From a supply perspective, total issuance jumped 19% MoM in August thanks to relatively robust tax-exempt issuance while new taxable supply slipped. YTD total municipal issuance is up 2% YoY to the highest pace in more than a decade, but it has been easily absorbed by strong investor demand.

AAA Municipal Yields



Municipal Credit Ratings Improving Despite Evident Natural Disaster Risks

The Covid pandemic brought uncertainty to the finances of many municipal issuers which led to negative rating outlooks and downgrades across wide swaths of the market. That trend has reversed as S&P reported in August that the number of rating upgrades exceeded downgrades for the first time since emergence of the pandemic in Q1 of 2020. In fact, in Q2 there was the lowest level of municipal rating downgrades since 2009. Improved operations and finances, primarily driven by stimulus payments and rising tax revenues from reopening trends, drove the S&P rating moves. The Hospital sector, at the epicenter of the pandemic response, lagged slightly in the S&P rating upgrades, but forward-looking rating outlooks are improving. In Q2, there were 17 positive outlook revisions in the Hospital sector and just 2 negative revisions; 85% of S&P's healthcare municipals either had a stable or positive rating outlook. For the broader municipal market, credit fundamentals remain strong even as investors closely monitored the impact of Hurricane Ida, which made landfall on August 29 as a category 4 storm, as well as the massive wildfires spreading across parts of California. Because of the hurricane, President Biden has already declared a major disaster in Louisiana as well as an emergency declaration in Mississippi due to Ida-related damages. Flooding, wind damage and power outages have impacted residents and businesses as well as curbed oil and gas production in the region. 3,600 Federal Emergency Management Agency (FEMA) employees have been deployed and federal aid funds are anticipated. Monitoring natural disaster and environmental risks in the municipal market remains an integral part of fundamental research. Hurricane Ida losses are expected to be significantly less than those experienced following Hurricane Katrina 16 years ago. Thankfully, \$14.5B in flood protection enhancements were made in New Orleans, proving to be money well spent to protect the region. Fortunately, Moody's rating service has noted that such natural disasters have not led to a single historical municipal bond default.

Lower-Quality Outperformance Stalls and Long-Term Maturities Lag

After five consecutive months of positive returns, rising yields pushed results into negative territory in August. Short-term maturities held their value best as the curve steepened which also helped the relative performance of the Pre-refunded sector, which has a shorter duration than other market sectors. The consistent outperformance of lower-rated municipals in recent months over higher-quality issues paused in August, but still holds a significant performance advantage YTD.

Total Returns of Selected Bloomberg Municipal Indices and Subsectors

| <u>Bloomberg Index/Sector</u> | <u>August</u> | <u>YTD</u> | <u>Bloomberg Quality</u> | <u>August</u> | <u>YTD</u> |
|---------------------------------------|---------------|------------|--------------------------|---------------|------------|
| Municipal Bond Index | -0.37% | 1.53% | AAA | -0.40% | 0.45% |
| General Obligation bonds | -0.34% | 1.04% | AA | -0.34% | 0.94% |
| Revenue bonds | -0.40% | 1.84% | A | -0.40% | 2.26% |
| Prerefunded bonds | -0.06% | 0.26% | BBB | -0.36% | 4.84% |
| Long maturities (22+ yrs.) | -0.80% | 2.60% | High Yield | -0.16% | 7.23% |
| Intermediate maturities (1 - 17 yrs.) | -0.20% | 1.10% | HY, ex-Puerto Rico | -0.16% | 7.36% |
| Short maturities (1 - 5 yrs.) | -0.03% | 0.63% | | | |

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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