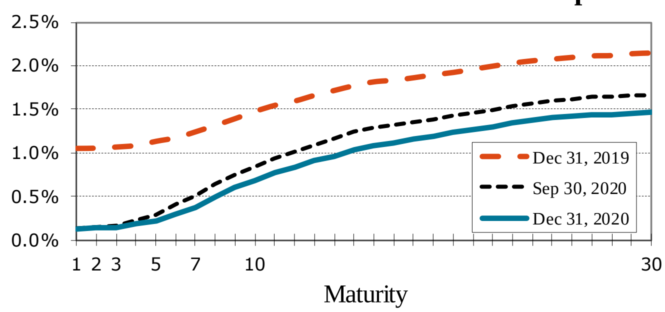
Baird Advisors
Municipal Fixed Income Market Commentary
2020 Review and 2021 Outlook

Key Municipal Events of 2020

The Covid-19 challenges of 2020 were unexpected and unprecedented, but so was the speed and magnitude of the monetary and fiscal responses. The result was a year of significant volatility, yet a rewarding one for investors who stayed the course. Over the full year, tax-exempt rates fell sharply across the curve with short rates falling 93bps and long yields declining 68bps, steepening the curve. As the year began, no one could have known the challenges that would soon be faced. Municipal funds were benefiting from a record streak of weekly inflows, state and local tax revenues were rising with the economy in its eleventh year of expansion and municipalities were adding to an already healthy level of reserves. News broke in January of the Covid-19 virus in the State of Washington; by the end of February, seven states had confirmed cases and it was spreading rapidly. Trading activity in the municipal market initially froze as the lockdowns began, then a torrent of selling was unleashed and a liquidity crisis quickly emerged.

Not only did the record streak of fund inflows end (at 60 weeks), but record weekly *outflows* occurred as municipal funds lost \$12.2B and \$13.7B in just the last two weeks of March, each 3 times larger than any prior weekly redemption. The selling and lack of dealer support for the market drove tax-exempt yields to record highs relative to comparable maturity Treasuries. At the peak, 5yr AAA exempt yields were 900% of the 5yr Treasury yield. Ten-year AAA municipal yields rose 190 bps (to 2.88%) in the first three weeks of March. Credit spreads widened dramatically as well; the BBB to AAA spread gapped out 210bps (to +280bps) before peaking in mid-May. Never had a U.S. economic shock been so swift, deep and broad, affecting so many municipalities. Investors were questioning the ability of municipalities to withstand this crisis and meet their obligations. Not surprisingly, the heaviest redemptions occurred in the High Yield segment of the municipal market.

AAA Municipal Yields



Maturity	12/31/19	9/30/20	12/31/20	Q4 Δ	2020 Δ
1	1.06%	0.13%	0.13%	0.00%	-0.93%
2	1.06%	0.15%	0.14%	-0.01%	-0.92%
3	1.07%	0.16%	0.14%	-0.02%	-0.93%
5	1.14%	0.29%	0.22%	-0.07%	-0.92%
7	1.25%	0.51%	0.37%	-0.14%	-0.88%
10	1.48%	0.84%	0.69%	-0.15%	-0.79%
30	2.15%	1.67%	1.47%	-0.20%	-0.68%

Sellers couldn't know how rapid and coordinated the response would be from policymakers (the Fed, Congress and the Trump administration) who agreed to provide massive support to stabilize the market. On March 27th, the President signed the \$2.2 trillion CARES Act which, along with other measures, offered substantial aid to nearly every sector of the municipal market. The goal was to cover Covid-19-related costs and help offset lost revenue. In addition, the establishment of the Municipal Liquidity Facility (MLF), which, for the first time ever, allowed the Fed to lend directly to states and other select municipalities. This facility, although used by just two municipalities (State of IL and NY MTA), most importantly offered investors the psychological support they were looking for. As the policymakers acted, AAA-rated municipal yields peaked on March 20th and opportunistic investors began to emerge, looking to capitalize on the incredible undervaluation that had been created in the downdraft. While the entire municipal market was "on sale," the hardest-hit sectors, such as Healthcare, Higher Education and Transportation, offered some of the best values for risk-seeking investors. From a credit perspective, the further in time we moved away from the initial economic shutdowns, the better the news became on tax revenues. Rather than the steep tax losses states initially anticipated, average tax revenues through September were down just 1% YoY, with most states within a +/- 5% range of the prior year. Not surprisingly, the states most dependent upon tourism, such as Nevada (-15.9%), Hawaii (-12.5%) and Florida (-11.1%) saw the greatest revenue declines. Other states, however, fared much better, experiencing YoY increases in tax revenue, including Vermont (+15.1%), New Mexico (+12.1%) and Idaho (+10.3%). Cities and school districts, which are more reliant on property taxes, saw average revenues rise over 4% YoY thanks to a strong residential housing market in most regions.

Investor demand was impressive once fund inflows resumed. In fact, annual 2020 net inflows of \$39.7B were the fourth highest on record, something that seemed nearly impossible amid the \$47.5B of redemptions over a five-week period in March/April. Several records were established on the supply side as well. Total municipal supply of \$500B in 2020 was a new record, as was October's issuance of \$80B just prior to the November elections. The heavy issuance was driven by a record \$181B of taxable municipal issuance (36% of total). This was up from \$83B in taxable supply in 2019, even exceeding the Build America Bond (BAB) issuance of 2010. While taxable municipal debt grew, tax-exempt issuance fell 6% YoY (to \$317B), providing a favorable supply/demand backdrop for tax-paying investors.

Finally, the 2020 elections also provided drama and some ongoing uncertainty. Amid claims of voter fraud by President Trump, President-elect Biden won a majority of both the popular vote and electoral college. Republicans did gain seats in the House, narrowing the Democratic majority, while control of the Senate hinges on the runoff elections in Georgia on January 5th. If Democrats gain control of the Senate, the probability of at least modest tax changes, additional fiscal stimulus and perhaps even a federal infrastructure plan all increase. One surprise among the many state referendums was the defeat of an Illinois constitutional amendment to move from a flat tax to a graduated income tax which they estimated would boost tax revenues by $3B annually. This makes Illinois' already difficult fiscal situation even more challenging. So far, the rating agencies have maintained the state's ratings at the lowest investment grade level awaiting the next steps by the Governor and legislature.

Solid Q4 Returns Complement Surprisingly Strong Full-Year Results

The decline in rates in Q4, primarily among intermediate and long-term rates, added to the already strong full-year returns. While short-term funds benefited from heavy inflows in 2020, performance among the longest maturities (6.25%) easily outperformed short maturities (2.83%) for the year. The Revenue sector outperformed other sectors in Q4, but GO's edged them out for all of 2020. A similar pattern emerged within the credit spectrum where lower quality issues set the pace in Q4, but AAA's, having held their value best during the economic lockdowns, outperformed lower-quality credits for the year.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	December	Q4	2020	Bloomberg Barclays Quality	December	Q4	2020
Municipal Bond Index	0.61%	1.82%	5.21%	AAA	0.28%	1.22%	5.51%
General Obligation bonds	0.48%	1.51%	5.49%	AA	0.43%	1.47%	5.24%
Revenue bonds	0.71%	2.11%	5.31%	A	0.82%	2.37%	5.27%
Prerefunded bonds	0.07%	0.12%	2.76%	BBB	1.72%	3.53%	4.55%
Long maturities (22+ yrs.)	0.92%	3.02%	6.25%	High Yield	1.87%	4.51%	4.89%
Intermediate maturities (1 - 17 yrs.)	0.48%	1.33%	4.73%	HY, ex-Puerto Rico	1.87%	4.27%	4.02%
Short maturities (1 - 5 yrs.)	0.20%	0.33%	2.83%				

2021 Outlook and Opportunities

While the entire world is anxious to turn the calendar to a new year, for the municipal market the early part of 2021 will likely be a continuation of the trends from late 2020. Covid-19 will continue to preoccupy the news, but with a shifting focus to vaccine distribution rather than a spreading virus. Although it may be several months before economic activity returns to pre-pandemic levels, the powerful combination of monetary and fiscal measures, as well as pent-up consumer demand, especially for travel and entertainment, should provide strong economic growth in 2021. The economic recovery will boost tax revenues, allowing municipalities to rebound from the pandemic decline. The favorable supply/demand backdrop that has supported tax-exempt municipal prices – even richening them relative to taxables in Q4 – should keep valuations elevated. Supply estimates for the new year are unusually wide given uncertainty on rates and how much refunding activity may occur, but total supply could match or even exceed the $500B of 2020. Taxable municipal issuance will remain robust, once again comprising one-third or more of total supply. While the taxable market grows, a trend that may continue for many years, the amount of tax-exempt debt outstanding is expected to remain steady or even decline in 2021. Demand remains strong even in the face of low nominal rates. Clearly, demographics play an important role as more baby boomers retire. This secular trend should continue to provide ongoing support, even increasing demand if rates were to rise. While investors realize the income return going forward will be less than in recent years, the desire to preserve capital may take on even greater importance in their allocation decisions. Coincidentally, the majority of municipal fund flows in 2020 went into short-term funds.

Seeking opportunities to add value to a managed municipal portfolio/fund in 2021 will be more important than ever given the low starting yield levels. In addition to the always important bottom-up security selection process, four key strategic areas of focus will be: **Carry, Credit, Compression and Curve**. We define "carry" here as the additional yield that a managed portfolio offers relative to an unmanaged benchmark. Any yield advantage should prove helpful since over extended periods "income" is the dominant contributor to total return. Secondly, credit analysis will be critical as not all municipalities will recover at the same pace, or to the same extent. Credits will need to be evaluated based on not only their sustainability through this period, but also on how longer-term behaviors and trends may have changed as a result of the pandemic. A third strategic opportunity exists through the further compression, or narrowing, of credit spreads. Narrowing spreads can occur when fundamental credit strength improves, as we expect in 2021, and as demand for additional yield is sought by investors, which was evident in Q4. Municipal spreads have already recovered more than one-half of the widening of 2020, but there is room for further compression, particularly if the municipal market follows the lead of corporate credit spreads which are virtually back to pre-pandemic levels. The desire for carry and the expectation of further spread compression support a modest credit overweight in prudently managed and appropriately diversified portfolios. A fourth strategic opportunity to add value in 2021 will be by optimizing curve exposure, particularly the benefit of rolling down an upwardly sloping curve. At year end, there was 45 bps of slope between the 5 – 10yr segments of the municipal curve. The intermediate segment, especially the 8 – 9yr maturities, offers investors roughly 70 bps of roll return over a twelve-month period assuming the curve slope remains unchanged. For perspective, the roll benefit on AAA bonds in that portion of the curve roughly matches the starting yields of 0.69% - 0.77% for those same maturities. We expect every basis point to matter in 2021, so strategic positioning of portfolios will be especially important as we look to the new year.

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.