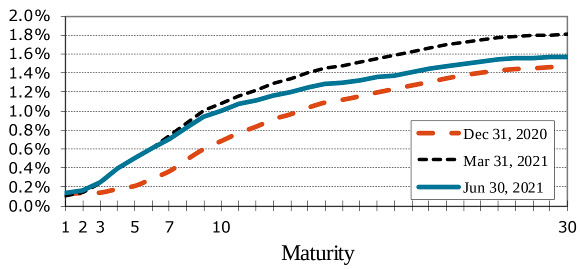
Baird Advisors
Municipal Fixed Income Market Commentary
June 2021

Curve Flattens on Both Record Demand and Supply

The tax-exempt curve flattened in the quarter (and June) as short rates rose 4 bps and long-term yields fell 24 bps. The curve shift was driven, in part, by the market's reaction to the Fed's updated economic projections in June (i.e., dot plots) which pulled forward expectations of the first rate adjustment; 13 of 18 members now expect at least one rate hike by the end of 2023. But the solid tone this quarter was primarily due to persistently strong demand even in the face of near-record issuance. Municipal fund inflows of $60B YTD were a first-half record and would already qualify as the third highest calendar year inflow ever. The anticipation of higher taxes, a much-improved state/local government credit outlook (see below) and an upwardly sloped curve which incentivizes maturity extension, have all contributed to the solid tone so far in 2021. Strong seasonal support also played a role in June as Bloomberg estimates that $165B of cash will be available for reinvestment over the June–August period from municipal maturities, calls and coupon payments. On the supply side, new issuance was surprisingly strong as both the second quarter and YTD totals were the highest ever for those periods. Of course, total supply was boosted by $66.2B of taxable issuance (28% of the total), but even the $170M of tax-exempt issuance was the most for any January–June period on record.

AAA Municipal Yields



Maturity	12/31/20	3/31/21	5/31/21	6/30/21	1Mo Δ	Q2 Δ	YTD Δ
1	0.13%	0.10%	0.09%	0.14%	0.05%	0.04%	0.01%
2	0.14%	0.14%	0.11%	0.16%	0.05%	0.02%	0.02%
3	0.14%	0.24%	0.19%	0.25%	0.06%	0.01%	0.11%
5	0.22%	0.50%	0.45%	0.51%	0.06%	0.01%	0.29%
7	0.37%	0.73%	0.66%	0.70%	0.04%	-0.03%	0.33%
10	0.69%	1.08%	0.97%	1.00%	0.03%	-0.08%	0.31%
30	1.47%	1.81%	1.59%	1.57%	-0.02%	-0.24%	0.10%

Fiscal Support and Record Tax Revenues Lead an Impressive Recovery for Municipal Credit

The rebound in municipal credit over the last year is both impressive in magnitude and unprecedented in speed. Few could have predicted at the depths of the Covid-pandemic that just over one year later most municipalities would be awash in cash and benefiting from record tax revenues as municipalities are today. The credit rebound is most evident at the state government level where, for example, California swung from an expected $54B budget deficit last March for the fiscal year just ended June 30th, to now a $76B surplus. New Jersey, a rating-challenged state (A3, with a Negative outlook until April), had its rating affirmed and the outlook upgraded to Stable last quarter. The recently-passed NJ state budget provides for the largest state pension payment ever, at $6.9B, $500M more than actuarily required, and the governor plans to pay down $2.5B of debt. Even Illinois, the state most often used to illustrate fiscal challenges (by us and many others), a state that was on the verge of losing its investment grade rating (Baa3 – with a Negative outlook in 2020), was recently upgraded to Baa2 with a Stable outlook by Moody's; the first rating upgrade of the state by Moody's since 1998! The Illinois budget for the new fiscal year allows for an increase in its pension contribution, the repayment of an emergency loan from the Fed and the ability to reduce its backlog of unpaid bills. All states benefited mightily from the nearly $1.2 trillion of federal fiscal support directed to municipal entities, more than offsetting any Covid-related expenses, as well as the incredibly strong economic recovery as society reopened. While YoY tax collection data are distorted by the significant weakness last year, comparisons to the pre-pandemic period of 2019 are a helpful gauge. According to BofA Research, aggregate state tax collections for the two-month April/May period in 2021 were 16.8% higher than the same period in 2019. As the recovery continues the debate for most states has shifted from, how/where to cut, rather now to how/where to spend and invest the windfall.

Longer Maturities and Lower Quality Continued to Lead Returns

Risk-taking was rewarded in June and in Q2 as longer maturities and lower-quality issues outperformed other segments of the market. BBBs provided 55 bps and 163 bps of excess return over AAAs for the month and quarter, respectively. Revenue bonds marginally outperformed GOs over each period, but each easily outpaced the shorter and higher-quality Prerefunded sector over all periods YTD.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	June	2Q	YTD	Bloomberg Barclays Quality	June	2Q	YTD
Municipal Bond Index	0.27%	1.42%	1.06%	AAA	0.12%	0.97%	0.06%
General Obligation bonds	0.19%	1.09%	0.55%	AA	0.18%	1.17%	0.51%
Revenue bonds	0.33%	1.66%	1.36%	A	0.44%	1.78%	1.84%
Prerefunded bonds	0.02%	0.18%	0.06%	BBB	0.67%	2.60%	3.91%
Long maturities (22+ yrs.)	0.69%	2.82%	2.33%	High Yield	1.27%	3.93%	6.13%
Intermediate maturities (1 - 17 yrs.)	0.13%	0.90%	0.57%	HY, ex-Puerto Rico	1.24%	3.81%	6.25%
Short maturities (1 - 5 yrs.)	0.01%	0.25%	0.33%				

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.

JG2020-1203*

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