

Muni Fortnightly

Treasury yields rise on concern for higher inflation and fed hawkishness. Baird issues reports on tax implications of discount bonds subject to De Minimis Rule. Muni ratios fall more.

PWM Fixed Income Research

Dave Violette, CFA, Vice President
Senior Fixed Income Analyst

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Bottom Line:

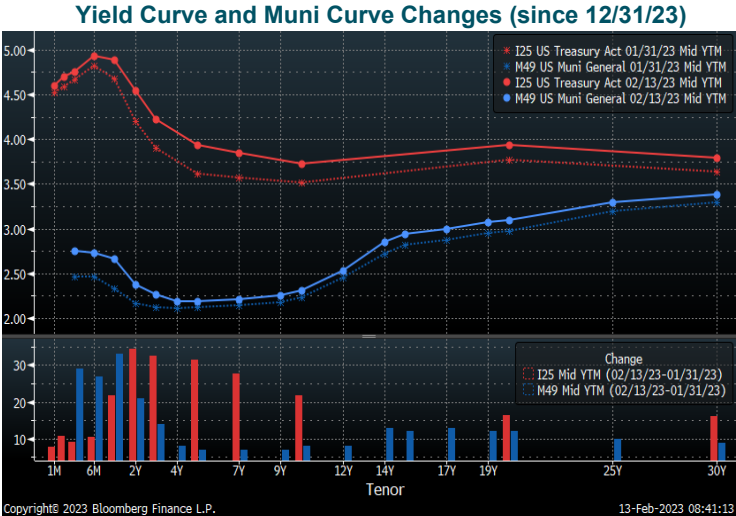
- Treasury and municipal yields rise sharply last week on re-inflation concerns.
- Muni valuations richen with 10yr AAA GO Ratio at lowest level since mid-2021.
- Baird highlights De minimis rules concerning municipal bond discount implications on taxes – see important links also in the body of this report concerning the tax treatment of bond discounts.
 - [Tax Treatment of Bond Premium and Discount](#) and [Tax Treatment of Bond Discount & Premium](#)
- Moody's highlights the strength of the Public Power Sector
- Moody's highlights state fiscal prudence and reserve strength into potential economic slowdown.

What Happened in the Bond Markets Last Week?

- Despite a relatively empty economic data calendar, Treasury yields managed to rack up some basis points and equities and credit spreads didn't shine either. With no real data of significance markets moved on ever more Fed speaker talk and on global changes. But for certain, the run up in yields was based on an expectation of higher near-term inflation data and associated Fed Funds Rate stickiness. The Rate which was once seen (not that long ago, pre-Labor report) to being cut by end of the year is no longer priced in. In fact, a substantial probability of a 3rd 25 bps hike yet to come is priced in - not just the two 25 bps rate hikes previously expected. This week, with much inflation data, will go a long way in developing market action between now and the next fed meeting on March 22nd.
- The Bloomberg Barclays Municipal Bond Index yield is 3.22%.
- The 10yr AAA GO Ratio has risen very sharply to 61.7.

(Since 1/31/23)	Treasuries		Munis (Bloomberg AAA GO Index)	
	Change (bps)	Yield (%)	Change (bps)	Yield (%)
3 mos.	+9	4.76%	-41	2.46%
1 year	+22	4.89%	-49	2.33%
2 year	+34	4.55%	-51	2.16%
5 year	+32	3.93%	-44	2.11%
10 year	+22	3.73%	-42	2.22%
30 year	+16	3.80%	-40	3.22%

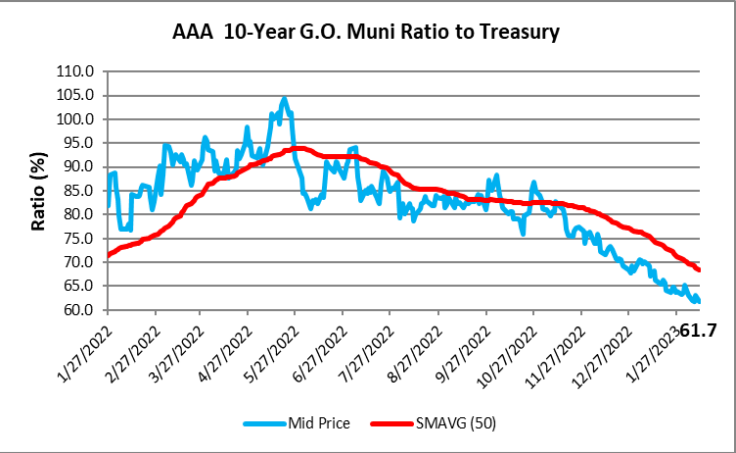
One can observe these changes by looking at how rates have changed along the curve for both the Treasury curve and for the AAA-rated G.O. Index since last week. The top panel shows four yield curves; two for the Treasury curve - one for the most current date and one from last week and two for the AAA-rated G.O. - current and last week. The bottom panel of the graph shows changes in the rates along both curves for the week for both Treasuries and the AAA G.O. Index.



Data Source: Bloomberg

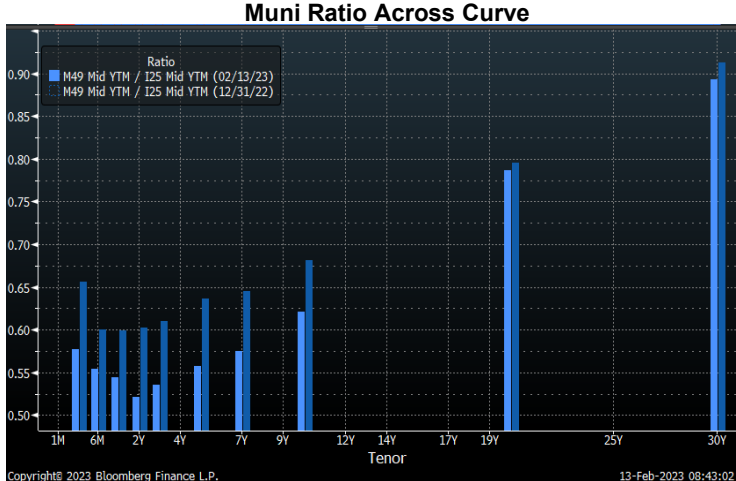
The 10yr AAA GO Ratio is 61.7.

The line graph to the right shows the ratio of 10-year AAA-rated muni yields to the 10-year Treasury yield over the last year.



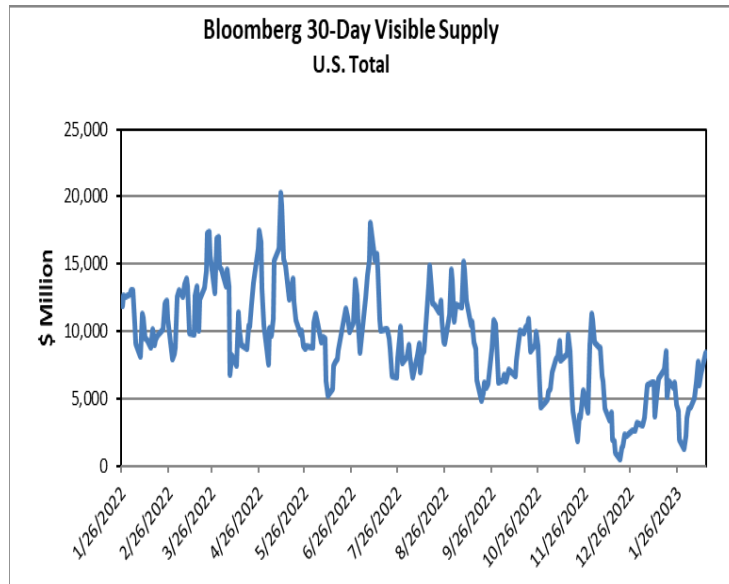
Data Source: Bloomberg

AAA Muni GO Ratios across the curve – changes since December 31, 2022.



Data Source: Bloomberg

Bloomberg 30-Day Visible Supply currently stands at \$8.4 billion. The 12-mo average is \$9.2 billion.



Data Source: Bloomberg

Articles of Interest

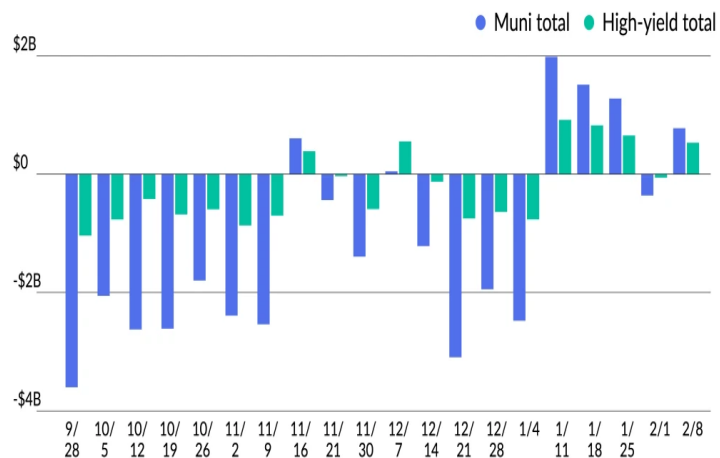
De Minimis Rule on Municipal Bond Discounts: FINRA has requested that firms communicate the tax implications of bonds trading at a discount. ***From Baird:*** With the rising interest rate environment, the price of bonds has been driven lower making securities more vulnerable to negative tax implications, such as the de minimis rule. The de minimis tax rule says that OID or market discount below a threshold is taxed as a capital gain when the bond matures or is sold. However, discounts larger than the threshold are taxed as ordinary income, even if the bond is a tax-exempt bond. With rising interest rates, these larger market discounts are more common. The de minimis level is 0.25% of a bond’s par value times the number of years between acquisition and maturity. Given that one of the primary benefits of municipal securities is that the coupon income received is generally exempt from taxation, the de minimis rule can create unintended, potential tax risk on investors in municipal bonds. Additionally, the potential taxes associated with the de minimis rule may present liquidity concerns as tax sensitive buyers in the secondary market may be less inclined to purchase the bonds from existing owners. Baird has published the [Tax Treatment of Bond Premium and Discount](#) and Summary of [Tax Treatment of Bond Discount & Premium](#) to help educate our clients about the tax treatment and risks associated with purchasing municipal bonds.

State Fiscal Governance and Reserves Provide Protection (Moody’s): In a *Sector Comment*, Moody’s indicates that while states two largest revenue streams are sales and income taxes and are sensitive to economic conditions they have suitable governance with respect to financial prudence and reserves to guard against potential economic slowing. The highlights of the report include: 1) Many states will incorporate slowing economic scenarios into their budgets, using less optimistic revenue forecasts for fiscal 2024. 2) While financial metrics may retreat from current “buoyant” levels they will maintain sizable surpluses and record reserves which will allow them to maintain credit quality.

Public Power Strong Financial Medians (Moody’s): Moody’s published a sector report on the Public Power sector financial conditions. Highlights of the report include: 1) fixed obligation charge coverage improved in 2021 from 2020 reflecting changing consumption patterns during the pandemic. 2) The sector has “ample liquidity” for market volatility and weaker economic conditions. 3) The median adjusted debt ratio increased slightly mainly due to an increase in adjusted net pension liabilities.

Muni Fund Flows: According to Refinitiv Lipper, muni funds had net inflows last week.

Refinitiv Lipper sees inflows



Source: Refinitiv Lipper

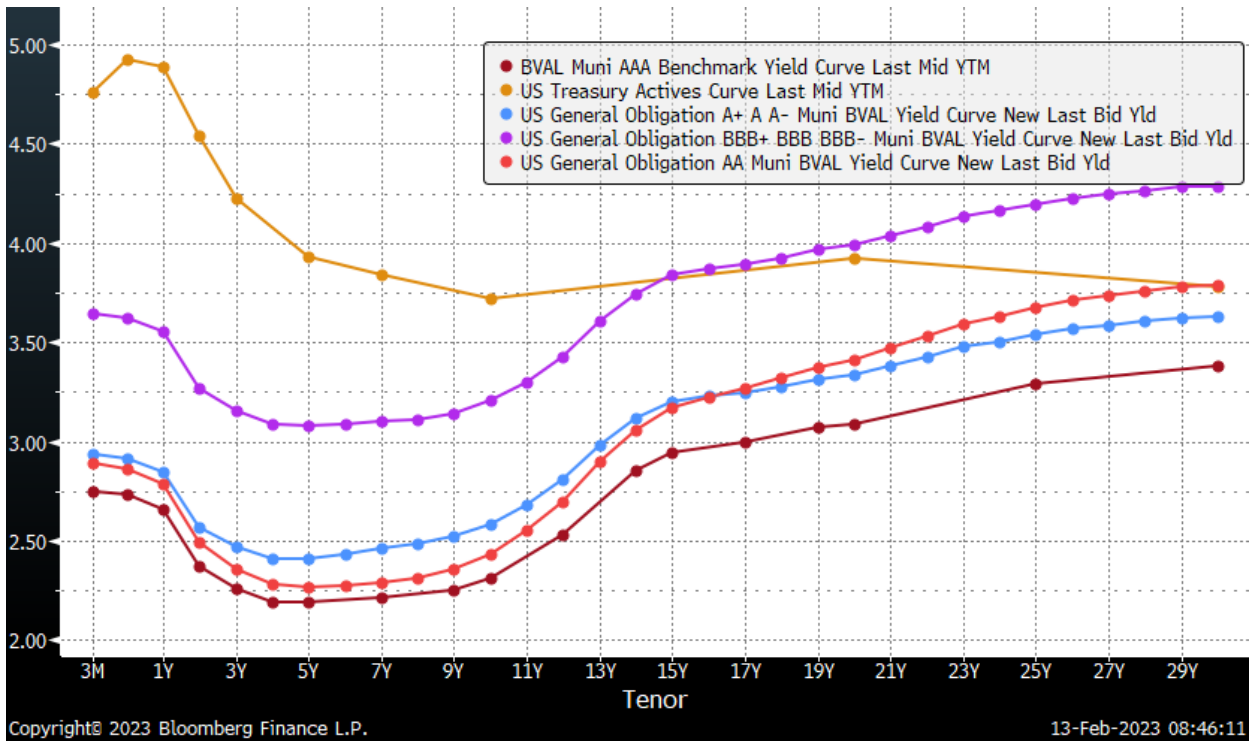
Relative Value by Maturity

AAA Muni Ratios and Spreads by Maturity - Data Source: Bloomberg

2/13/2023	Yield-to-worst (%)		0% Tax Rate		35% Tax Equivalent	
Maturity (yrs.)	AAA Gen. Oblig.	Treasury	Spread (bps)	Ratio (%)	Spread (bps)	Ratio (%)
1	2.66	4.88	-78.4	54.6	-78.4	83.9
2	2.38	4.55	-89.6	52.2	-89.6	80.3
3	2.26	4.23	-74.7	53.5	-74.7	82.3
4	2.20	4.07	-68.5	54.0	-68.5	83.2
5	2.19	3.94	-56.6	55.7	-56.6	85.6
7	2.22	3.85	-44.3	57.5	-44.3	88.5
10	2.31	3.73	-17.5	61.9	-17.5	95.3
15	2.95	3.71	82.7	79.5	82.7	122.3
20	3.10	3.94	83.0	78.7	83.0	121.1
25	3.30	3.87	120.6	85.3	120.6	131.2
30	3.39	3.80	141.5	89.2	141.5	137.2

Relative Value by Rating

Muni Index Yield Curve by Credit Rating – Data Source: Bloomberg



For more information please contact your Financial Advisor.

Appendix – Important Disclosures

Some of the potential risks associated with fixed income investments include call risk, reinvestment risk, default risk and inflation risk. Additionally, it is important that an investor is familiar with the inverse relationship between a bond's price and its yield. Bond prices will fall as interest rates rise and vice versa.

When considering a potential investment, investors should compare the credit qualities of available bond issues before they invest. The two most recognized rating agencies that assign credit ratings to bond issuers are Moody's Investors Service ("Moody's") and Standard & Poor's Corporation ("S&P"). Moody's lowest investment-grade rating for a bond is Baa3 and S&P's lowest investment-grade rating for a bond is BBB-. Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest).

The Bond Buyer 20-Bond Index consists of 20 general obligation bonds that mature in 20 years. The average rating of the 20 bonds is roughly equivalent to Moody's Investors Service's Aa2 rating and Standard & Poor's Corp.'s AA. The Bond Buyer 11-Bond Index uses a select group of 11 bonds in the 20-Bond Index. The average rating of the 11 bonds is roughly equivalent to Moody's Aa1 and S&P's AA-plus. The Bond Buyer Revenue Bond Index consists of 25 various revenue bonds that mature in 30 years. The average rating is roughly equivalent to Moody's A1 and S&P's A-plus. The indexes represent theoretical yields rather than actual price or yield quotations. Municipal bond traders are asked to estimate what a current-coupon bond for each issuer in the indexes would yield if the bond was sold at par value. The indexes are simple averages of the average estimated yields of the bonds, are unmanaged and a direct investment cannot be made in them.

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