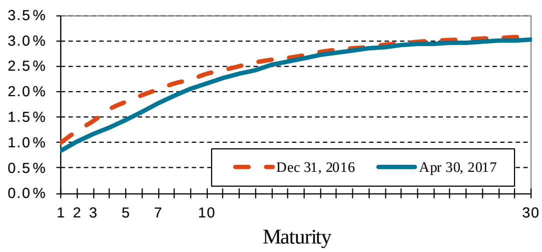
Baird Advisors
Municipal Fixed Income Market Comments
April 2017

Municipal Yields and Supply Remains Modest

Tax-free yields followed the lead of the Treasury market last month as yields fell across the municipal curve thanks to softer economic data, falling inflation rates, and light new supply. Municipal issuance in April fell 20% from the same month last year and YTD remains 12% behind 2016's pace. While new money borrowings are rising gradually, the level of refunding volume has been cut in half on a YoY basis; there is simply less debt to be refinanced given the rise in rates post-election and heavy refunding issuance in recent years. Demand for municipals remained solid, evidenced by the nearly $2.5B of positive tax-free fund flows last month. The inflows occurred despite the release of President Trump's tax reform outline, which would lower both corporate and individual tax rates to help boost the pace of economic growth. His plan would also simplify the individual tax code by cutting the number of tax brackets from seven to three (10%, 25%, and 35%). President Trump has promised more details on the plan in June, but the plan faces significant hurdles in its current form. Nonetheless, the market uncertainty is helping to keep tax-free valuations relatively appealing to taxable alternatives. The 10-year AAA tax-free yield, for example, is currently trading at 95% of a similar maturity taxable Treasury bond, implying a very low marginal tax rate.

AAA Municipal Yields



Maturity	Apr 30, 2016	Dec 31, 2016	Mar 31, 2017	Apr 30, 2017	1Mo Change	YTD Change	12Mo Change
1	0.56%	1.00%	0.85%	0.84%	-0.01%	-0.16%	0.28%
2	0.64%	1.23%	1.03%	1.01%	-0.02%	-0.22%	0.37%
3	0.76%	1.43%	1.22%	1.18%	-0.04%	-0.25%	0.42%
5	0.98%	1.80%	1.58%	1.45%	-0.13%	-0.35%	0.47%
7	1.22%	2.05%	1.92%	1.78%	-0.14%	-0.27%	0.56%
10	1.61%	2.35%	2.26%	2.16%	-0.10%	-0.19%	0.55%
30	2.58%	3.08%	3.07%	3.02%	-0.05%	-0.06%	0.44%

Credit Updates – General Obligation Sector

The general obligation (GO) sector is a meaningful component of the municipal market, typically representing between 25% - 40% of most municipal benchmarks. The GO sector includes both state and local issues, with the local issuers including cities, counties and school districts. While income taxes are the primary source of revenue for most states (for some it is sales taxes), property taxes are the dominant source of revenue for most local GOs. Not surprisingly, there is a strong correlation between national home price changes and property tax revenues and, as a result, the local GO sector has experienced broad swings in valuation during the sharp housing price declines of the financial crisis in 2008 – 09 and the subsequent steady improvement in values ever since. The post-crisis rise in home values has boosted property values and local tax revenues, helping municipalities to rebuild depleted reserves. Offsetting this improvement, however, has been an increase in pension costs. While many municipalities have enacted pension reforms to reduce future costs, more work and progress is needed. Unfortunately, pension investment returns have not met expectations and many municipalities have failed to make their full actuarially required annual pension contributions; the combination leaves many GO credits with rising pension and retirement related costs going forward. Higher pension costs are one reason that municipalities have been reluctant to borrow for infrastructure needs. New and/or higher taxes are being considered in many locations to meet growing needs, including higher sales taxes and user fees. For example, last month both California and Tennessee opted to increase their gasoline tax by 6 cents and 12 cents per gallon, respectively, to help fund infrastructure needs. We expect more states and local GO issuers to take similar steps to help meet rising pension and infrastructure costs.

Solid April Returns

April returns built upon the solid Q1 performance as municipal yields drifted lower across the yield curve. Although intermediate yields fell the most, longer maturities marginally outperformed both intermediate and shorter segments of the curve last month. Revenue bonds were the best performing sector last month and remain the YTD performance leader. Credit spreads widened modestly in April, but lower quality issues remain the best performing securities YTD.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	April	YTD	12Mo	Bloomberg Barclays Quality	April	YTD	12Mo
Municipal Bond Index	0.73%	2.32%	0.14%	AAA	0.70%	2.14%	-0.20%
General Obligation bonds	0.69%	2.33%	-0.14%	AA	0.72%	2.22%	0.01%
Revenue bonds	0.79%	2.43%	0.21%	A	0.79%	2.51%	0.58%
Prerefunded bonds	0.29%	1.29%	0.47%	BBB	0.63%	2.82%	0.33%
Long maturities (22+ yrs.)	0.74%	2.49%	0.08%	High Yield	0.68%	4.76%	4.38%
Intermediate maturities (1 - 17 yrs.)	0.71%	2.27%	0.21%	HY, ex-Puerto Rico	1.20%	6.00%	3.00%
Short maturities (1 - 5 yrs.)	0.32%	1.53%	0.63%				

Disclosures

This is not a complete analysis of every material fact regarding any company, industry or security. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

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.

Indices are unmanaged, and are not available for direct investment. *Past performance is not a guarantee of future results.*

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.