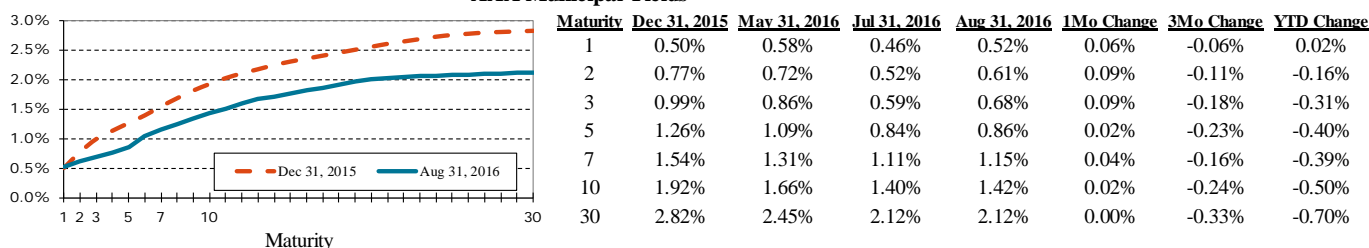


Baird Advisors
Municipal Fixed Income Market Comments
August 2016

Supply and Short-Term Rates Rise

New supply jumped significantly in August, both from the prior month and relative to the same month last year. Tax-free issuance rose 21% year-over-year in August as new money borrowings and refunding activity both accelerated, pushing year-to-date borrowing to just 1% behind last year's pace. Particularly encouraging has been the 9% year-over-year increase in new money borrowings to help meet the evident infrastructure needs all across the country. Demand was also robust as the streak of mutual fund inflows continued, stretching to 48 weeks now without interruption. Short term rates rose modestly last month while intermediate and longer-term maturities were little changed. While the increased probability of a September Fed Funds rate hike might explain part of the reason for higher short-term rates, the more direct cause was a supply/demand imbalance among tax-free money market securities due to pending regulatory reforms. In mid-October new SEC rules will require institutional money market funds to adopt a floating net asset value, plus the right to restrict investor withdrawals and impose liquidity fees at times of extreme market stress. The rule changes are causing many investors to switch to government money funds which are exempt from the new SEC rules. Therefore, the heavy selling of tax-free money market securities put upward pressure on both floating rate issues and short-term fixed rate yields last month.

AAA Municipal Yields



Credit Updates

President Obama announced the seven members that will serve on the Financial Control Board for Puerto Rico authorized by the recently passed PROMESA bill. The Board members were selected from a list provided by Congressional leaders from both parties and among the seven members three are Democrats and four are Republicans. Investor reaction to the selections was mixed. While viewed as a group of smart individuals with broad experience in finance and bankruptcy law, some were critical of the choice of two former presidents of the Government Development Bank (GDB), the entity which oversaw much of the debt issuance on the island. The Board has 30 days to designate a chairman who will oversee the review and restructuring efforts.

The recent slowing of U.S. economic growth is showing up in moderating state tax revenues. For example, for the fourth month in a row California state revenues came in below budget and July's figures fell 9.8% (\$591 million) short. The disappointment in July was broad based as personal income taxes, corporate taxes, and retail sales taxes were all below expectations. The California general obligation credit remains strong and highly-rated (Aa3/AA-/AA-), and the ease with which the state recently placed a \$2.6B borrowing indicates strong investor demand. Yet, if revenues don't improve over the next few months then mid-year spending adjustments will be necessary. Cutting expenses, whether in California or any municipality, is never easy given political considerations as well as rising infrastructure, pension, and healthcare related costs.

Muted Monthly Returns

Municipal market returns were muted but positive in August as modestly higher rates were offset by a slight narrowing of credit spreads. A-rated issues outperformed all other investment grade rating categories, but tax-free, high yield issues outperformed all others. Shorter maturities lagged other maturity segments due to the upward pressure on front end of the curve. Among market sectors, Prerefunded issues lagged due to the heavy weighting of Pre-re's on the shorter end of the yield curve as well as the lower average yield within this sector.

Total Returns of Selected Barclays Municipal Indices and Subsectors

<u>Barclays Index/Sector</u>	<u>August</u>	<u>3Mo</u>	<u>YTD</u>	<u>Barclays Quality</u>	<u>August</u>	<u>3Mo</u>	<u>YTD</u>
Municipal Bond Index	0.13%	1.79%	4.54%	AAA	0.02%	1.47%	3.78%
General Obligation bonds	0.06%	1.64%	4.09%	AA	0.08%	1.63%	4.14%
Revenue bonds	0.20%	1.99%	5.07%	A	0.32%	2.22%	5.53%
Prerefunded bonds	-0.15%	0.55%	1.34%	BBB	0.12%	2.05%	5.53%
Long maturities (22+ yrs.)	0.31%	2.74%	7.06%	High Yield	0.36%	4.16%	9.08%
Intermediate maturities (1 - 17 yrs.)	0.04%	1.41%	3.56%	HY, ex-Puerto Rico	0.12%	2.53%	8.55%
Short maturities (1 - 5 yrs.)	-0.11%	0.63%	1.53%				

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 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 Barclays Municipal Bond Index and do not represent separate indices.

The 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 Barclays Municipal Bond Index or 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.