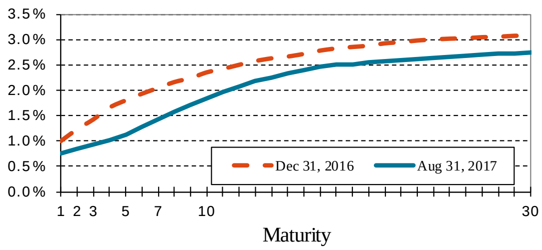
Baird Advisors
Municipal Fixed Income Market Comments
August 2017

Strong Demand Drives Yields Lower

The favorable summer season of light municipal supply and solid demand continued through August, providing investors another month of strong absolute returns. New supply continued to disappoint as it slipped 27% from August of last year and year-to-date issuance is off 15% from 2016's record pace. The primary cause of the year-over-year supply decline is lower refunding volume. There is less savings to be captured with rates higher than year-ago levels, but also less outstanding debt eligible for refunding. Heavy refunding volume in recent years has already refinanced much of what is eligible in the current rate environment. Unfortunately, the prospects for a rebound in refunding volume are not promising. Refunding volume is a function both of interest rates and the level of tax-free issuance ten years prior (most refundings are targeted to the first call date, which is typically ten years from the time of issuance). Looking back in time, tax-exempt supply in the 2008 – 2010 period was relatively light for two reasons. First, municipalities were reluctant to borrow for new projects during and immediately following the financial crisis. Second, nearly $190B of issuance in 2009/10 was *taxable*, issued through the Build America Bond (BAB) program. This is unlikely to be refunded since the issuer loses the federal subsidy if the debt is refinanced. That said, the favorable supply/demand picture of the summer becomes a bit less so this fall. Net outstanding supply is expected to increase by $4B in September, up from a net decrease of -$12B in August and a total of -$50B for the summer period of June - August.

AAA Municipal Yields



Maturity	Dec 31, 2016	Jun 30, 2017	Jul 31, 2017	Aug 31, 2017	1Mo Change	QTD Change	YTD Change
1	1.00%	0.84%	0.85%	0.76%	-0.09%	-0.08%	-0.24%
2	1.23%	0.99%	0.98%	0.85%	-0.13%	-0.14%	-0.38%
3	1.43%	1.11%	1.06%	0.94%	-0.12%	-0.17%	-0.49%
5	1.80%	1.35%	1.23%	1.12%	-0.11%	-0.23%	-0.68%
7	2.05%	1.60%	1.51%	1.42%	-0.09%	-0.18%	-0.63%
10	2.35%	1.96%	1.90%	1.84%	-0.06%	-0.12%	-0.51%
30	3.08%	2.81%	2.76%	2.74%	-0.02%	-0.07%	-0.34%

Credit Update

Hurricane Harvey may end up being the most costly U.S. natural disaster ever. The unprecedented rainfall and flooding that occurred along the coast of Texas and Louisiana, up to 52 inches in some areas, wreaked tremendous damage in the region. To put the rainfall in context, the Houston area received as much rain in five days as it does in a typical year. While it's still early in the damage assessment process, it is unlikely that damages from the storm will lead to long-term credit challenges or defaults for local municipalities if past natural disasters are a precedent. While the total cost of Hurricane Katrina that struck the Gulf Coast in 2005 caused total damages of $160B (in current dollars), municipalities survived and rebuilt with significant state and federal support. We expect Congress to once again authorize necessary federal funding for the Harvey affected areas as well. In addition, the State of Texas and most of its municipalities were in a strong fiscal position at the time of the storm. Texas has grown faster than most states, with the gross state product (GSP) increasing by 60.4% from 2000 to 2015, above the 27.6% average gain for all states. With strong growth and conservative budgeting, Texas holds a AAA rating by all three of the major rating agencies. At the end of FY 2016, the state's economic stabilization fund had $9.7B in assets, a strong 6.6% of total general fund revenues. While there will certainly be a period of economic weakness as the water recedes and storm damage is assessed, the Houston area and southeastern Texas should rebound strongly in coming months as the rebuilding process begins.

Risk Was Rewarded in August

Risk-seeking investors were rewarded with outperformance in August. The longest segment of the yield curve (22+ years) outperformed both short and intermediate maturities by 58 bps and 31 bps, respectively, last month. Lower quality issues also outperformed higher quality credits; BBB rated issues outperformed AAA rated debt by 83 bps in August. Extending the risk-on benefit, the High Yield municipal sector had another solid month of performance and remains the YTD pace setter as well.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	August	3Mo	YTD	Bloomberg Barclays Quality	August	3Mo	YTD
Municipal Bond Index	0.76%	1.21%	5.20%	AAA	0.60%	0.88%	4.57%
General Obligation bonds	0.69%	1.12%	5.15%	AA	0.63%	1.04%	4.86%
Revenue bonds	0.83%	1.32%	5.56%	A	0.94%	1.43%	5.75%
Prerefunded bonds	0.35%	0.50%	2.26%	BBB	1.43%	2.36%	7.18%
Long maturities (22+ yrs.)	0.97%	1.69%	6.58%	High Yield	1.38%	1.82%	8.30%
Intermediate maturities (1 - 17 yrs.)	0.66%	1.01%	4.66%	HY, ex-Puerto Rico	1.51%	2.15%	10.83%
Short maturities (1 - 5 yrs.)	0.39%	0.56%	2.60%				

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.