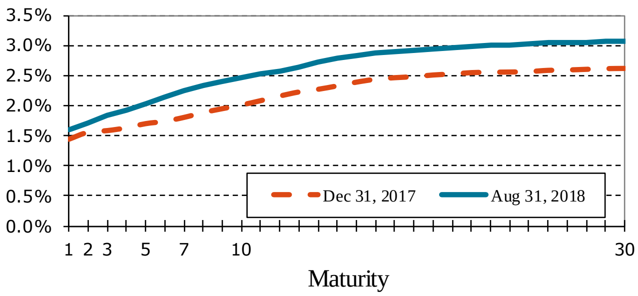
Baird Advisors
Municipal Fixed Income Market Commentary
August 2018

Favorable Supply/Demand Backdrop Leaves Rates Little-Changed

Municipal yields were little-changed in August as the supportive summer technical backdrop provided a strong bid for the market helping to limit volatility. Although the rate changes last month were modest, the curve flattened marginally as short-term yields rose more than intermediate and longer maturities. August was another in a recent string of months in which the amount of debt rolling off, combined with new demand for municipals, exceeded the amount of new supply. Although total supply YTD remains well below last year's pace (-15% YoY), due to a lack of refunding issuance, it is encouraging to see new money borrowings rising, even exceeding expectations. Borrowing to fund infrastructure projects has risen 21% YoY, well above the 12% average annual increase of new borrowing over the last three years. State and local governments are willing to borrow more due to rising tax revenues along with the recognition of an aging infrastructure, which grows more expensive to repair the longer it is delayed. Assuming the economy continues to grow at a steady pace, the level of new money borrowing should also rise through the balance of the year and into 2019.

AAA Municipal Yields



Maturity	Dec 31, 2017	Jul 31, 2018	Aug 31, 2018	1Mo	YTD
1	1.44%	1.47%	1.60%	0.13%	0.16%
2	1.56%	1.62%	1.71%	0.09%	0.15%
3	1.59%	1.76%	1.83%	0.07%	0.24%
5	1.70%	1.97%	2.03%	0.06%	0.33%
7	1.80%	2.22%	2.25%	0.03%	0.45%
10	2.01%	2.49%	2.47%	-0.02%	0.46%
30	2.62%	3.06%	3.08%	0.02%	0.46%

Other Market News

- The IRS and Treasury Department jointly proposed regulations to stop perceived tax abuses by states which currently allow taxpayers to make charitable contributions as a work around to the $10,000 federal cap on state and local (SALT) deductions. States now have 45 days to comment on the proposal, but some are threatening legal action as well.
- Chicago is considering issuing up to $10B of taxable pension obligation bonds (POBs) through its sales tax securitization structure in an effort to boost the city's poorly funded pension plans. Chicago has contributed just over $1.0B/year in aggregate to the four city pension plans both this year and last, but the cost is set to rise, doubling by 2022 if left unchanged. While the city would lose flexibility on its annual pension cost under a POB, it would help Chicago smooth out the rising pension costs over a more extended period. The market awaits their decision.
- Banks continued to trim their municipal exposure, reducing holdings by -1.7% in Q2, a slightly slower pace than the -2.7% decline in Q1. The incentive for banks to own tax-free bonds was reduced following the cut in the corporate tax rate at year end and while the pace of municipal liquidation/roll-off by banks has been gradual it is likely to continue. The lack of bank participation in the market may not be fully realized until supply rises or market liquidity declines.
- Houston residents overwhelmingly approved a $2.5B flood-prevention bond referendum in August. An amazing 85% of voters said "yes" to the measure, given the lingering memories of the devastation from Hurricane Harvey last year.

Flattening Curve Benefits Long Maturities

The modest flattening of the tax-free yield curve in August led to the outperformance of the long end of the curve relative to shorter maturity segments. Returns for the short maturities were modestly negative, as was the return of the Prerefunded sector which has a shorter average duration than other market sectors. From a quality perspective, lower quality issues, particularly the High Yield tax-free category, set the pace last month across all quality ratings.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	August	YTD	Bloomberg Barclays Quality	August	YTD
Municipal Bond Index	0.26%	0.25%	AAA	0.19%	-0.12%
General Obligation bonds	0.23%	0.19%	AA	0.25%	0.13%
Revenue bonds	0.30%	0.20%	A	0.29%	0.39%
Prerefunded bonds	-0.02%	0.85%	BBB	0.33%	1.28%
Long maturities (22+ yrs.)	0.41%	-0.23%	High Yield	0.80%	4.86%
Intermediate maturities (1 - 17 yrs.)	0.18%	0.43%	HY, ex-Puerto Rico	0.61%	3.92%
Short maturities (1 - 5 yrs.)	-0.04%	1.04%			

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.