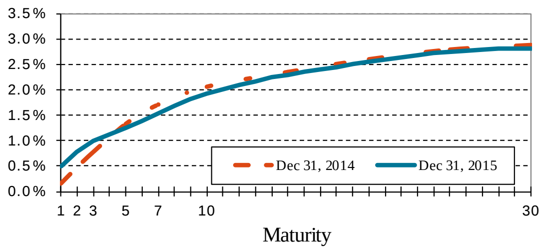
Baird Advisors
Municipal Fixed Income Market Comments
December 2015

The Fed and Favorable Technicals Flatten the Curve

The municipal market closed out 2015 with the strong tone it held for much of the year. The tax-free municipal market was the best performing sector of the U.S. fixed income markets for both the quarter and the full calendar year. Even more impressive was that this performance occurred in the midst of the first increase in the federal funds rate in over nine years. Credit the Fed, particularly Chair Janet Yellen, with adequately preparing the markets for this long-awaited move. The fact that tax-free yields at year end were unchanged or lower at all maturities than they were on December 16th, the day of the Fed announcement, shows that even the retail-oriented nature of the municipal market had fully priced in the 25 bps of rate adjustment.

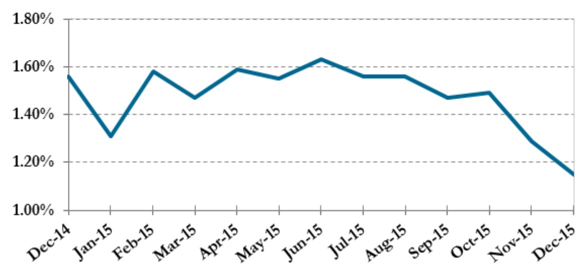
AAA Municipal Yields



Maturity	Dec 31, 2014	Sep 30, 2015	Nov 30, 2015	Dec 31, 2015	1Mo Change	3Mo Change	YTD Change
1	0.16%	0.23%	0.34%	0.50%	0.16%	0.27%	0.34%
2	0.48%	0.55%	0.72%	0.77%	0.05%	0.22%	0.29%
3	0.78%	0.79%	0.92%	0.99%	0.07%	0.20%	0.21%
5	1.33%	1.27%	1.26%	1.26%	0.00%	-0.01%	-0.07%
7	1.71%	1.65%	1.60%	1.54%	-0.06%	-0.11%	-0.17%
10	2.06%	2.03%	2.02%	1.92%	-0.10%	-0.11%	-0.14%
30	2.88%	3.03%	2.96%	2.82%	-0.14%	-0.21%	-0.06%

The tax-free curve underwent a dramatic flattening trend in the quarter, as short-term rates rose while intermediate and longer yields fell. The fulcrum of the curve shift this quarter was the five-year maturity, where yields were essentially unchanged. Surrounding the fulcrum, yields on maturities shorter than five years rose as much as 27 bps and longer rates fell a nearly equivalent 21 bps. Chart 1 to the right illustrates the flattening trend for the full calendar year, as measured by the yield difference between 2-year and 10-year AAA tax-free rates. Through June the slope of the curve was little changed, but as the probability of the Fed rate hike grew, the curve flattened from a peak of +163 bps in June to +115 bps at year end.

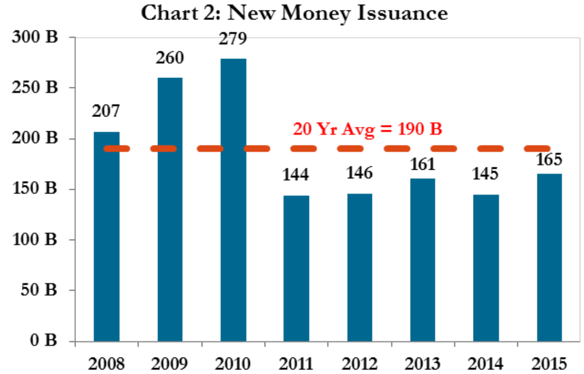
Chart 1: Muni Slope (2s10s)



Source: MMD, Blooomberg

The primary reason for the strong relative performance of the municipal market for the quarter was an improving technical backdrop. The pace of tax-free issuance slowed, falling approximately 10% from the third quarter pace, as refunding activity declined. Total 2015 issuance, particularly the refunding supply, was front-loaded into the first half of the year as municipalities sought to lock in savings prior to the anticipated Fed rate hike(s); issuers were likely not expecting that intermediate and long yields would fall, as they did surrounding the Fed move. While the pace of refinancing slowed late in the year, the volume of new money borrowings remained steady, but below its long term average and well off the recent peak levels of 2009 and 2010 when the Build America Bond (BAB) issuance was active (Chart 2). Despite low nominal yields and the significant infrastructure needs across the country, municipal borrowings to fund these necessary projects are relatively low. A frugal mentality on the part of municipalities and tax payers is partially responsible for the modest borrowing level. Rising health care and pension-related costs are another concern. Yet, demand for municipal debt was strong, more than matching the modest supply in the fourth quarter. Municipal mutual funds closed the year with thirteen consecutive weeks of inflows and a total over $13B of inflows in 2015.

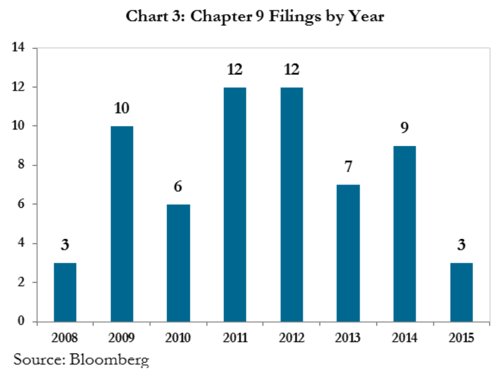
Chart 2: New Money Issuance



Source: JPMorgan Securities

Municipal Credit Improves and Bankruptcy Filings Decline

Puerto Rico dominated the credit headlines once again in the fourth quarter. After making full payment on debt service due on December 1st, accomplished only by activating their constitutional authority to clawback revenues targeted for other entities and purposes, Governor Padilla announced they would fall $37 million short on interest payments due on January 1 to public corporation bondholders. The U.S. Congress began working toward a solution in December that could provide federal guidance, if not financial assistance, and House Speaker Paul Ryan instructed committees under his jurisdiction to come up with a "responsible solution" to Puerto Rico's fiscal crisis by the end of the first quarter. Adding to the confusion for investors, the U.S. Supreme Court agreed to review a lower court decision which ruled that Puerto Rico's public corporation restructuring law was unconstitutional. While not expected to rule before June, if the lower court decision were overturned it would at least provide a partial solution for restructuring outstanding debt. Virtually all of Puerto Rico credits are trading at depressed prices, reflecting both the complexity of the situation and the growing probability of less than full repayment on at least some of the island's debt. That said, the market may be pricing in more pain than will actually be realized by bondholders, creating pockets of opportunity. Case in point, the Puerto Rico Electric Authority (PREPA) recently reached agreement with its creditors that, if fully implemented, would result in a 15% haircut to bondholders, a less painful outcome than the market had expected. Stay tuned.



The less-reported but more important credit story this year has been the general improvement in conditions for most municipalities. State and local revenues have been rising for four years and, according to the National League of Cities 2015 Survey, city finance officers are the most optimistic they've been in a quarter century. Surprising to many, perhaps, is that the number of Chapter 9 bankruptcy filings also continues to fall (Chart 3). After peaking at a post-financial crisis high of twelve in 2011 and 2012, there were just three filings in 2015. This is a favorable sign for investors as well as an indication that municipalities may have realized that a bankruptcy filing is costly and quite time consuming. It should remain the last resort for most fiscally stressed municipalities.

Strong Quarter, Solid Year

The municipal market logged its second consecutive quarter of strong returns, both nominally and relative to the taxable fixed market. A consistent theme for the quarter was that investors were rewarded for taking risk. Longer maturities outperformed short maturities due to the flattening of the yield curve. Lower quality investment grade issues outperformed higher quality issues. The high yield municipal market posted positive returns, even with Puerto Rico as 25% of the sector, and was relatively unaffected by challenges in the taxable corporate high yield market. The risk-on theme proved consistent across sectors of the municipal market as well. For example, the pre-refunded sector lagged all other municipal sectors, given their close trading relationship to the Treasury market, while Tobacco, Housing, Hospitals, and Transportation were among the best performers.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Barclays Index/Sector	Dec	3Mo	YTD	Barclays Quality	Dec	3Mo	YTD
Municipal Bond Index	0.70%	1.50%	3.30%	AAA	0.52%	1.06%	2.73%
General Obligation bonds	0.67%	1.40%	3.09%	AA	0.65%	1.29%	3.16%
Revenue bonds	0.79%	1.71%	3.62%	A	0.89%	1.99%	3.71%
Prerefunded bonds	-0.01%	0.00%	1.00%	BBB	0.77%	2.36%	4.25%
Long maturities (22+ yrs.)	1.10%	2.44%	4.52%	High Yield	0.15%	1.78%	1.81%
Intermediate maturities (1 - 17 yrs.)	0.52%	1.12%	2.83%	HY, ex-Puerto Rico	0.82%	2.85%	7.50%
Short maturities (1 - 5 yrs.)	-0.01%	0.08%	1.21%				

Outlook

The municipal market will likely carry the solid year-end momentum into the new year. Total supply in 2016 may slip a bit from the nearly $400B issued in 2015 simply because the amount of debt with favorable refunding characteristics is less than at the start of last year. We do expect that new money financings will increase modestly, given both the favorable rate environment and the nation's significant infrastructure needs, but the increase will likely be insufficient to fully offset the decline in refunding volume. That said, we expect the traditional municipal seasonal pattern, in which supply/demand imbalances typically occur, to provide variations in relative value throughout the year. It would not be surprising, for example, to see supply outstrip demand in late-Spring, as reinvestment demand typically declines, but both the pre- and post-Spring environment are likely to see more demand than supply. The Fed once again plays a significant role in the market outlook, particularly regarding the yield curve. The market currently expects less upward change in the federal funds rate than does the Fed's own forecast, so tracking economic data and Fed guidance will remain critical to proper curve positioning. Yet, our base case outlook remains one of further flattening of the yield curve. While we expect to see higher rates at all points along the curve, with more pronounced increases among shorter maturities, if inflation remains in-check and the Fed remains sufficiently transparent, then intermediate and longer term rates may not rise much, if at all. Accepting a modest amount of credit risk should continue to be a rewarding posture for investors. Expectations for continued economic growth, even if modest, and the desire to maintain a structurally balanced budget, imply a favorable credit backdrop. Pension risk awareness will continue to grow, thanks to new government accounting rules which require greater disclosure of unfunded liabilities and given the significant impact on stakeholders, including investors, politicians as well as current and retired public employees. Therefore, continuing the trend of 2015, investors will likely continue to favor revenue-backed issues over general obligation debt, the latter of which typically carries a higher pension burden. Within the general obligation sector, we expect trading divergences to grow between municipal issuers based on pension funding status. Finally, with 2016 being a Presidential election year, a focus on the potential for tax reform is likely. If tax platforms focus on limiting exemptions, then tax-free market volatility may rise. If so, we would look for opportunities to add exposure to the municipal market at potentially attractive valuations.

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.

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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.

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