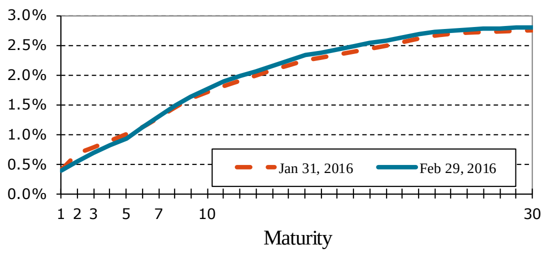
Baird Advisors
Municipal Fixed Income Market Comments
February 2016

Municipals Zig While Treasuries Zag

The rich valuations that existed in the municipal market relative to Treasuries at year end disappeared over the last two months. Although yield changes varied across the tax-free curve in February, the steady decline in rates across much of the Treasury curve has enhanced the relative value of municipals. The divergence between the two markets was most evident last month in the 10-year maturity range where Treasury yields fell 19 bps while tax-free yields *rose* 5 bps. The directional differences between the two markets were less pronounced in other maturities, but nonetheless reflected some reluctance on the part of municipal investors to push rates lower. Not surprisingly, retail-oriented municipal investors often are more focused on absolute yields than are institutional investors, which have index-focused or liability-matching motivations regardless of yield levels. At the same time, some crossover buyers, such as insurance companies, may have found better value last month among taxable corporates given the spread widening that has occurred in that market sector. That said, demand for municipals remained steady, more than matching the new issue supply. Tax-free fund flows have been consistently positive since mid-2015, including in February, successfully capturing much of the roll-off from recent bond calls and maturities.

AAA Municipal Yields



Maturity	Feb 28, 2015	Dec 31, 2015	Jan 31, 2016	Feb 29, 2016	1Mo Change	YTD Change	12Mo Change
1	0.14%	0.50%	0.40%	0.39%	-0.01%	-0.11%	0.25%
2	0.44%	0.77%	0.66%	0.54%	-0.12%	-0.23%	0.10%
3	0.79%	0.99%	0.78%	0.68%	-0.10%	-0.31%	-0.11%
5	1.19%	1.26%	1.00%	0.93%	-0.07%	-0.33%	-0.26%
7	1.60%	1.54%	1.28%	1.30%	0.02%	-0.24%	-0.30%
10	2.02%	1.92%	1.71%	1.76%	0.05%	-0.16%	-0.26%
30	2.87%	2.82%	2.75%	2.80%	0.05%	-0.02%	-0.07%

Credit Updates

Puerto Rico released a Restructuring Proposal last month that received a rather cool reception from bondholders. The proposal would cut the $49.2B of tax-supported debt by 46% to $26.5B, while not even addressing the unfunded pension liabilities or other necessary structural reforms. The plan would involve a voluntary exchange of existing bonds for two new bonds. The first is a “Base Bond,” the initial value of which would vary depending upon the issuing authority, with interest payments beginning in 2018 at a 3% coupon rate, rising to 5% in 2021 and beyond. The second exchange security would be a “Growth Bond,” with interest and principal paid only if Commonwealth revenue exceeds certain target levels. Congress is also working on a comprehensive solution of its own with a target deadline for release by March 31. Preliminary reports suggest Congress will recommend a Financial Control Board be established with power over budgetary and debt matters, modeled after what was successfully implemented to oversee the financially stressed District of Columbia in the 1990’s. Whether or not Congress will also grant the authority to restructure some or all outstanding Puerto Rico debt remains uncertain.

The other significant municipal credit in the news last month was the Chicago Board of Education (BOE). Illinois’ largest school district paid as much as an 8.5% tax-free yield to issue $752 million in debt, reflecting significant investor credit concern. Those concerns have been shared by the major credit agencies which assigned ratings below investment grade. Yet, the BOE has historically had sufficient state revenue to cover debt service, while also having the authority to levy property taxes if necessary. Until the political stalemate within Illinois is resolved this credit will remain under pressure. The good news is that this issue likely eliminates the need for further borrowing in 2016.

Modestly Positive Monthly Returns

Short maturities were the top performers along the curve given the slight decline in rates in that segment. Prerefunded issues also did well since it is the sector most closely linked to Treasury rates. Finally, despite the uncertainty surrounding the Puerto Rico proposal, the municipal high yield sector outperformed all others market categories.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Barclays Index/Sector	Feb	3Mo	YTD	Barclays Quality	Feb	3Mo	YTD
Municipal Bond Index	0.16%	2.06%	1.35%	AAA	0.12%	1.81%	1.29%
General Obligation bonds	0.11%	1.98%	1.31%	AA	0.15%	1.98%	1.32%
Revenue bonds	0.17%	2.23%	1.43%	A	0.17%	2.34%	1.43%
Prerefunded bonds	0.25%	0.80%	0.81%	BBB	0.21%	2.20%	1.41%
Long maturities (22+ yrs.)	0.18%	2.46%	1.35%	High Yield	1.10%	1.83%	1.68%
Intermediate maturities (1 - 17 yrs.)	0.18%	1.90%	1.37%	HY, ex-Puerto Rico	0.62%	2.52%	1.69%
Short maturities (1 - 5 yrs.)	0.32%	0.93%	0.95%				

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.