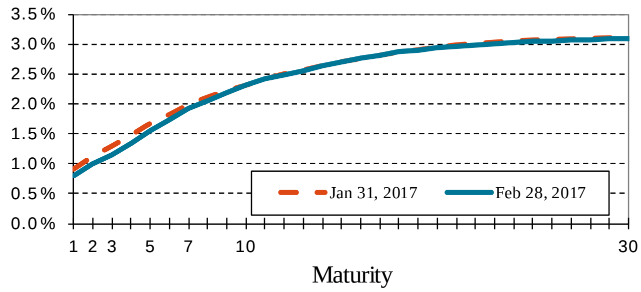
Baird Advisors
Municipal Fixed Income Market Comments
February 2017

Favorable Supply/Demand Provides Supportive Backdrop

Municipal yields fell last month thanks to a supportive supply/demand backdrop. The market perception is that GOP proposed tax reform changes may take longer than initially anticipated, perhaps not becoming effective until 2018, if they occur at all. The solid demand for municipals was evident in the flows into tax-free funds which experienced inflows in seven of the first eight weeks of the year. Against this demand, new supply fell sharply in February, declining 35% on a year-over-year basis. One reason for the dip in supply was due to the move higher in market rates post-election which reduced the incentive for municipalities to refinance outstanding debt. Year-to-date refunding volume has fallen 45% from last year's pace. However, total supply for the year is just 4% behind 2016 thanks to strong issuance in January. The move lower in tax-free yields this year is not what many were expecting, particularly as economic data has improved causing the Fed to signal a desire to raise the fed funds rate at its March 15th meeting. Interestingly, while short-term Treasury yields rose last month, responding to the increased probability of a near-term Fed rate hike, short tax-free yields fell. The directional divergence between the markets, largely occurring in the last week of the month, led to relatively rich valuations among short term municipal yields. Better relative values existed in the 10-year maturity range where AAA tax-free yields were 96% of comparable taxable Treasury yields as of month end.

AAA Municipal Yields



Maturity	Dec 31, 2016	Jan 31, 2017	Feb 28, 2017	1Mo Change	YTD Change
1	1.00%	0.91%	0.79%	-0.12%	-0.21%
2	1.23%	1.12%	0.99%	-0.13%	-0.24%
3	1.43%	1.30%	1.16%	-0.14%	-0.27%
5	1.80%	1.67%	1.55%	-0.12%	-0.25%
7	2.05%	1.99%	1.92%	-0.07%	-0.13%
10	2.35%	2.31%	2.30%	-0.01%	-0.05%
30	3.08%	3.11%	3.10%	-0.01%	0.02%

Credit Update

- The opportunity to reach a "grand bargain" budget agreement in Illinois between Republican Governor Rauner and the Democratic legislature appears to have reached another disappointing impasse. Among the sticking points was reluctance by the Governor to agree to a permanent income tax increase, offset by just a two year freeze on property taxes. The state is now more than halfway through its second consecutive year without a formal budget agreement and the rating agencies are watching closely to see if a resolution can be found.

- The nation watched last month as heavy rains in California forced an evacuation of residents near the Oroville dam. The dam reached its full capacity requiring water to be diverted to emergency spillways, which were severely damaged in the process. The good news in this is that the heavy rains recently means that no areas of the state are any longer considered in "exceptional drought." This helps ease the credit concerns of investors with municipal debt backed by water revenues in areas previously considered to be in extreme drought. Yet, a full recovery of water levels is still dependent on additional rain as more than one-half the state geographically remains "abnormally dry" according to the U.S. Drought Monitor. The bad news is that the damage to the dam from the heavy rains serves as another reminder of the need for ongoing infrastructure investment in California and across the country.

Second Month of Solid Returns

The decline in tax-free rates in February provided a second consecutive month of solid returns for municipal investors. Longer maturities marginally outperformed short and intermediate issues for the month. Lower quality issues, particularly the high yield municipal sector, outperformed high grades; BBB's outperformed AAA's by 34 bps in February.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	February	YTD	12Mo	Bloomberg Barclays Quality	February	YTD	12Mo
Municipal Bond Index	0.69%	1.36%	0.25%	AAA	0.66%	1.25%	-0.21%
General Obligation bonds	0.72%	1.37%	-0.17%	AA	0.63%	1.29%	0.01%
Revenue bonds	0.71%	1.39%	0.40%	A	0.77%	1.47%	0.90%
Prerefunded bonds	0.48%	1.05%	0.23%	BBB	1.00%	1.75%	0.68%
Long maturities (22+ yrs.)	0.78%	1.40%	0.92%	High Yield	2.38%	3.82%	5.17%
Intermediate maturities (1 - 17 yrs.)	0.67%	1.38%	0.02%	HY, ex-Puerto Rico	2.30%	3.63%	3.67%
Short maturities (1 - 5 yrs.)	0.55%	1.22%	0.34%				

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.