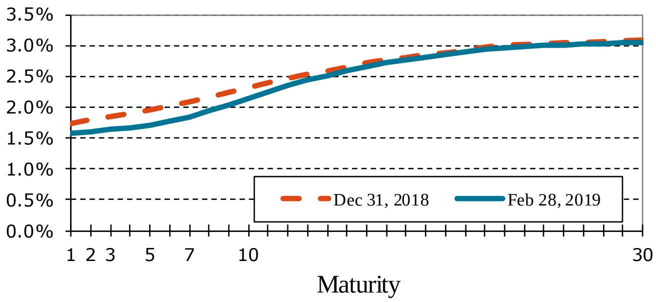
Baird Advisors
Municipal Fixed Income Market Commentary
February 2019

Tax-Free Yields Fall on Strong Demand, Light Supply

Favorable market technicals, strong demand and relatively light supply pushed municipal yields modestly lower last month. Investor demand for tax-free debt continued at the strongest annual pace in at least ten years as measured by municipal fund cash flows. Inflows have occurred in eight of the first nine weeks of 2019, totaling over $11B. This confirms what was widely believed at the time, that the fund outflows in 4Q were primarily tax related as investors harvested losses as interest rates rose. Investor demand in February was distributed across all maturities, leaving the slope of the tax-free curve little changed. The relative steepness of the municipal curve is a distinguishing and important advantage for tax-free investors. The longer end of the municipal curve is the most attractive when compared to taxable Treasury yields. For example, the yield spread between 2's – 30's in municipals is +145 bps, which exceeds the yield pickup between the same two Treasury maturities by 92 bps (+149 vs. +57). Regarding municipal supply, while issuance is up 21% relative to last year's pace, the year-over-year comparison is misleading. New issuance was extremely light early last year. An estimated $50B of supply was pulled into the final months of 2017 as municipalities rushed to market ahead of the tax reform uncertainty. Average monthly issuance of just $24B this year would equate to an annualized rate of just $288B, well below the approximately $370B that is expected. There is seasonality to municipal issuance and light supply early in the year is common. Supply levels will certainly improve in coming months, but not enough to match the amount of debt rolling off, leading to expected negative net supply for all of 2019.

AAA Municipal Yields



Maturity	Dec 31, 2018	Jan 31, 2019	Feb 28, 2019	1Mo	YTD
1	1.74%	1.66%	1.59%	-0.07%	-0.15%
2	1.80%	1.68%	1.61%	-0.07%	-0.19%
3	1.85%	1.70%	1.64%	-0.06%	-0.21%
5	1.96%	1.79%	1.71%	-0.08%	-0.25%
7	2.09%	1.92%	1.84%	-0.08%	-0.25%
10	2.32%	2.19%	2.14%	-0.05%	-0.18%
30	3.09%	3.10%	3.06%	-0.04%	-0.03%

Puerto Rico Update: COFINA Debt Restructured, HUD Approves $8.2B Recovery Plan

Ever so slowly, Puerto Rico's recovery seems to be occurring. The plan of adjustment, which exchanged more than $17B of sales-tax-backed debt, called COFINA, for $12B of new securities, was approved by the federal judge overseeing the island's debt restructuring. Senior bondholders recovered 93 cents on the dollar, subordinate investors 53 cents, reducing total debt service by an estimated $17.5B over 40 years, or an average of $456 million annually. COFINA debt now has first claim on 53 cents of all future sales taxes; the balance flowing to Puerto Rico's general fund. In addition, late in the month, HUD approved $8.2B of funds for the rebuilding plan after the devastation from Hurricane Maria in September 2017. These funds, which will be distributed as rebuilding occurs, are in addition to $1.5B of federal money approved last summer. Unfortunately, the debt battles in Puerto Rico will continue, as roughly $13B of GO debt is yet to be restructured, in addition to a long-term plan for the island's estimated $50B unfunded pension liability. Outmigration remains a concern as an estimated 130,000 people left the island in the year ending July 2018. Yet, 3.2 million people remain on the island, more than twice the population of Hawaii and larger than the population of at least 30 states in the continental U.S.

Solid Returns YTD for Municipals

February was another favorable month for investors with positive returns across all segments of the market. The longest maturities outperformed both intermediate and short-term debt last month. Prerefunded bonds lagged other market sectors but this was due to the shorter average maturity of these issues. Among investment grade credits, lower quality ratings outperformed thanks to a tightening of credit spreads for the month. BBB-rated issues were the best performers for the month and YTD.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	February	YTD	Bloomberg Barclays Quality	February	YTD
Municipal Bond Index	0.54%	1.30%	AAA	0.46%	1.27%
General Obligation bonds	0.53%	1.32%	AA	0.51%	1.24%
Revenue bonds	0.56%	1.32%	A	0.60%	1.37%
Prerefunded bonds	0.32%	0.88%	BBB	0.65%	1.45%
Long maturities (22+ yrs.)	0.64%	1.20%	High Yield	0.54%	1.22%
Intermediate maturities (1 - 17 yrs.)	0.49%	1.34%	HY, ex-Puerto Rico	0.48%	1.13%
Short maturities (1 - 5 yrs.)	0.33%	0.89%			

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.