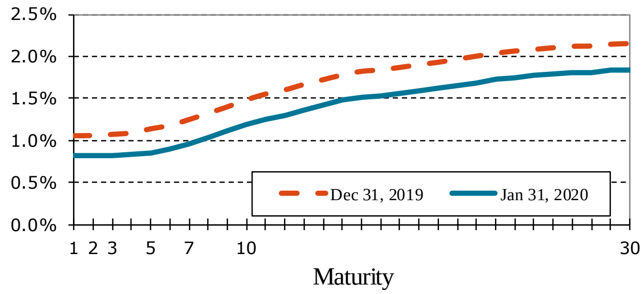
Baird Advisors
Municipal Fixed Income Market Commentary
January 2020

Strong Start to the New Year for Municipals

2020 began with a surprisingly strong rally as tax-free yields fell sharply across the curve, pushing long-term, high-grade yields to the lowest levels since the 1950's. The curve flattened as long-term rates fell more than short-term yields. Demand for municipals was heavy throughout the month as January inflows totaled $12.4B, exceeding the record pace of 2019. Looking back more than a year, municipal fund flows have remained positive for 56 consecutive weeks – an incredible run. Favorable demographics are certainly a key factor, if not the main driver, of the ongoing demand for fixed income assets. Investors have gotten comfortable in the post-financial crisis era with low nominal yields and moderate inflation. A growing segment of high net worth investors are aging and the benefits of a higher quality, income producing asset, like municipals, that also helps to minimize their tax burden is appealing to many. Talk of higher tax rates among those vying for the Democratic Party nomination, undoubtedly, is supportive for the tax-exempt market as well. From a supply perspective, although new issuance rose 18% YoY, a growing portion of this was taxable. Tax-exempt issuance rose a respectable 9% YoY, against light comps from a year ago, but taxable issuance more than doubled, and comprised one-third of total municipal supply.

AAA Municipal Yields



Maturity	12/31/18	12/31/19	1/31/20	1Mo Chg
1	1.74%	1.06%	0.82%	-0.24%
2	1.80%	1.06%	0.82%	-0.24%
3	1.85%	1.07%	0.82%	-0.25%
5	1.96%	1.14%	0.85%	-0.29%
7	2.09%	1.25%	0.96%	-0.29%
10	2.32%	1.48%	1.18%	-0.30%
30	3.09%	2.15%	1.84%	-0.31%

Reserve Levels Continue to Rise; House Democrats Release Infrastructure Plan

While our expectation is for a continuation of gradual economic growth in 2020, many state and local governments continue to prepare for the next recession. According to a 2019 survey of the National Association of State Budget Officers, median reserve levels for state governments' are now 8% of general fund spending, nearly double the 4.8% set aside prior to the Great Recession in 2008 and far better than the slim balance of 0.3% in 2003. According to Fitch, local governments continue to add to reserves as well, but at a more gradual pace. Cities and counties had a median level of 30% in reserves in 2018, up from 20% in 2009. School district reserves rose to 20% from less than 15% over the same period. The challenges municipalities faced during the last recession, and the ongoing demands of increased spending on pension and infrastructure needs, have led to a higher level of fiscal prudence across the majority of state and local governments.

Although the odds of passing a bipartisan infrastructure plan in this election year are low, House Democrats last month outlined a framework to spend $760B over five years toward this effort. It was smaller in size than the Senate Democratic plan in 2018 ($1,022B), and placed greater emphasis on Highway Transportation needs, with 43% of the spending compared to 27% in the Senate plan. If the Democrats were to regain the White House and take control of Congress, the House plan could be a guide for the spending priorities. Regardless of which party is in charge, the current backdrop of low borrowing rates and abundant market liquidity is certainly a favorable environment for funding the infrastructure needs in the capital markets.

Risk-on Strategies Continued to Dominate Market Returns

The decline in rates led to strong performance to start the year. Risk-on strategies continued their dominance over more cautious approaches in January, as those who sought more duration and/or credit exposure were rewarded. Longer maturities returned 2.43%, easily outperforming the 0.67% return of short maturities. Returns for lower quality municipal credits, such as BBB's (2.30%) and High Yield (2.46%) also outpaced the return on AAA rated issues (1.69%). Not surprisingly, Prerefunded bonds (0.64%) lagged the returns of both the General Obligation (1.77%) and Revenue (1.90%) market sectors.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	2019	January
Municipal Bond Index	7.54%	1.80%
General Obligation bonds	7.30%	1.77%
Revenue bonds	7.93%	1.90%
Prerefunded bonds	3.55%	0.64%
Long maturities (22+ yrs.)	10.26%	2.43%
Intermediate maturities (1 - 17 yrs.)	6.44%	1.53%
Short maturities (1 - 5 yrs.)	3.66%	0.67%

Bloomberg Barclays Quality	2019	January
AAA	6.73%	1.69%
AA	7.12%	1.71%
A	8.10%	1.86%
BBB	9.94%	2.30%
High Yield	10.68%	2.46%
HY, ex-Puerto Rico	9.68%	1.98%

Disclosures

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.

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.