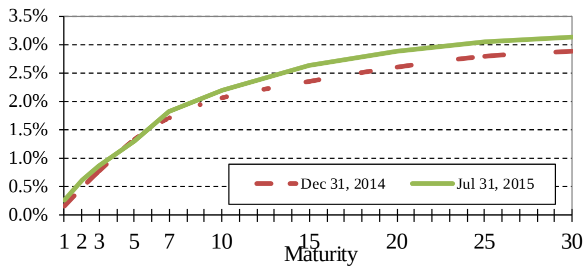
Baird Advisors
Municipal Fixed Income Market Comments
July 2015

Municipals Rally and the Curve Flattens

The municipal market followed the lead of Treasuries last month, which saw yields fall. A myriad of concerns led to the decline in rates, most notably a sharp decline in Chinese stocks with expectations of slower growth which also put downward pressure on global commodity prices. Oil serves as a good example, as WTI Crude prices fell over 21%, closing July at $47.12/bbl. Weaker commodities led to lower inflation expectations, which helped push municipal yields lower at all points along the curve, but particularly so among intermediate and long-term maturities which fell more than short rates. The municipal market also benefited from a favorable summer seasonal supply/demand backdrop. Despite a steady pace of new supply, and relatively persistent, albeit modest, fund outflows, the outstanding supply of municipal debt continued to shrink last month as more debt rolled-off than was issued. The seasonal support should continue through August as well. Tax-free yields remain an attractive option for investors, particularly those in higher income tax brackets. At month end, the tax-free yield on a 10-year AAA municipal bond was 2.19%, essentially the same as that of a taxable 10-year Treasury yield (2.18%).

AAA Municipal Yields



Maturity	Dec 31, 2014	Mar 31, 2015	Jun 30, 2015	Jul 31, 2015	1Mo Change	YTD Change
1	0.16%	0.19%	0.31%	0.27%	-0.04%	0.11%
2	0.48%	0.49%	0.63%	0.62%	-0.01%	0.14%
3	0.78%	0.82%	0.93%	0.87%	-0.06%	0.09%
5	1.33%	1.24%	1.38%	1.30%	-0.08%	-0.03%
7	1.71%	1.60%	1.87%	1.82%	-0.05%	0.11%
10	2.06%	1.96%	2.28%	2.19%	-0.09%	0.13%
30	2.88%	2.80%	3.28%	3.12%	-0.16%	0.24%

Credit News

The fiscal troubles in Chicago continued last month as a Cook County Circuit Court judge declared the city's pension reform measures as unconstitutional. Chicago is appealing to the Illinois Supreme Court, but faces long odds given recent rulings on similar state pension reform efforts. The other dominant news story last month was Puerto Rico and the continued deterioration in rating and price. The Puerto Rico Public Finance Authority defaulted on a $58 million payment due on August 1st, the first ever default by a Commonwealth public entity.

Moody's released an updated U.S. Municipal Bond Defaults and Recoveries study, which covers the 45 year period of 1970 – 2014. The updated report, dated July 24th, once again confirmed the low historic default rate for municipal debt. It found just 95 defaults on Moody's-rated issues over the entire 45 year period, and none in 2014. The report noted that defaults were most frequent among (multi-family) housing and healthcare issues, not surprisingly since each more closely resemble a corporate financial structure than do traditional municipal sectors. For comparison, just eight defaults occurred among local general obligation issues. A key take-away from the study was the low ten-year cumulative default rate for investment grade municipal debt at just 0.08%, much lower than the 2.81% rate for investment grade corporate debt over the same period. The average recovery rate was also higher on defaulted municipal credits, although the rate varied significantly across municipal sectors. The Moody's study in no way discounts the need or importance of sound fundamental credit research on municipal credits. It does, however, illustrate the solid financial strength that investors expect to find when they invest in the municipal market.

Solid Returns in July

The positive returns in July helped push YTD market performance back into positive territory. Longer maturities outperformed other maturity segments as the curve flattened. Credit spreads widened moderately as BBB performance lagged, and high yield underperformed, although this was largely due to Puerto Rico price weakness.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Barclays Index/Sector	July	YTD	Barclays Quality	July	YTD
Municipal Bond Index	0.72%	0.84%	AAA	0.68%	0.73%
General Obligation bonds	0.71%	0.64%	AA	0.75%	0.90%
Revenue bonds	0.77%	0.95%	A	0.75%	0.75%
Prerefunded bonds	0.31%	0.45%	BBB	0.39%	1.10%
Long maturities (22+ yrs.)	1.06%	1.02%	High Yield	-0.54%	-2.45%
Intermediate maturities (1 - 17 yrs.)	0.61%	0.78%	HY - ex Puerto Rico	0.82%	2.72%
Short maturities (1 - 5 yrs.)	0.32%	0.71%			

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, prerefunded 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.