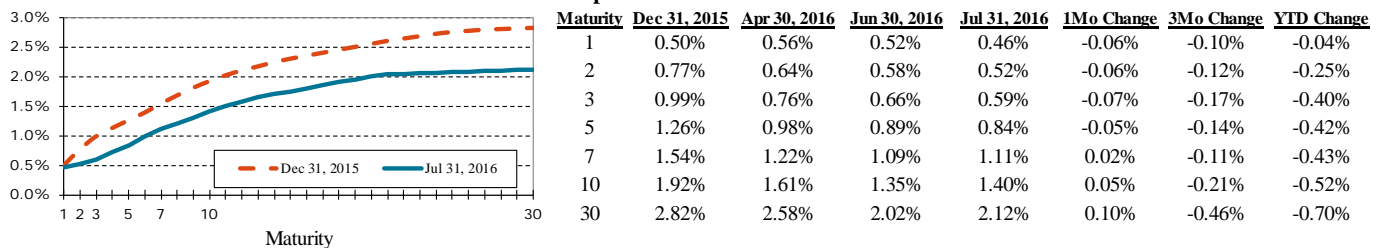


Baird Advisors
Municipal Fixed Income Market Comments
July 2016

A Mid-Summer (Post-Brexit) Pause

The municipal yield curve reversed what has been a flattening trend for several months and steepened modestly in July. Short-term yields fell slightly while intermediate and long-term rates rose as much as 10 bps in the 30-year segment. Following the late-June, post-Brexit market rally, tax-free (and Treasury) rates fell to record low levels early in July, only to bounce off the lows as retail interest waned, causing longer duration yields to drift modestly higher. Overall, however, the supply/demand backdrop remained quite favorable last month. The streak of consecutive weekly flows into municipal funds, which began last October, continued throughout the month, at 43 weeks it is the fourth longest inflow period since at least 1992. At the same time, new supply fell in July from the prior month and was off 27% from the same month last year. Year-to-date total municipal issuance is 4% behind the 2015 pace, as refunding volume has declined, but lower rates should ultimately lead to more refundings and (hopefully) more new money borrowings for the balance of 2016.

AAA Municipal Yields



Credit Updates

Infrastructure spending was a topic at both of the recent Republican and Democratic conventions. GOP candidate Donald Trump, while not yet offering a specific plan, has talked repeatedly about the poor condition of U.S. roads, bridges and airports relative to other countries. Democratic candidate Hillary Clinton has proposed spending \$275B over five years and the intent to set up a national infrastructure bank which would leverage both public and private funds to spur large-scale projects. It's unlikely that either party will adequately fund the \$3.3 trillion the American Society of Civil Engineers says is needed through 2025. While the municipal market will certainly play an important role in this process (e.g. new money municipal financing is up 9% year-to-date, from \$91.6B to \$99.9B), other funding sources are also needed to meet America's significant infrastructure needs.

The housing sector of the municipal market is one that tends to perform well in the late stages of a credit cycle and currently offers both credit and structural opportunities for investors. While the fundamental backdrop for municipal credit continues to improve, the pace of improvement is likely to slow. State and local governments have done an impressive job repairing their financial position since the Great Recession ended in June 2009. Broadly speaking, structural budget deficits have disappeared and reserve levels have been rebuilt, even exceeding pre-recession levels. That said, the pace of economic growth has slowed in the U.S., averaging just 1.0% in the first half of 2016, suggesting the tax revenue growth will also slow. A benefit of housing revenue-backed issues is they are typically less affected by cyclical factors than other sectors. Higher-quality, single-family mortgage pools, often with a significant portion of government guaranteed loans, with a well-defined prepayment structure are issues of focus in the current environment.

Modestly Positive Monthly Returns

Curve allocation was an important factor in determining relative performance last month. Strong demand for the shortest maturities (1- 5 years) led to outperformance of that curve segment relative to the longest maturities (22+ years). The outperformance of short-term debt also benefited the Prerefunded sector over both GO's and Revenue bonds since Prerefunded debt is heavily focused among the shorter maturities. The high yield municipal sector continued to outperform higher quality issues, as they have on a year-to-date basis as well.

Total Returns of Selected Barclays Municipal Indices and Subsectors

<u>Barclays Index/Sector</u>	<u>July</u>	<u>3Mo</u>	<u>YTD</u>	<u>Barclays Quality</u>	<u>July</u>	<u>3Mo</u>	<u>YTD</u>
Municipal Bond Index	0.06%	1.93%	4.40%	AAA	0.02%	1.56%	3.76%
General Obligation bonds	0.07%	1.75%	4.03%	AA	0.06%	1.76%	4.06%
Revenue bonds	0.04%	2.14%	4.86%	A	0.07%	2.33%	5.19%
Prerefunded bonds	0.21%	0.67%	1.50%	BBB	0.11%	2.50%	5.41%
Long maturities (22+ yrs.)	-0.10%	3.31%	6.73%	High Yield	0.65%	5.15%	7.00%
Intermediate maturities (1 - 17 yrs.)	0.14%	1.42%	3.52%	HY, ex-Puerto Rico	0.69%	3.76%	5.71%
Short maturities (1 - 5 yrs.)	0.27%	0.68%	1.64%				

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.