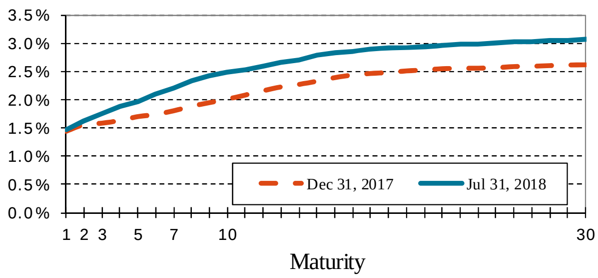
Baird Advisors
Municipal Fixed Income Market Commentary
July 2018

Tax-Free Rates Hold Steady as Taxable Yields Rise

Municipal yields were little-changed in July, holding steady as rates in the taxable market moved higher. The tax-free market continued to benefit from a favorable supply/demand backdrop, particularly the short end of the curve. July's new issue volume was less than the amount rolling off from coupons, calls and maturing debt, leading to a negative net supply position that is expected to continue into August. YoY total supply comparisons improved slightly (from -20% to -16%), and positive weekly inflows to tax-free funds in eleven of the last twelve weeks confirm the solid post-tax-reform demand for the sector. The outperformance of municipal rates relative to taxables was most noticeable among short-term maturities in July. Floating rate tax-free yields, which can be quite volatile, based on shifting investor demand, fell sharply in July while taxable Libor rates were steady. To a lesser extent, the short-term fixed rate maturities witnessed the same relative strength as 2-year tax-free yields fell 3 bps while the 2-year Treasury yield rose 14 bps. Although many investors find the short end of the tax-free curve desirable in a rising rate environment, the outperformance of that segment of the municipal curve has likely run its course. Investors may now be sufficiently incentivized to capitalize on the relative steepness of the municipal curve by extending into intermediates where both the yield pick-up and roll-down benefits are more favorable. To illustrate, the 2's-10's slope of the municipal curve closed July at a spread of +87 bps, compared to +29 bps in the Treasury curve.

AAA Municipal Yields



Maturity	Dec 31, 2017	Jun 30, 2018	Jul 31, 2018	1Mo	YTD
1	1.44%	1.47%	1.47%	0.00%	0.03%
2	1.56%	1.65%	1.62%	-0.03%	0.06%
3	1.59%	1.79%	1.76%	-0.03%	0.17%
5	1.70%	2.00%	1.97%	-0.03%	0.27%
7	1.80%	2.20%	2.22%	0.02%	0.42%
10	2.01%	2.47%	2.49%	0.02%	0.48%
30	2.62%	3.00%	3.06%	0.06%	0.44%

Illinois and Chicago Stabilize

From a credit perspective, July was a good month for the State of Illinois, Chicago, and credits connected to both municipal entities. There is little doubt that both the state and the city continue to face significant long-term fiscal challenges. Each faces already high and rising fixed costs related to a heavy debt burden, among the largest unfunded pension liabilities in the country, and rising health care costs. Yet, Moody's affirmed the ratings on both the Illinois (Baa3) and Chicago (Ba1) general obligation debt last month and improved the outlook to "stable" for both. Not surprisingly, credit spreads on each issuer, which have been narrowing for the last year or more, tightened further on the news. The favorable development for the state is primarily due to the revenue boost realized after both personal and corporate taxes were raised last year. An additional $4.5B of tax revenue was gained from the rate hikes in FY2018, and total state revenues rose nearly $9B YoY thanks to stronger economic growth. Chicago's finances have stabilized also, thanks both to a strong and diverse city economy, but also phased-in property tax increases and a new water and sewer tax that has boosted city revenues. While Chicago has reasonably solid reserves, at roughly 20% of revenues, the state has very little. Barring an economic downturn, the stable outlook is understandable by Moody's, but both issuers will need to take additional measures at some point if they hope to climb back up the ratings ladder.

Long End Lags and BBBs Outperform

Tax-free returns were positive in July led by the short and intermediate maturity segments of the curve. The modest rise in yields on the long end of the curve caused that segment of the market to lag. There was little performance differentiation across the various sectors of the municipal market, but lower quality issues, in particular BBB-rated debt, outperformed both higher-quality alternatives as well as the tax-free High Yield category.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	July	YTD	Bloomberg Barclays Quality	July	YTD
Municipal Bond Index	0.24%	-0.01%	AAA	0.16%	-0.31%
General Obligation bonds	0.30%	-0.04%	AA	0.20%	-0.12%
Revenue bonds	0.21%	-0.10%	A	0.28%	0.10%
Prerefunded bonds	0.27%	0.87%	BBB	0.55%	0.95%
Long maturities (22+ yrs.)	0.02%	-0.64%	High Yield	0.35%	4.03%
Intermediate maturities (1 - 17 yrs.)	0.32%	0.25%	HY, ex-Puerto Rico	0.33%	3.29%
Short maturities (1 - 5 yrs.)	0.30%	1.07%			

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.