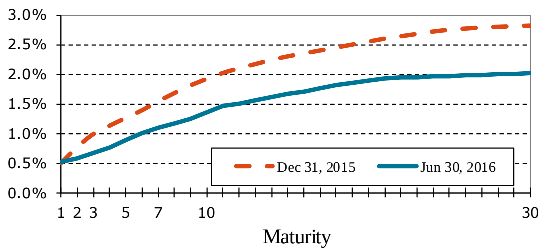
Baird Advisors
Municipal Fixed Income Market Comments
June 2016

Lower, Flatter, Narrower

Interest rates moved steadily lower during the second quarter, but the pace of decline accelerated in late-June after the Brexit vote in the United Kingdom. The surprising "leave" outcome led to sharply lower rates, particularly among the longest maturity tax-free yields as expectations of any Fed rate hike this year disappeared. To put the curve flattening during the quarter in perspective, long-term tax-free rates fell by a stunning 67 bps, far outpacing the 33 bps decline in 30-year taxable Treasury yields. Short-term tax-free rates fell by just 3 bps, leading to the flattest tax-free curve between 1-30 years (+150 bps) since the financial crisis. The same motivation that led investors into longer maturities also encouraged many to stretch for yield among lower quality issues, leading to narrower credit spreads. The trend toward lower yields, a flatter curve, and narrower credit spreads occurred against a backdrop of rising supply. New issuance rose 9% in June, the second straight month of year-over-year volume increases, bringing YTD supply just 4% below 2015's pace. Demand was robust as the streak of municipal mutual fund inflows continued uninterrupted, now at 38 consecutive weeks, averaging approximately $1.1B per week. July and August are the second and third highest months for reinvestment from bond calls and maturities this year (behind June), suggesting a continuation of the favorable technical market backdrop through the balance of the summer.

AAA Municipal Yields



Maturity	Dec 31, 2015	Mar 31, 2016	May 31, 2016	Jun 30, 2016	1Mo Change	3Mo Change	YTD Change
1	0.50%	0.55%	0.58%	0.52%	-0.06%	-0.03%	0.02%
2	0.77%	0.67%	0.72%	0.58%	-0.14%	-0.09%	-0.19%
3	0.99%	0.81%	0.86%	0.66%	-0.20%	-0.15%	-0.33%
5	1.26%	1.07%	1.09%	0.89%	-0.20%	-0.18%	-0.37%
7	1.54%	1.32%	1.31%	1.09%	-0.22%	-0.23%	-0.45%
10	1.92%	1.70%	1.66%	1.35%	-0.31%	-0.35%	-0.57%
30	2.82%	2.69%	2.45%	2.02%	-0.43%	-0.67%	-0.80%

Credit Updates

On June 30th President Obama signed the PROMESA bill which allows Puerto Rico to begin working through its severe fiscal challenges. Among the many features of the bill, it allows for: 1) the stay of all debt-related litigation against the Commonwealth through at least February 2017, 2) the establishment of a seven member Control Board with power over financial matters, and 3) the ability to force any holdout bondholders to accept debt restructuring terms if two-thirds of bondholders consent voluntarily. The bill did not, however, prevent the default on $911 million of July 1 debt payments, $780 million of which was constitutionally backed general obligation debt.

Another last minute deal occurred in Illinois as Republican Governor Rauner and the Democratic-led legislature reached a compromise on a six month spending plan. Having gone a full year without a budget, this plan assures schools will open in the fall, provides some financial relief for Chicago Public Schools (CPS), and allows the city of Chicago to raise property taxes to help pay for CPS pensions. Illinois' ratings recently fell into the "BBB" category by all three major rating agencies. Despite the ratings pressure, Illinois successfully borrowed $550 million in the market at spreads in the ten year maturity range of approximately +190 bps to AAA rated tax-free yields; only slightly wider than where it was trading prior to issuance.

Strong Quarterly Returns

The returns for both the month of June and the full quarter illustrate how risk-seeking investors were well rewarded. Longer-term segments of the market outperformed shorter maturities, with the longest bonds returning an impressive 4.5% return for the quarter. While the quality performance differences for the quarter weren't as dramatic as the curve disparity (+385 bps between the short and long maturities), the outperformance of BBB over AAA credits was still an impressive 101 bps. Further evidence of the risk-on theme is found in the high yield sector, the best performing sector in June and for the full quarter, thanks to a price rebound for select Puerto Rico credits as prospects for passage of the PROMESA bill improved.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Barclays Index/Sector	June	3Mo	YTD	Barclays Quality	June	3Mo	YTD
Municipal Bond Index	1.59%	2.61%	4.33%	AAA	1.43%	2.20%	3.74%
General Obligation bonds	1.52%	2.41%	3.96%	AA	1.49%	2.40%	4.00%
Revenue bonds	1.74%	2.92%	4.82%	A	1.82%	3.14%	5.12%
Prerefunded bonds	0.49%	0.65%	1.28%	BBB	1.82%	3.21%	5.30%
Long maturities (22+ yrs.)	2.53%	4.51%	6.84%	High Yield	3.11%	4.58%	6.31%
Intermediate maturities (1 - 17 yrs.)	1.24%	1.90%	3.38%	HY, ex-Puerto Rico	1.88%	3.17%	4.99%
Short maturities (1 - 5 yrs.)	0.48%	0.66%	1.37%				

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.