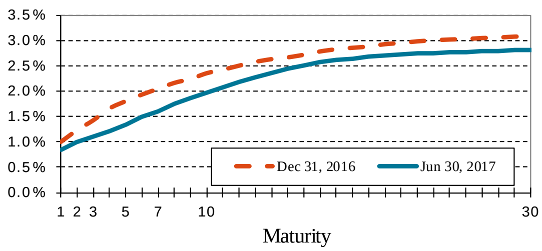
Baird Advisors
Municipal Fixed Income Market Comments
June 2017

Modest Retracement but Favorable Backdrop Remains

Tax-free rates rose modestly in June, pushed higher by slight upward pressure on Treasury yields. For the second quarter and through the first six months of the year, the resiliency of the municipal market has been impressive; particularly so given the well-known desire of the Trump Administration to reform the tax code. Witnessing the challenges of getting healthcare reform passed has lowered investor expectations for meaningful tax reform. Any tax changes that may occur are now expected to be “later and less” than initial post-election assumptions. Additional support for the municipal market was provided by a favorable supply/demand imbalance as supply levels dipped on a 43% YoY decline in refunding volume, leaving YTD total supply 14% behind last year’s pace. At the same time, over $5.6B of new money flowed into tax-free funds and ETFs (according to Lipper data), the majority of which was directed to long-term and high yield tax-free investment vehicles offering greater income. That risk-on perspective led to a flatter municipal curve during the quarter, as long rates fell more than short rates, and a narrowing of credit spreads. For example, yields on 10-year, BBB rated municipal issues narrowed to AAA issues by 15 bps for the quarter and 53 bps YTD. The favorable supply/demand conditions that have helped the market are expected to remain through the summer as more debt rolls off than is scheduled to be issued in both July and August.

AAA Municipal Yields



Maturity	Dec 31, 2016	Mar 31, 2017	May 31, 2017	Jun 30, 2017	1Mo Change	3Mo Change	YTD Change
1	1.00%	0.85%	0.76%	0.84%	0.08%	-0.01%	-0.16%
2	1.23%	1.03%	0.89%	0.99%	0.10%	-0.04%	-0.24%
3	1.43%	1.22%	0.99%	1.11%	0.12%	-0.11%	-0.32%
5	1.80%	1.58%	1.24%	1.35%	0.11%	-0.23%	-0.45%
7	2.05%	1.92%	1.51%	1.60%	0.09%	-0.32%	-0.45%
10	2.35%	2.26%	1.90%	1.96%	0.06%	-0.30%	-0.39%
30	3.08%	3.07%	2.76%	2.81%	0.05%	-0.26%	-0.27%

Credit Updates

The political leaders in Illinois were unable to pass a budget by the June 30 deadline, which means the state enters its third consecutive fiscal year without a formal spending plan. A bill was passed in the House after the deadline that would increase income taxes by an estimated $5B combined with a 5% across the board spending cut to state agencies, saving $2.4B in expenses. The bill now moves to the Senate for review. Governor Rauner has stated that he would veto this bill, given the tax increases without the reform measures he’s seeking, but it appears there may be sufficient support to override his veto. Whether the credit rating agencies will view the progress in discussions as sufficient to postpone further ratings downgrades remains uncertain. S&P, in particular, indicated a below investment grade rating was likely for the state if no agreement was reached by month end. While several other states are still working to finalize a budget, none are as financially stressed as Illinois. A rating below investment grade for Illinois’ state general obligation credit, if it were to occur, would be unprecedented.

Unfortunately, the negative news on Illinois and a handful of other credits often overshadows the good news occurring among most other municipalities. Recent data from the Census Bureau reported that state and local tax revenues rose 4.1% in 1Q2017, even above the 3.4% average pace since the last recession. Income taxes and property taxes led the gains, rising 7.1% and 6.3%, respectively, on a YoY basis. At the same time, the spring fiscal survey of states, sponsored by the National Association of State Budget Officers, showed that state spending was expected to rise just 1.0% in fiscal year 2018, below expected revenue increases and the lowest increase since the Great Recession. Caution still rules the day when it comes to state spending plans.

Strong Mid-year Municipal Returns

Modestly negative returns in June only marginally detracted from the strong quarterly and YTD returns for the municipal market. In the second quarter risk-seeking strategies were rewarded as long-term maturities outperformed both short and intermediate issues. Lower quality investment grade rated issues also outperformed AAA and AA securities last quarter, but the High Yield municipal sector was the clear leader in the first half of 2017.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	June	3Mo	YTD	Bloomberg Barclays Quality	June	3Mo	YTD
Municipal Bond Index	-0.36%	1.96%	3.57%	AAA	-0.45%	1.73%	3.19%
General Obligation bonds	-0.50%	1.80%	3.46%	AA	-0.36%	1.89%	3.41%
Revenue bonds	-0.32%	2.19%	3.85%	A	-0.30%	2.19%	3.94%
Prerefunded bonds	-0.21%	0.54%	1.54%	BBB	-0.37%	2.09%	4.32%
Long maturities (22+ yrs.)	-0.25%	2.75%	4.54%	High Yield	-0.22%	1.99%	6.13%
Intermediate maturities (1 - 17 yrs.)	-0.38%	1.64%	3.21%	HY, ex-Puerto Rico	-0.28%	3.29%	8.19%
Short maturities (1 - 5 yrs.)	-0.25%	0.56%	1.77%				

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.