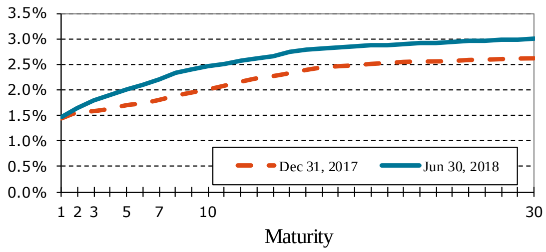
Baird Advisors
Municipal Fixed Income Market Commentary
June 2018

Short Rates Fall, Tax-free Curve Steepens

The short end of the tax-free curve set the pace in June as rates fell as much as 19 bps. The fact that short tax-free rates fell in the same month that the Fed raised the federal funds rate by 25 bps, the second increase this year, highlights the strong individual investor demand for municipals. Tax-free funds actually received positive flows in each of the last eight weeks of the quarter. Institutional demand, however, was less stable as select banks and P&C insurers sold a modest portion of their tax-free holdings in the quarter given the lower corporate income tax rate. Institutional selling was welcomed by a supply-starved market given the disappearance of tax-free advanced refundings. New issue volume was off 12% in Q2 from the same quarter last year and 20% behind YTD. Nonetheless, longer-term rates rose modestly last month which caused the municipal curve to steepen, diverging from the ongoing flattening trend in the U.S. Treasury market. The +82 bps yield spread between 2s-10s in municipals provides a significant roll-down advantage over the + 33 bps yield pick-up in the same segment of the Treasury curve.

AAA Municipal Yields



Maturity	Dec 31, 2017	Mar 31, 2018	May 31, 2018	Jun 30, 2018	1Mo	2Q	YTD
1	1.44%	1.55%	1.66%	1.47%	-0.19%	-0.08%	0.03%
2	1.56%	1.68%	1.78%	1.65%	-0.13%	-0.03%	0.09%
3	1.59%	1.81%	1.87%	1.79%	-0.08%	-0.02%	0.20%
5	1.70%	2.07%	2.02%	2.00%	-0.02%	-0.07%	0.30%
7	1.80%	2.25%	2.22%	2.20%	-0.02%	-0.05%	0.40%
10	2.01%	2.48%	2.43%	2.47%	0.04%	-0.01%	0.46%
30	2.62%	3.01%	2.94%	3.00%	0.06%	-0.01%	0.38%

Supreme Court Rulings and Stronger Economy Benefit Municipalities

- The U.S. Supreme Court offered benefits to states through two separate rulings in June and a prior decision in May. In the *Murphy v. NCAA* case in May, the Court legalized gambling on sports. While the revenue benefit is expected to be modest, a few select states (e.g. NJ, PA, and MS) should begin to "win" relatively quickly.

- In a 5-4 ruling in June, the Court ruled in the *South Dakota v. Wayfair* case that states can collect sales tax on online transactions from retailers that do not have a physical presence in the state. While not all states levy a sales tax, the decision will help many states, particularly those that do not levy a state income tax but rely instead primarily on sales tax revenue (e.g. FL, SD, TN, and TX). The U.S. Governmental Accountability Office (GAO) estimates state and local governments could see an additional $8.5B - $13.4B annually from the decision, based on 2017 data.

- Perhaps even more significant, in a similar 5-4 decision in the *Janus v. AFSCME* case the Supreme Court ruled that non-member government employees can opt-out of paying union dues. Over time, this will likely benefit municipalities in labor negotiations, particularly in the critical area of pension related benefits.

- While the pace of economic growth may approach 3% in 2018, the National Association of State Budget Officers (NASBO) expects state revenues to grow by 4.9%, with some state revenues rising as much as 10% YoY. Many states are using the stronger tax revenues to build reserves for the next slowdown. The median state rainy day fund balance has grown to 5.8% of expenditures from a low of 1.9% in 2011, and surpassing the 4.9% pre-recession peak.

Curve Mattered in June; Credit Drove Q2 Returns

Curve positioning was the most important performance factor in June as short-term debt outperformed long-term maturities given the steepening curve. However, credit risk was the driving factor for the full quarter, as BBB and High Yield municipals outperformed higher quality issues. The same influences of curve and credit also explain YTD performance differences; High Yield is the YTD performance leader while short-term debt has outperformed intermediate and long maturities.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	June	2Q	YTD	Bloomberg Barclays Quality	June	2Q	YTD
Municipal Bond Index	0.09%	0.87%	-0.25%	AAA	0.09%	0.72%	-0.48%
General Obligation bonds	0.06%	0.87%	-0.34%	AA	0.06%	0.80%	-0.32%
Revenue bonds	0.07%	0.90%	-0.31%	A	0.10%	0.91%	-0.18%
Prerefunded bonds	0.35%	0.63%	0.59%	BBB	0.16%	1.41%	0.40%
Long maturities (22+ yrs.)	-0.13%	0.92%	-0.66%	High Yield	0.50%	3.06%	3.66%
Intermediate maturities (1 - 17 yrs.)	0.18%	0.85%	-0.07%	HY, ex-Puerto Rico	0.39%	2.72%	2.95%
Short maturities (1 - 5 yrs.)	0.36%	0.66%	0.77%				

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.