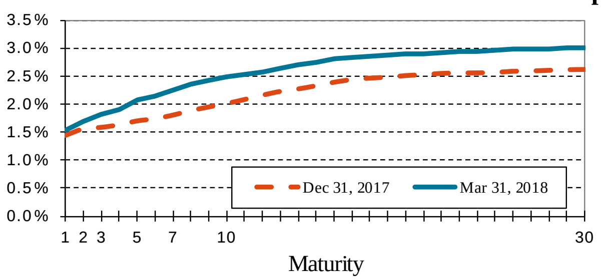
# Baird Advisors
# Municipal Fixed Income Market Commentary
# March 2018

## Higher Yields and Steeper Curve in Q1

Short and intermediate maturity tax-free yields continued to move higher in March, extending the rising rate trend since year end, but long-term municipal rates bucked the trend and fell last month. As expected, municipal issuance declined in Q1 as a result of the tax reform legislation; supply was off 32% YoY primarily due to the elimination of tax-exempt refundings. Overall demand, however, was positive with cash inflows to municipal funds in ten of the first thirteen weeks of 2018, according to Lipper. For the quarter, tax-free yields rose at all points along the curve with the most significant increase in the 10-year range where yields rose 47 bps. Unlike the U.S. Treasury curve, which flattened as yields rose in Q1 (i.e. short rates rose more than long), the municipal curve instead steepened with short rates rising modestly while longer yields shifted notably higher. There are many reasons for divergences between the slope of the Treasury and municipal curves, but principal among them is the segmentation of buyers in the municipal market. Individual investors, which as noted above continue to demonstrate strong interest in the tax-free market, tend to focus on intermediate and shorter maturities when buying, while institutional investors, such as banks and insurance companies, have historically participated beyond ten years. Lowering the corporate tax rate to 21% from 35% reduced the marginal demand from these institutions, leading to the recent relative steepening of the municipal curve.

**AAA Municipal Yields**




| Maturity | Dec 31, 2017 | Feb 28, 2018 | Mar 31, 2018 | 1Mo Change | 1Q Change |
|---|---|---|---|---|---|
| 1 | 1.44% | 1.38% | 1.55% | 0.17% | 0.11% |
| 2 | 1.56% | 1.57% | 1.68% | 0.11% | 0.12% |
| 3 | 1.59% | 1.71% | 1.81% | 0.10% | 0.22% |
| 5 | 1.70% | 1.99% | 2.07% | 0.08% | 0.37% |
| 7 | 1.80% | 2.21% | 2.25% | 0.04% | 0.45% |
| 10 | 2.01% | 2.49% | 2.48% | -0.01% | 0.47% |
| 30 | 2.62% | 3.10% | 3.01% | -0.09% | 0.39% |

## Improving State Tax Revenues and Municipal Credit Ratings

An unexpected surprise of tax reform has been improved state tax revenues. When the legislation was passed, there was concern that capping the state and local tax deduction at $10,000 could hurt states with higher tax rates as tax sensitivity rose and residents could flee for more favorable tax environments. While those concerns may still pose long term risks for select states, in the short term the federal tax changes, combined with the favorable stock market performance in 2017 and stronger GDP growth have provided a surprising surge in state tax revenues on a broad basis in fiscal year 2018. For example, repealing the personal exemption and limiting other deductions effectively increased a tax filer's adjusted gross income, generating higher tax revenues in states that do not make offsetting adjustments. In addition, those states that levy income taxes on investment gains and income (e.g. TN, CA, NY) benefited from a nearly 20% gain in the S&P 500 in 2017. Also, stronger nominal economic growth enhances personal and corporate income taxes as well as sales tax revenues. The result is that many states are already reporting a significant increase in tax revenues. Morgan Stanley reports an average increase of over 10% in YoY revenue comparisons for the December/January period. Some of this boost is nonrecurring, but a portion should be sustained as long as economic growth remains solid. Even before the recent boost in revenues, the municipal credit trend has been favorable. Moody's reported that ratings upgrades outpaced downgrades for the third consecutive year in 2017. Among the 11,344 rated credits in the Moody's public finance universe, upgrades outpace downgrades by 68%, 774 to 461, respectively. Two sectors which experienced more negative ratings pressure than positive was in Healthcare and Higher Education; both sectors witnessed more downgrades than upgrades, emphasizing the importance of ongoing credit analysis and review across the municipal credit spectrum.

## Solid March Returns Help Minimize Q1 Setback

In March, the longest maturities outperformed shorter tenors on the curve but suffered the worst performance for the full quarter as rates rose and the yield curve steepened. Prerefunded issues were the best performing sector in Q1 due to its short average maturity structure and scarcity. Along the quality spectrum, High Yield municipals outperformed higher quality categories.

## Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

| Bloomberg Barclays Index/Sector | March | 1Q | 2017 | Bloomberg Barclays Quality | March | 1Q | 2017 |
|---|---|---|---|---|---|---|---|
| Municipal Bond Index | 0.37% | -1.11% | 5.45% | AAA | 0.33% | -1.19% | 4.45% |
| General Obligation bonds | 0.34% | -1.20% | 5.24% | AA | 0.35% | -1.11% | 4.96% |
| Revenue bonds | 0.43% | -1.19% | 6.00% | A | 0.39% | -1.08% | 6.16% |
| Prerefunded bonds | -0.05% | -0.04% | 1.37% | BBB | 0.47% | -1.00% | 8.74% |
| Long maturities (22+ yrs.) | 0.71% | -1.56% | 8.19% | High Yield | 1.46% | 0.58% | 9.69% |
| Intermediate maturities (1 - 17 yrs.) | 0.22% | -0.91% | 4.33% | HY, ex-Puerto Rico | 1.15% | 0.23% | 12.86% |
| Short maturities (1 - 5 yrs.) | -0.07% | 0.10% | 1.61% | | | | |

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.