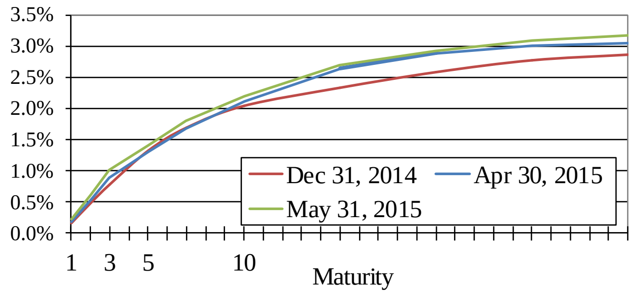
**Baird Advisors**
**Municipal Fixed Income Market Comments**
**May 2015**

### Yields Rise and Curve Steepens

Tax-free yields moved in a similar manner as the Treasury market in May as yields rose during the month and the curve steepened. In addition to the U.S. economy showing some signs of modest reacceleration, the municipal market also struggled with abundant new supply in the face of modest outflows. Supply in May was robust, with nearly $32B in new issuance, up 36% year-over-year. At the same time, tax-free funds experienced four consecutive weeks of modest outflows. YTD aggregate inflows are still strongly positive at more than $11B, but the recent outflows point to an investor base that may becoming a bit more anxious over the prospects of the Fed's first rate hike which is expected later this year.

**AAA Municipal Yields**




| Maturity | Dec 31, 2014 | Apr 30, 2015 | May 31, 2015 | 1Mo Change | YTD Change |
|---|---|---|---|---|---|
| 1 | 0.16% | 0.22% | 0.22% | 0.00% | 0.06% |
| 2 | 0.48% | 0.53% | 0.62% | 0.09% | 0.14% |
| 3 | 0.78% | 0.88% | 1.01% | 0.13% | 0.23% |
| 5 | 1.32% | 1.30% | 1.41% | 0.11% | 0.09% |
| 7 | 1.69% | 1.67% | 1.81% | 0.14% | 0.12% |
| 10 | 2.04% | 2.12% | 2.19% | 0.07% | 0.15% |
| 30 | 2.86% | 3.05% | 3.16% | 0.11% | 0.30% |

### Attractive Valuations and Improving Summer Seasonals

YTD total municipal supply is up 56% from the slow pace early in 2014, and full 2015 supply estimates of $400B now seem quite likely. Thanks to the low rate environment, nearly 70% of all new issues are refunding related, a factor which adds net duration to the market and has contributed to tax-free yields rising more than taxable yields YTD. At month end, for example, the 5-year segment of the curve was the only maturity in which AAA rated tax-free issues were yielding less than their Treasury counterparts. Attractive cross-market valuations and a soon-to-be improving supply/demand backdrop may lead to improved relative performance over the summer. In June net issuance swings from positive to an estimated net negative $18B as the pace of bond calls and maturities increases. The favorable technical pattern should persist through August.

### Credit Updates

- On May 12th, Moody's lowered the ratings of over $13B of Chicago debt to below investment grade, following the Illinois Supreme Court ruling that retirement benefits were protected by the state constitution and could not be cut. Both S&P (A-) and Fitch (BBB+) still maintain investment grade ratings for Chicago GO debt (albeit with negative outlooks), which helped hold off what could have been significant financial penalties from the city's swap counterparties. Chicago was able to issue over $800M of debt to refinance floating rate obligations, but at spreads as wide as +300 bps to comparable maturity AAA rated issues, a significant yield penalty from prior issues.
- Puerto Rico's governor signed into law a sales tax increase, scheduled to take effect July 1, which is expected to bring in up to $1.2B of additional revenue. The new sales tax of 11.5%, up from 7.0%, is the highest among any U.S. state or territory, and will now likely allow additional financing to help the island avoid a liquidity squeeze in coming months.
- The Rockefeller Institute of Government reported that state tax revenues in Q4 2014 were 5.7% above prior year levels, with strong gains in both personal income taxes and sales tax revenues. Early figures for Q1 2015 suggest further gains are likely. At the same time, expenditure demand is rising as well. State spending for key services, such as education, health care spending, and pension costs are keeping pressure on states to maintain structurally balanced budgets.

**Total Returns of Selected Barclays Indices and Subsectors**

| Barclays Index/Sector | May | YTD | Barclays Quality | May | YTD |
|---|---|---|---|---|---|
| Municipal Bond Index | -0.28% | 0.21% | AAA | -0.21% | 0.10% |
| Long maturities (22+ yrs.) | -0.33% | 0.29% | AA | -0.22% | 0.22% |
| Intermediate maturities (2 - 17 yrs.) | -0.31% | 0.18% | A | -0.37% | 0.09% |
| Short maturities (1 - 5 yrs.) | -0.17% | 0.20% | BBB | -0.39% | 1.09% |
| Prerefunded bonds | -0.19% | 0.02% | High Yield | 1.13% | 1.83% |
| General Obligation bonds | -0.35% | 0.00% | | | |
| Revenue bonds | -0.26% | 0.29% | | | |

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.

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, prerefunded 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.*