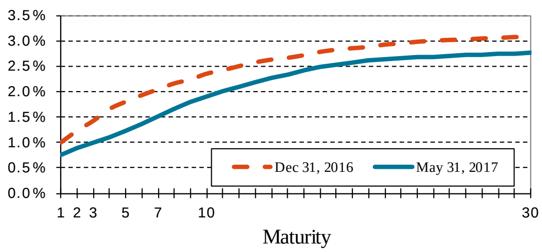
Baird Advisors
Municipal Fixed Income Market Comments
May 2017

Light Supply, Stalled Tax Reform, Leads to Municipal Rally

Several factors contributed to a strong rally in the municipal market last month. A lack of new municipal supply helped fuel demand even as yields moved lower across the yield curve. Intermediate and long-term yields fell more than shorter maturities, continuing the YTD flattening trend. May's volume was 20% below the same month last year and YTD supply is off 13% from 2016's record pace. Treasury Secretary Mnuchin's comments to the Senate Finance Committee provided additional support when he stated the Administration's "strong" support for the municipal tax exemption. Lack of progress on President Trump's fiscal agenda has pushed tax reform expectations to 2018 with any changes in tax policy now likely to be modest. The result was municipal outperformance relative to Treasuries. For example, two-year Treasury yields rose 2 bps while tax-free yields fell 12 bps; in 10-year space, Treasury yields fell 8 bps as municipal yields fell 26 bps. The outperformance of tax-free issues left municipal valuations on the richer side of recent ranges relative to Treasuries, but the municipal strength is likely to remain through the summer based on favorable supply/demand. Outstanding supply is expected to shrink by as much as $40B from June – August as more debt rolls off than is issued during this period of seasonal strength.

AAA Municipal Yields



Maturity	Dec 31, 2016	Mar 31, 2017	Apr 30, 2017	May 31, 2017	1Mo Change	QTD Change	YTD Change
1	1.00%	0.85%	0.84%	0.76%	-0.08%	-0.09%	-0.24%
2	1.23%	1.03%	1.01%	0.89%	-0.12%	-0.14%	-0.34%
3	1.43%	1.22%	1.18%	0.99%	-0.19%	-0.23%	-0.44%
5	1.80%	1.58%	1.45%	1.24%	-0.21%	-0.34%	-0.56%
7	2.05%	1.92%	1.78%	1.51%	-0.27%	-0.41%	-0.54%
10	2.35%	2.26%	2.16%	1.90%	-0.26%	-0.36%	-0.45%
30	3.08%	3.07%	3.02%	2.76%	-0.26%	-0.31%	-0.32%

Credit Updates

Puerto Rico officially filed what is the equivalent of bankruptcy protection for a U.S. territory and a federal judge has been appointed to referee the battle among various credit groups. A long, difficult road ahead is expected for all involved. Of particular near term importance is how general obligation bondholders will fare relative to holders of sales tax bonds (COFINAs). Each believes they have the priority claim on island revenues and tens of billions of debt are at stake. Another troubled municipal story remains the State of Illinois (Baa3/BBB-/BBB), which missed a May 31 deadline to pass a budget with a simple majority. With one month left in the fiscal year, a three-fifths majority is now required to reach an agreement. June 30th will be two full years without an official budget if no agreement is reached by then. Rating agencies reacted with further downgrades as the May deadline passed. If there is a silver lining in the clouds over Illinois, it is that the problems are largely political. Much of the state, and particularly metro-Chicago, remains a vibrant economic region. Also, the State of Connecticut (A1/A+/A+) was downgraded one notch by all three major rating agencies due to a large budget gap and high unfunded pension liabilities. Recently, however, public employees agreed to a three year wage freeze and to contribute more for pension and healthcare benefits. These changes, if finalized, would save the state more than $1.5B over the next two years to help reduce the budget deficit. On the other side of the credit spectrum, Gov. Brown in California is proposing a $6B cash infusion to CalPERS in addition to the state's required annual contribution. Knowing how volatile California state revenues can be, he is hoping to reduce long term liabilities while state revenues are strong and reserve levels are high. If approved this additional payment would save the state $11B over 20 years – a prudent fiscal move for the state.

Strong Returns in May

The decline in yields across the municipal curve led to strong market returns in May. Risk-seeking investors were well rewarded as longer maturities and lower quality credits outperformed shorter and higher rated issues. Prerefunded issues lagged others due to their higher credit quality and shorter average maturity relative to other market sectors. High-yield municipals, excluding Puerto Rico debt, continued to be the market leader for the month and YTD.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	May	YTD	12Mo	Bloomberg Barclays Quality	May	YTD	12Mo
Municipal Bond Index	1.59%	3.94%	1.46%	AAA	1.49%	3.66%	1.18%
General Obligation bonds	1.62%	3.98%	1.30%	AA	1.53%	3.78%	1.33%
Revenue bonds	1.71%	4.18%	1.57%	A	1.70%	4.25%	1.84%
Prerefunded bonds	0.45%	1.75%	0.95%	BBB	1.83%	4.71%	1.60%
Long maturities (22+ yrs.)	2.25%	4.80%	1.45%	High Yield	1.53%	6.36%	4.60%
Intermediate maturities (1 - 17 yrs.)	1.31%	3.61%	1.47%	HY, ex-Puerto Rico	2.35%	8.50%	4.23%
Short maturities (1 - 5 yrs.)	0.50%	2.03%	1.20%				

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.