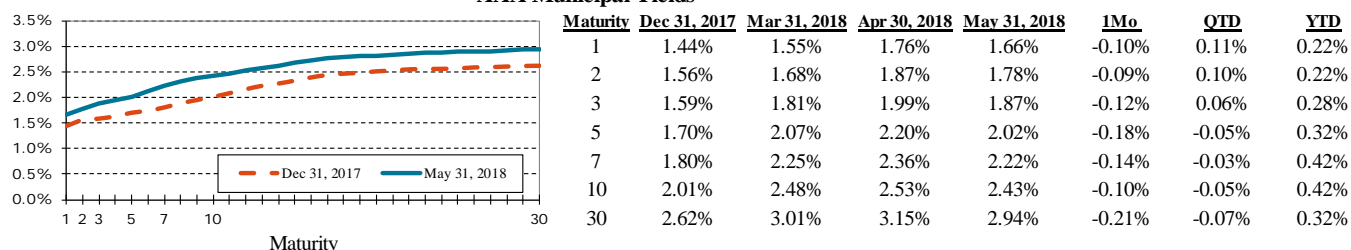


Baird Advisors
Municipal Fixed Income Market Commentary
May 2018

Yields Fall as Supply Remains Light

Tax-free yields fell approximately 10 to 20 bps across the curve in May, declining more than Treasury yields in most maturities. The municipal market continued to benefit from relatively light supply as YTD issuance through May is 22% below last year's pace. New money borrowing which helps fund infrastructure projects is actually up 18% YoY, but a more than 50% decline in refundings has been the primary factor limiting supply. Going forward, issuance is expected to remain light and supportive of valuations with an estimated -\$50B net decrease in outstanding supply from June through August. Modest selling from U.S. banks and insurance companies, given the lower corporate tax rate, may partially offset the light new supply. According to SEC filings some of the biggest U.S. banks were net sellers in the first quarter. According to Barclays, total bank exposure to municipals fell by an estimated \$15B in the first quarter, a small percentage of the \$570B of municipal debt they held at year end. For example, Bank of America, Citigroup, JP Morgan Chase and Wells Fargo reduced their municipal holdings by a total of \$7.8B in 1Q. Retail investors continue to show steady interest in municipals as flows into municipal funds were positive in three of the four weeks of May.

AAA Municipal Yields



Other Municipal Developments

- Unlike the contentious and lengthy political battles of the last few years, the Illinois legislature and Governor reached a budget agreement before the start of the new fiscal year on July 1st. An overwhelming majority of both Democrats and Republicans agreed to a \$38.5B spending plan as neither party wanted a prolonged battle ahead of the November elections. Unfortunately, this budget agreement does not address either the \$6.6B backlog of unpaid bills nor the ongoing need for pension reform for the state.
- Texas is booming. Data from the U.S. Census Bureau showed that seven of the 15 fastest growing city populations last year were in Texas. The populations of Frisco, New Braunfels, and Pflugerville each grew by more than 6.5% in 2017 alone. The rise in energy prices is certainly helping the Texas economy, but a favorable tax environment in the state is also a draw. For municipal investors, the population growth leads to more borrowing needs and in April Texas voters approved over \$4B of new borrowing. These funds will be used to finance new schools and other infrastructure needs, including transportation projects, flood control issues and hurricane related risks.
- The U.S. Supreme Court opened the door for legalized sports betting to spread across the country by its recent ruling in the Murphy v. NCAA case. New Jersey was the direct beneficiary of the decision, but Pennsylvania and Mississippi are also well positioned to benefit in the near term from the ruling as well. A recent study commissioned by the American Gaming Association estimated the expansion of sport gambling could generate \$3.4B annually for state and local governments, which is helpful, but would represent a small fraction (0.3%) of total state and local tax revenue.

Positive Returns in May

Falling yields generated positive returns across all portions of the municipal market in May. Longer maturities outperformed shorter segments of the yield curve and lower quality credits outperformed higher quality. Prerefunded bonds lagged other market sectors due to both its higher quality and shorter average duration relative to other market sectors.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

<u>Bloomberg Barclays Index/Sector</u>	<u>May</u>	<u>YTD</u>	<u>12Mo</u>	<u>Bloomberg Barclays Quality</u>	<u>May</u>	<u>YTD</u>	<u>12Mo</u>
Municipal Bond Index	1.15%	-0.33%	1.11%	AAA	1.06%	-0.57%	0.20%
General Obligation bonds	1.19%	-0.40%	0.80%	AA	1.12%	-0.38%	0.75%
Revenue bonds	1.19%	-0.38%	1.36%	A	1.14%	-0.28%	1.55%
Prerefunded bonds	0.53%	0.24%	-0.13%	BBB	1.48%	0.23%	4.10%
Long maturities (22+ yrs.)	1.69%	-0.53%	2.69%	High Yield	2.09%	3.15%	6.38%
Intermediate maturities (1 - 17 yrs.)	0.94%	-0.25%	0.45%	HY, ex-Puerto Rico	1.91%	2.56%	6.68%
Short maturities (1 - 5 yrs.)	0.55%	0.40%	-0.01%				

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.