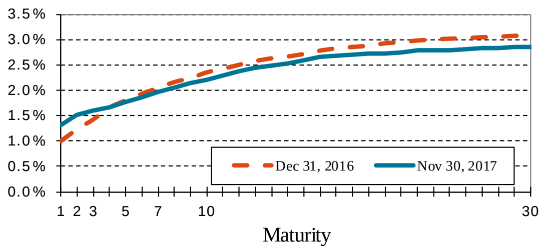
Baird Advisors
Municipal Fixed Income Market Comments
November 2017

Tax Reform Boosts Supply, Pressures Yields Higher

Actual supply and the anticipation of even more supply pushed yields higher across the short to intermediate segment of the tax-free yield curve last month. Short rates rose more than 40 bps while yields on the longest maturities modestly declined, leading to a flatter yield curve. The flattening was an extension of an ongoing trend, driven by the Fed's normalization of monetary policy, but was exaggerated last month in the municipal market by the growing belief that a tax reform bill will pass. The sentiment shift on tax reform forced issuers to consider pulling forward future refunding issues and even new money borrowings for private activity bonds, both of which may be restricted or eliminated in the new legislation (see below). Municipal supply of $36.8B was issued in November, up 11% from the same month last year, but it is estimated that as much as $60B could be issued in December. If so, that would be the highest monthly supply since a similar surge of issuance prior to the passage of the 1986 tax reform. Market yields adjusted higher in order to clear both current supply and the expected rush of year-end issuance. Additional pressure emerged for the front end of the curve as investors sold short-term bonds to extend along the curve on the belief that tax-free issuance may decline. The unique conditions in the municipal market led to a larger yield adjustment among municipals than within taxables, enhancing the value of tax-free bonds for investors looking to capitalize on this potential municipal market opportunity.

AAA Municipal Yields



Maturity	Dec 31, 2016	Aug 31, 2017	Oct 31, 2017	Nov 30, 2017	1Mo Change	3Mo Change	YTD Change
1	1.00%	0.76%	0.99%	1.32%	0.33%	0.56%	0.32%
2	1.23%	0.85%	1.09%	1.52%	0.43%	0.67%	0.29%
3	1.43%	0.94%	1.21%	1.61%	0.40%	0.67%	0.18%
5	1.80%	1.12%	1.45%	1.78%	0.33%	0.66%	-0.02%
7	2.05%	1.42%	1.70%	1.96%	0.26%	0.54%	-0.09%
10	2.35%	1.84%	2.03%	2.21%	0.18%	0.37%	-0.14%
30	3.08%	2.74%	2.89%	2.86%	-0.03%	0.12%	-0.22%

Tax Reform and the Potential Municipal Impact

The House tax reform bill, which passed in mid-November, and the Senate bill, which passed just after month end, each have provisions which would have both positive and negative effects on the municipal market. **The key take-away from the bills, however, would be a reduction in tax-free debt issuance going forward**. Both the House and Senate reform plans eliminate advance refundings (i.e. refinancings done more than 90 days prior to a call date) in the tax-exempt market, forcing issuers to consider a more costly refinancing in the taxable market. If advance refundings are lost, tax-free issuance next year could drop by up to 20%. The House bill goes further, also eliminating the tax-free issuance of private activity bonds, including 501c3 entities, such as private universities and charter schools, housings, airports, hospitals, and more. While supply would be reduced, demand from individuals should remain strong as top marginal income tax rates are likely to remain at or near current levels. The bills also propose to reduce or eliminate the deduction of state and local taxes (SALT), making in-state tax-exempt bonds in several high-tax states especially valuable to investors. Less supply and solid demand would create a technical imbalance which could enhance the value of tax-free bonds relative to taxables. On the negative side, however, the municipal market may see less participation from corporations if their tax rate is lowered. For example, lowering the corporate rate to 20%, as is currently proposed, may cause banks and insurance companies to redirect more of their fixed income demand to the taxable market. Also, altering the SALT deduction could negatively impact general obligation credits over time. Tax payers may become more sensitive to taxes being paid and requests for future tax increases, thereby reducing a municipality's financial flexibility. The two bills will now move to a House-Senate reconciliation committee with hopes for passage of a final bill before year end.

Negative Returns on Supply Pressures

The upward adjustment in yields last month led to negative returns across all but the longest segment of the yield curve. Prerefunded bonds lagged other sectors while Revenue bonds outpaced GOs by 19 bps. Lower credit quality debt outperformed higher quality issues and High Yield municipals continued to outperform all other issues.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	November	3Mo	YTD	Bloomberg Barclays Quality	November	3Mo	YTD
Municipal Bond Index	-0.54%	-0.80%	4.36%	AAA	-0.68%	-1.10%	3.41%
General Obligation bonds	-0.65%	-0.92%	4.18%	AA	-0.59%	-0.92%	3.90%
Revenue bonds	-0.46%	-0.72%	4.80%	A	-0.45%	-0.68%	5.02%
Prerefunded bonds	-0.79%	-1.11%	1.12%	BBB	-0.17%	0.25%	7.45%
Long maturities (22+ yrs.)	0.20%	-0.03%	6.55%	High Yield	0.25%	-0.01%	8.29%
Intermediate maturities (1 - 17 yrs.)	-0.81%	-1.13%	3.47%	HY, ex-Puerto Rico	0.31%	0.47%	11.35%
Short maturities (1 - 5 yrs.)	-0.83%	-1.17%	1.41%				

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.

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