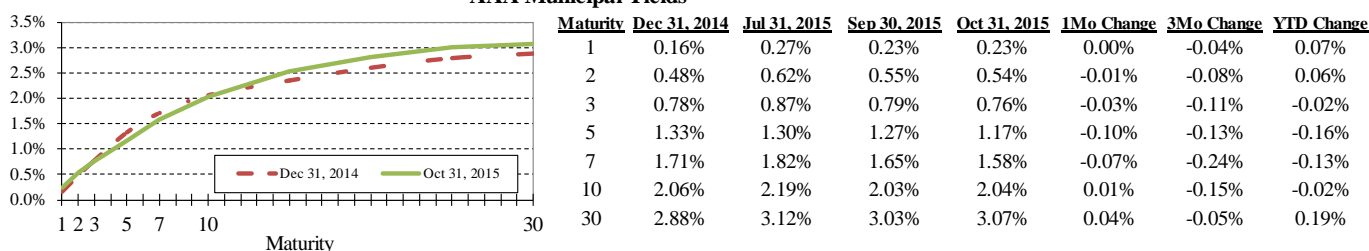


Baird Advisors
Municipal Fixed Income Market Comments
October 2015

Municipal Outperformance with Modest Steepening

The municipal market easily absorbed more robust monthly issuance after the September lull thanks to solid and consistent mutual fund inflows. October's supply of more than \$31 billion was well ahead of the \$24 billion in the prior month, but still off 8% from the heavy issuance in October 2014. Year-to-date supply for 2015 is 30% above last year's pace, roughly two-thirds of which has been refunding related. The solid tone in the municipal market was particularly evident among short and intermediate maturities where yields fell, while long term rates rose slightly. The tone of the municipal market was even more impressive after considering the rise in Treasury yields and the typical seasonal softness for municipals in October. The outperformance of tax-free yields led to a modestly overvalued municipal market at month end, particularly among short-term yields. For example, 2-year and 5-year AAA tax-free yields were just 74% and 76%, respectively, of comparable maturity Treasury rates. The three-month median municipal/Treasury yield ratio for these same maturities is 88% and 89%, respectively. Not surprisingly, the municipal market was less sensitive to the shift in sentiment than Treasuries following the October post-FOMC press release. The Fed hinted at a higher probability of a December rate hike despite relative economic weakness across much of the data last month.

AAA Municipal Yields



Other Municipal News

- Michigan remains a focus for municipal investors. First, the state is considering a bill that would clarify the priority of repayment of unlimited tax general obligation (UTGO) debt in bankruptcy. Although opposed by the Governor, the bill would grant express statutory lien status to the UTGO tax levy as has been done in other states, such as California, New Jersey, and Rhode Island. At the same time, Governor Snyder has proposed splitting Detroit's current school district. A new district would be responsible for the education, operations, and pension liability, with the help of additional state aid. The \$2.1 billion of outstanding debt would remain with the old district, repaid from existing property taxes.
- Two states, Pennsylvania and Illinois, remain without a budget now five months into the new fiscal year. Although Pennsylvania's state rating has not changed, Moody's lowered the ratings and outlook on several community colleges dependent upon state aid. Both Moody's and Fitch lowered the Illinois state rating one notch, to Baa1 and BBB+, respectively. The ratings on several Illinois public universities were also cut due to the budget impasse.
- The Obama Administration put forth a comprehensive solution to assist Puerto Rico's looming fiscal crisis. The plan includes a new type of bankruptcy protection, unique for U.S. territories, a broadening of the island's Medicaid program, and the installation of a financial control board. The plan would require Congressional approval.

Tobacco Issues Drive High Yield Outperformance

Performance across the municipal market was modestly positive in October, thanks to the yield declines among short and intermediate maturities and stable to narrower credit spreads. High yield issues continued its recent streak of outperformance despite growing uncertainty over Puerto Rico. A strong rally in the Tobacco sector was the major force for the high yield performance. The first year-over-year increase in cigarette shipments since 2006 was reported, a reversal from the recent 3% or greater annual declines, which boosted confidence among bondholders. Chicago credits also rallied after the passage of a multi-year increase in property taxes, which should help reduce, but not eliminate, the structural deficit the city continues to face.

Total Returns of Selected Barclays Municipal Indices and Subsectors

<u>Barclays Index/Sector</u>	<u>Oct</u>	<u>3Mo</u>	<u>YTD</u>	<u>Barclays Quality</u>	<u>Oct</u>	<u>3Mo</u>	<u>YTD</u>
Municipal Bond Index	0.40%	1.32%	2.17%	AAA	0.29%	1.21%	1.95%
General Obligation bonds	0.37%	1.39%	2.03%	AA	0.32%	1.27%	2.18%
Revenue bonds	0.44%	1.36%	2.32%	A	0.50%	1.43%	2.19%
Prerefunded bonds	0.14%	0.69%	1.14%	BBB	0.88%	1.63%	2.74%
Long maturities (22+ yrs.)	0.44%	1.44%	2.48%	High Yield	1.22%	3.79%	1.25%
Intermediate maturities (1 - 17 yrs.)	0.38%	1.28%	2.08%	HY - ex Puerto Rico	1.45%	3.23%	6.04%
Short maturities (1 - 5 yrs.)	0.27%	0.69%	1.40%				

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 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.