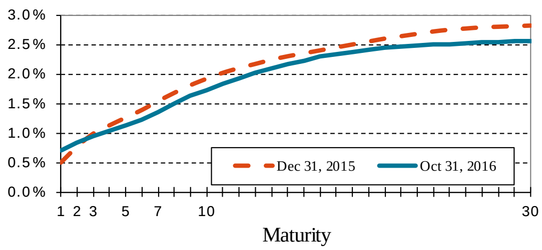
Baird Advisors
Municipal Fixed Income Market Comments
October 2016

Record Supply Leads to Higher Yields and Steeper Curve

Tax-free yields followed the directional lead of the Treasury market last month as rates rose and the yield curve steepened. The exception to this trend was the shortest end of the curve which held steady thanks to modest inflows into municipal money market funds and short-term alternatives. Short rates had previously risen ahead of the October implementation of new SEC money market regulations, helping to attract investor interest. Longer term rates rose, however, as record new supply required higher yield levels to clear the market. Over $53B of municipal debt was issued in October, the largest single month of supply in the last thirty years. Heavier issuance in recent months boosted the full year supply outlook to as much as $450B, above the record municipal volume of $433B set back in 2010. A good portion of the issuance back then was taxable, thanks to the post-crisis Build American Bond (BAB) program which created $188B of new supply from November 2009 through 2010. In contrast, taxable municipal issuance in 2016 is lower on a year-over-year basis, while tax-free supply is 12% above last year's pace. Still, the ability of the market to digest the record supply, even as municipal fund inflows slowed, was impressive. Three out of the four weeks in October witnessed positive mutual fund flows, although at a more moderate pace than in prior months. However, the streak of consecutive weekly inflows ended at 55 weeks; the third longest period since 2004.

AAA Municipal Yields



Maturity	Dec 31, 2015	Jul 31, 2016	Sep 30, 2016	Oct 31, 2016	1Mo Change	3Mo Change	YTD Change
1	0.50%	0.46%	0.78%	0.70%	-0.08%	0.24%	0.20%
2	0.77%	0.52%	0.82%	0.84%	0.02%	0.32%	0.07%
3	0.99%	0.59%	0.88%	0.94%	0.06%	0.35%	-0.05%
5	1.26%	0.84%	1.02%	1.13%	0.11%	0.29%	-0.13%
7	1.54%	1.11%	1.19%	1.36%	0.17%	0.25%	-0.18%
10	1.92%	1.40%	1.51%	1.73%	0.22%	0.33%	-0.19%
30	2.82%	2.12%	2.31%	2.56%	0.25%	0.44%	-0.26%

Infrastructure Spending to Rise

Adding to the supply comments above, the municipal market has benefited from an increase in refunding supply in 2016, which is running 6% above last year's pace. However, the real supply surprise has been the 19% increase in new money issuance. Certainly, some supply is being pulled forward in advance of the near-term uncertainty surrounding the November elections, a potential increase in the Fed Funds rate in December, as well as longer-term concerns over the tax and spending policies of a new administration in January. Still, the boost in new money supply may foretell improved levels of supply in 2017 and beyond that will help finance infrastructure needs. Municipalities remain reluctant to take on significant new projects given the sluggish pace of economic growth and moderating tax revenues, but necessary repairs and upgrades to existing infrastructure can only be delayed so long before spending becomes critical. To this end, a record level of ballot initiatives will be voted on in November for transportation projects alone. Voters in 26 states will decide on over $250B of spending referendums for nearly 400 local and regional transportation-oriented projects, according to the Eno Center for Transportation. Federal infrastructure spending initiatives are also likely in 2017, regardless of which candidate occupies the White House in January. In a rare example of bipartisan support, both Democrat and Republican parties seem to agree that additional spending is needed on our nation's infrastructure. Tackling the massive U.S. investment needs, which the American Society of Civil Engineers estimates to be as much as $3.6 trillion by 2020, will require a combination of public (federal, state and local) and private funds in order to make meaningful progress over the next several years.

Negative October Returns

Higher yields led to negative returns across the municipal market in October, although performance varied based on risk level. For example, short-term and intermediate maturities outperformed longer maturities as the curve steepened. Higher quality issues outperformed both lower quality investment grade as well as High Yield municipal credits. Across market sectors, Prerefunded issues outperformed others thanks primarily to their lower average duration relative to the general obligation and revenue-backed sectors.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	October	3Mo	YTD
Municipal Bond Index	-1.05%	-1.41%	2.92%
General Obligation bonds	-1.03%	-1.43%	2.54%
Revenue bonds	-1.17%	-1.50%	3.29%
Prerefunded bonds	-0.06%	-0.59%	0.90%
Long maturities (22+ yrs.)	-1.56%	-2.11%	4.48%
Intermediate maturities (1 - 17 yrs.)	-0.81%	-1.14%	2.35%
Short maturities (1 - 5 yrs.)	-0.11%	-0.58%	1.05%

Bloomberg Barclays Quality	October	3Mo	YTD
AAA	-0.90%	-1.39%	2.32%
AA	-1.00%	-1.42%	2.58%
A	-1.18%	-1.34%	3.78%
BBB	-1.28%	-1.64%	3.68%
High Yield	-1.24%	-0.62%	8.01%
HY, ex-Puerto Rico	-1.37%	-1.43%	6.87%

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.