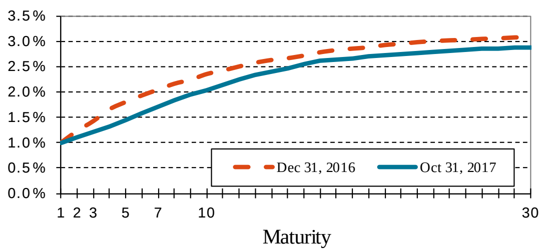
Baird Advisors
Municipal Fixed Income Market Comments
October 2017

Rates Rise Modestly, Curve Flattens

Short and intermediate term tax–free rates rose modestly last month while long term yields fell slightly, flattening the yield curve. The flattening that occurred in October, with short rates rising more than long, was a continuation of the gradual yet persistent curve trend that began in early-2014, well before the Fed's first rate hike, and reflects the ongoing normalization of monetary policy. Municipal yields remained in a narrow range despite greater focus on tax reform and rising costs from the string of costly natural disasters in the U.S. Regarding tax reform, the market anxiously awaits the details of the House tax bill scheduled for release in early-November. The framework of the proposed GOP tax changes, however, appears to be neutral-to-positive for tax-free valuations, helping explain the relative calm. Similarly, while the wildfires in northern California were devastating, causing an estimated $3B in damages in Sonoma County, there is unlikely to be any long-term financial impact on the area; the same view as in Texas and Florida following the severe hurricanes in September. Ongoing support for the municipal market has been provided by favorable supply/demand conditions. Last month, tax-free funds continued to receive positive, albeit modest, inflows, while supply remains light. YoY supply comparisons for last month are not meaningful since last October was the highest month of issuance in over 30 years. Nonetheless, YTD municipal issuance is 18% behind the 2016 pace, despite $6B of issuance for the State of Illinois last month alone. It's very unlikely that supply will pick up meaningfully before year end as the push for tax reform has a much higher priority than a federal infrastructure plan at this point.

AAA Municipal Yields



Maturity	Dec 31, 2016	Jul 31, 2017	Sep 30, 2017	Oct 31, 2017	1Mo Change	3Mo Change	YTD Change
1	1.00%	0.85%	0.92%	0.99%	0.07%	0.14%	-0.01%
2	1.23%	0.98%	1.02%	1.09%	0.07%	0.11%	-0.14%
3	1.43%	1.06%	1.13%	1.21%	0.08%	0.15%	-0.22%
5	1.80%	1.23%	1.37%	1.45%	0.08%	0.22%	-0.35%
7	2.05%	1.51%	1.64%	1.70%	0.06%	0.19%	-0.35%
10	2.35%	1.90%	2.00%	2.03%	0.03%	0.13%	-0.32%
30	3.08%	2.76%	2.90%	2.89%	-0.01%	0.13%	-0.19%

Tax Reform and Credit Updates

Details of the House's version of the tax plan were not yet available at month end, but tax-free investors have reacted favorably so far to the broad framework outlined by the GOP. While a decline in the corporate tax rate to 20% from the current 35% level could marginally reduce demand from banks and insurance companies, the impact would be most noticeable in higher relative yields on long-end maturities, steepening the yield curve. A steeper curve would likely be welcomed by many individual investors, perhaps bringing more individual demand into the market. It is expected that the top marginal rate will remain at or very close to the current 39.6% rate, maintaining the value of the tax exemption for many investors. In addition, if the state and local tax deduction were limited or eliminated, as proposed, it may have a positive impact on the demand for tax-free bonds in the higher income tax states. The details of the plan will be very important to more fully evaluate when they are released.

The top credit story last month was that Connecticut finally reached a bipartisan budget agreement that closed a projected $3.5B deficit over the next two fiscal years. As part of the budget, the state agreed to provide nearly $50 million of financial assistance to Hartford, the state capital, to avert a threatened Chapter 9 bankruptcy filing. Hartford bonds rallied on the news, but the city intends to continue negotiations with all stakeholders, including bond holders and insurers guaranteeing the debt, to assure that Hartford can remain on a favorable path going forward.

Modestly Positive October Returns

The modest upward pressure across much of the tax-free curve limited returns in October, although all but the shortest maturity segments had a positive return. The longest maturity segment, where rates fell slightly, outperformed the rest of the curve. Lower quality issues outperformed higher quality, and the Prerefunded sector lagged all others. Puerto Rico bond prices weakened further last month on post-hurricane uncertainty, limiting the performance of the High Yield municipal market.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	October	3Mo	YTD	Bloomberg Barclays Quality	October	3Mo	YTD
Municipal Bond Index	0.24%	0.49%	4.92%	AAA	0.19%	0.17%	4.12%
General Obligation bonds	0.21%	0.41%	4.86%	AA	0.23%	0.30%	4.52%
Revenue bonds	0.28%	0.58%	5.29%	A	0.26%	0.70%	5.50%
Prerefunded bonds	0.00%	0.02%	1.93%	BBB	0.38%	1.86%	7.63%
Long maturities (22+ yrs.)	0.47%	0.73%	6.33%	High Yield	0.27%	1.11%	8.01%
Intermediate maturities (1 - 17 yrs.)	0.14%	0.34%	4.32%	HY, ex-Puerto Rico	0.59%	1.66%	11.00%
Short maturities (1 - 5 yrs.)	-0.02%	0.05%	2.25%				

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.

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