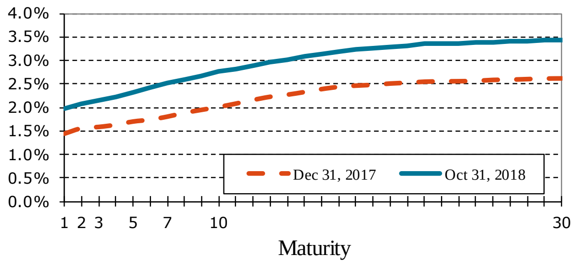
Baird Advisors
Municipal Fixed Income Market Commentary
October 2018

Upward Pressure on Rates Continues

Rising Treasury yields pushed tax-free yields higher in October, but the municipal market struggled as the supply/demand backdrop became less favorable. Tax-free rates rose in all maturity segments last month, but the curve steepened as long-term rates rose more than shorter yields. October was the second heaviest month of supply this year, with $33.4B of issuance, up 34% from September. At the same time, municipal funds experienced consistent weekly outflows, in part due to heightened market volatility as rates rose, but tax-loss harvesting of municipals (i.e. selling to offset gains in other assets) was also a contributing factor. Not surprisingly, long-term funds and High Yield municipal funds saw the heaviest outflows, given the higher relative volatility of each category. However, short-term municipal fund flows were positive on a four-week rolling basis. The persistent bid for short-term municipals reflects the duration sensitivity of individual investors as rates are rising. On the other hand, a lack of buying from banks and insurance companies on the longer end of the curve has been driven by the reduced corporate income tax rate. This segmentation of demand along the curve contributed to the resteepening of the curve slope in October and YTD.

AAA Municipal Yields



Maturity	Dec 31, 2017	Sep 30, 2018	Oct 31, 2018	1Mo	YTD
1	1.44%	1.92%	1.97%	0.05%	0.53%
2	1.56%	1.98%	2.08%	0.10%	0.52%
3	1.59%	2.07%	2.15%	0.08%	0.56%
5	1.70%	2.23%	2.32%	0.09%	0.62%
7	1.80%	2.42%	2.52%	0.10%	0.72%
10	2.01%	2.62%	2.76%	0.14%	0.75%
30	2.62%	3.26%	3.44%	0.18%	0.82%

Other Market News

Elections matter for the municipal market. Over $75B of referendums for municipal bond borrowings are on state and local ballots this November, well above the $47B average of the last four midterm elections. In addition, control of the House will determine future tax policy discussions – including whether there is a move to make permanent the recent tax changes or perhaps roll-back some provisions, even possibly revisiting the ability to advance refund outstanding municipal debt. Infrastructure funding methodology and prioritization is also expected to be another post-election focus for politicians and investors alike.

Tax-free issuance is likely to increase in 2019 thanks to a recent IRS release confirming the ability for municipalities to advance refund *taxable* municipal debt, including Build America Bonds (BABs), with tax-exempt bonds. A few "tax-free for taxable refundings" have already occurred, but this opens the door for many more. Of the $170B taxable BAB debt outstanding, $19B and $29B is callable in 2019 and 2020, respectively, resulting in potentially $20 - $25B of additional tax-free supply next year. Also, outstanding taxable municipal supply will shrink, enhancing the relative value of that taxable market sector.

Finally, a joint study by the Center for State and Local Government Excellence and the Center for Retirement Research at Boston College found a growing divide in government pension funding ratios. While the average public pension funding level of 72% has held relatively steady for several years, hidden in this average is both the strength and weakness of some plans. When divided into three funding groups, the top one-third of plans are funded at 90%, the middle third at 73%, the bottom third at just 55%, with the gap between the top and bottom groups continuing to widen. They cited plan investment returns and contribution practices as the two most important factors of the relative funding differences.

Short Maturities Outperform as Rates Rise

Rates rose, but short-term rates rose less than other curve segments leading to their outperformance last month. Revenue bonds modestly lagged the return of GOs, while the shorter duration Prere's provided the best sector performance. Widening credit spreads in October caused the underperformance of BBBs and High Yield municipals relative to high-grades for the month.

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	-0.62%	-1.01%	-1.01%	AAA	-0.56%	-1.02%	-1.33%
General Obligation bonds	-0.57%	-1.01%	-1.05%	AA	-0.58%	-0.98%	-1.09%
Revenue bonds	-0.69%	-1.05%	-1.15%	A	-0.65%	-1.01%	-0.91%
Prerefunded bonds	-0.05%	-0.45%	0.42%	BBB	-0.81%	-1.14%	-0.21%
Long maturities (22+ yrs.)	-1.12%	-1.62%	-2.25%	High Yield	-1.25%	-0.85%	3.14%
Intermediate maturities (1 - 17 yrs.)	-0.41%	-0.79%	-0.54%	HY, ex-Puerto Rico	-1.29%	-1.18%	2.07%
Short maturities (1 - 5 yrs.)	-0.04%	-0.45%	0.62%				

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.