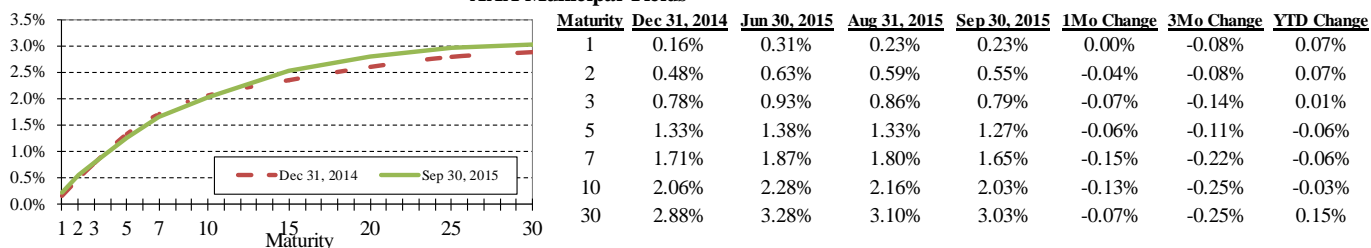


**Baird Advisors**  
**Municipal Fixed Income Market Comments**  
**September 2015**

### Lower Municipal Rates on Slowing New Issuance

Similar to the Treasury market, municipal rates fell and the yield curve flattened last quarter thanks to a risk-off rally. Amid heightened volatility across global markets, driven most notably by Chinese related equity market declines and a surprise Yuan devaluation, municipal yield changes were relatively muted even as they drifted lower. Municipal valuations relative to Treasuries were little changed during last quarter, but became less attractive relative to corporates due to the widening of credit spreads in that market. One helpful factor for municipals was the moderate pace of new issuance. A total of \$84.5B was issued in the third quarter, up 8.5% from last year, but down sharply from the \$116.5B issued in the 2Q and the \$107.8B in 1Q. The slower pace of issuance was largely due to less refunding activity, which slowed from the brisk first-half pace when issuers were rushing to market in anticipation of a Fed rate hike. The Fed opted not to hike in September, but may yet move this year or in early 2016. Year-to-date municipal issuance is still up 34.2% against the 2014 pace and, despite the recent slowing, remains on target to achieve the \$400B annual supply many expected. Overall demand for tax-free debt has been solid despite modest, yet persistent, outflows from municipal funds during the quarter. Lipper fund flow data indicate \$2.9B in outflows in the third quarter, \$2B of which were from short-term funds (presumably due once again to rate hike concerns). Yet, fund flows are positive YTD (+\$5.1B) and non-fund investors, including banks, insurance companies and separate account managers have stepped up their purchases of municipal securities.

**AAA Municipal Yields**



### Credit News

- In Chicago, Mayor Emanuel proposed a \$543 million property tax hike to be phased in over four years. If passed, essentially all of the new revenue would be used to fund police and fire pension fund shortfalls. The market reacted favorably to the news as Chicago credit spreads narrowed despite no reaction from the rating agencies.
- Puerto Rico officials estimate they face a \$13B funding shortfall for debt payments over the next five years and hope to begin negotiations with creditors in October. They announced the intention to “respect the priority of debts” which, if true, suggests greater protection for general obligation and sales tax (COFINA) debt relative to other island issuers.
- In the latest pension news, Wilshire Consulting reported that local government pensions are now 75% funded, on average, up from 70% in the prior year thanks to solid stock market returns; the second year of improvement. On the flipside, investment returns generally underperformed plan assumptions in the past year, even as return assumptions continue to drift lower. The National Association of State Retirement Administrators reported the average public pension plan return assumption is now 7.68%, the lowest since at least 1989 and down from a peak of 8.1% in 2001.

### Third Quarter Drives YTD Performance

Returns across all tax-free sectors and curve segments were positive in the third quarter; a quarter that accounts for essentially all of the YTD performance. The flattening yield curve led to the outperformance of the intermediate and long maturity segments over short-term issues. Unlike corporate spreads in the taxable market which widened on the quarter, credit spreads in the municipal market were little changed. In fact, the high yield municipal sector set the pace for the quarter, particularly when Puerto Rico high yield issues are excluded.

### Total Returns of Selected Barclays Municipal Indices and Subsectors

<u>Barclays Index/Sector</u>	<u>Sep</u>	<u>3Q</u>	<u>YTD</u>	<u>Barclays Quality</u>	<u>Sep</u>	<u>3Q</u>	<u>YTD</u>
Municipal Bond Index	0.72%	1.65%	1.77%	AAA	0.67%	1.60%	1.65%
General Obligation bonds	0.80%	1.73%	1.66%	AA	0.69%	1.70%	1.85%
Revenue bonds	0.73%	1.70%	1.88%	A	0.82%	1.68%	1.68%
Prerefunded bonds	0.40%	0.86%	1.00%	BBB	0.74%	1.13%	1.85%
Long maturities (22+ yrs.)	0.72%	2.07%	2.03%	High Yield	2.12%	1.99%	0.03%
Intermediate maturities (1 - 17 yrs.)	0.71%	1.51%	1.69%	HY - ex Puerto Rico	1.30%	2.59%	4.52%
Short maturities (1 - 5 yrs.)	0.32%	0.74%	1.13%				

## 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](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.