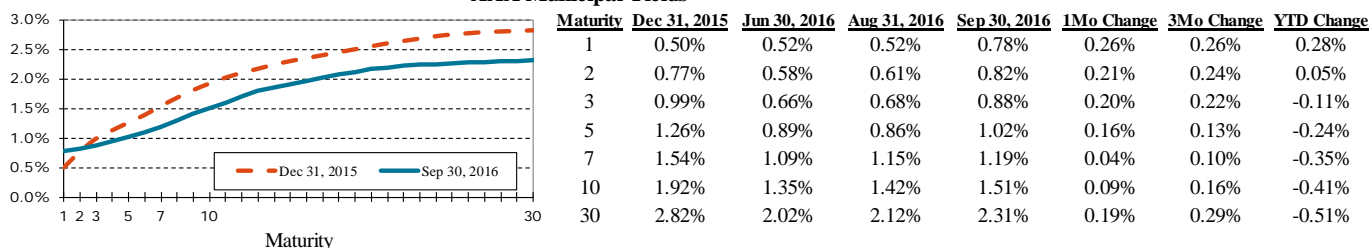


Baird Advisors
Municipal Fixed Income Market Comments
September 2016

Rising Short Tax-Free Rates Creates Attractive Relative Value

Tax-free yields rose for the quarter with the most significant yield changes occurring on the shortest and longest ends of the yield curve. Shorter yields were driven higher by new SEC regulations which take effect in October. Investors shifted out of institutional tax-free money market funds, which are required to have a floating net asset value when the rules become effective, to government money market funds which are excluded from the new rules. The selling of tax-free cash equivalents pushed both floating rate and short-term fixed rate yields higher. Two-year tax-free yields rose 24 bps for the quarter, in contrast to the same maturity Treasury yields which fell 3 bps, creating an attractive relative opportunity among shorter maturities for tax paying investors. Yields also rose on intermediate and longer maturities, in part due to heavy new supply. Last month's issuance was the highest September volume on record, going back to 1986. Year-to-date supply is now 5% above last year's pace, and appears likely to exceed the \$403B issued for all of 2015. The additional supply is due primarily to an increase in new money borrowings, which are up 15% year-over-year through September; a good sign for infrastructure financing.

AAA Municipal Yields



Credit Updates

Both Presidential candidates Hillary Clinton and Donald Trump have proposed tax law changes which, if enacted, could negatively impact municipal market valuations; the former by capping the interest exemption and the latter through lower tax rates. Municipal investors are skeptical that major tax reform will occur given the polarized political environment. Yet, elections do matter for the municipal market, particularly at the state and local level. There are twelve governor races in November, eight are currently held by Democrats and four by Republicans. Any party shifts at the governor and/or state legislative level will be worth monitoring. Ballot referendums are also important from a regulatory and tax policy perspective. In California alone there are 17 voter initiatives on the ballot, including Proposition 55 which would extend the income tax increase of 3% enacted in 2012, due to expire in 2018, until 2030. At 13.3%, California's current state income tax is the highest in the U.S. and is a key reason that California-exempt bonds trade at a premium value relative to bonds in other states.

Pension headlines during the quarter focused on disappointing plan investment returns. The median public plan return in FY2015 ranged from 3 – 4%, and FY2016 was likely lower, between 1 – 2%. Both annual returns were below median plan assumptions of 7 – 8%. The good news is that plan sponsors are gradually reducing the expected investment returns to reflect a lower interest rate environment. CalPERS, the largest public pension plan in the country, recently lowered the fund's projected return to 6.5% from 7.5%, and the Illinois Teacher's Retirement System return assumption was reduced to 7.0 from 7.5%. Lower plan returns require higher pension contributions, which in turn limits spending in other areas. The need for ongoing pension reform remains a focus for policy makers, particularly in jurisdictions where courts have shown flexibility.

Modestly Negative Quarterly Returns

Higher yields across the curve led to modestly negative returns in September and for the quarter. The longest maturities underperformed other segments of the curve. There was little performance difference across market sectors and only modest variance among investment grade credits. High yield issues, particularly Puerto Rico, outpaced all other categories.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

<u>Bloomberg Barclays Index/Sector</u>	<u>September</u>	<u>3Mo</u>	<u>YTD</u>	<u>Bloomberg Barclays Quality</u>	<u>September</u>	<u>3Mo</u>	<u>YTD</u>
Municipal Bond Index	-0.50%	-0.30%	4.01%	AAA	-0.51%	-0.47%	3.26%
General Obligation bonds	-0.46%	-0.34%	3.61%	AA	-0.50%	-0.37%	3.61%
Revenue bonds	-0.53%	-0.29%	4.51%	A	-0.49%	-0.10%	5.01%
Prerefunded bonds	-0.37%	-0.31%	0.96%	BBB	-0.49%	-0.27%	5.02%
Long maturities (22+ yrs.)	-0.87%	-0.67%	6.13%	High Yield	0.27%	1.29%	9.37%
Intermediate maturities (1 - 17 yrs.)	-0.36%	-0.19%	3.18%	HY, ex-Puerto Rico	-0.17%	0.47%	8.36%
Short maturities (1 - 5 yrs.)	-0.37%	-0.21%	1.15%				

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.