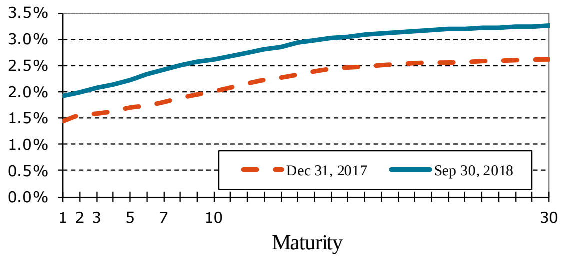
Baird Advisors
Municipal Fixed Income Market Commentary
September 2018

Tax-Free Yields Rise Despite Moderate Supply

Similar to higher yields in the Treasury market, tax-free rates rose last month by roughly 20 bps across much of the municipal curve. The September increase represented most of the move up in rates for the full quarter. Short-term yields rose more than longer maturities, flattening the curve and helping to bring the front end of the tax-free curve into closer alignment with taxable yields from previously rich valuations. The recent yield volatility led to mixed tax-free cash flows in September; nonetheless they were sufficient to meet the modest new issuance levels in the quarter. Total supply was off 9% from the same quarter last year and YTD supply is 15% behind last year's pace. One bright spot in the supply story remains "new money" issuance which is up 25% year-over-year. Institutional investors continue to transition their municipal holdings to reflect the lower corporate income tax rate of 21%. The most recent data, for the period ending June 30th, show that banks and the largest P&C insurers continued a gradual reduction of their municipal holdings. In addition to the new tax rate, an accounting rule change regarding callable bonds has also influenced bank allocations, leading to a 2% reduction in their municipal holdings in Q2 and 5% YTD, for a total decline in bank municipals of $27B since year end. The lack of bank and insurance company buying has mostly impacted valuations among longer maturities where AAA-rate tax-free rates now yield 100% of long-term, taxable Treasuries.

AAA Municipal Yields



Maturity	Dec 31, 2017	Jun 30, 2018	Aug 31, 2018	Sep 30, 2018	1Mo	3Q	YTD
1	1.44%	1.47%	1.60%	1.92%	0.32%	0.45%	0.48%
2	1.56%	1.65%	1.71%	1.98%	0.27%	0.33%	0.42%
3	1.59%	1.79%	1.83%	2.07%	0.24%	0.28%	0.48%
5	1.70%	2.00%	2.03%	2.23%	0.20%	0.23%	0.53%
7	1.80%	2.20%	2.25%	2.42%	0.17%	0.22%	0.62%
10	2.01%	2.47%	2.47%	2.62%	0.15%	0.15%	0.61%
30	2.62%	3.00%	3.08%	3.26%	0.18%	0.26%	0.64%

Other Market News

- Hurricane Florence struck the coast of the Carolinas as a Category 1 storm in September with sustained winds of 90 mph. It was the first major storm to hit the U.S. coast in 2018 and, similar to previous storms, very heavy rains led to severe flooding and significant damage. Early estimates place the natural disaster costs as high as $50B, when both physical and economic losses are considered; among the 10 most costly natural disasters ever in the U.S. So far, the rating agencies are waiting to more fully assess damages before taking any possible rating action on the coastal municipalities. Similar to other costly natural disasters, FEMA is expected to play a major role in helping to cover most of the uninsured repair and replacement damage caused by the storm. We don't, therefore, expect there to be any long-term, negative impact on the municipalities affected by the storm.

- The nuclear power industry in the U.S. has been under pressure for some time due to competition from renewable energy sources as well as the low relative cost of natural gas. Cost overruns have also plagued new nuclear projects to the point that construction on two new plants in South Carolina was recently halted as the owners feared unacceptable future cost overruns following the bankruptcy of Westinghouse Electric Co. In contrast, the owners of two plants under construction in Georgia voted last month to continue construction, but only after reaching a hard-fought agreement which caps the portion of future costs (and overruns) the public municipalities will have to cover.

Rising Rates Produce Negative Returns; Long Maturities Lag on Steeper Curve

Higher yields across the municipal curve pushed returns into negative territory across all maturities last quarter with the worst returns occurring among the longest maturities. Short maturities held in the best for the quarter and remain positive on a YTD basis. The Prerefunded sector outperformed other sectors during the quarter, thanks to its shorter average maturity. While there was little difference in quality in September, lower-quality issues outperformed for the quarter.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	September	3mo	YTD
Municipal Bond Index	-0.65%	-0.15%	-0.40%
General Obligation bonds	-0.67%	-0.14%	-0.48%
Revenue bonds	-0.66%	-0.16%	-0.46%
Prerefunded bonds	-0.38%	-0.12%	0.47%
Long maturities (22+ yrs.)	-0.91%	-0.48%	-1.13%
Intermediate maturities (1 - 17 yrs.)	-0.56%	-0.06%	-0.13%
Short maturities (1 - 5 yrs.)	-0.37%	-0.11%	0.66%

Bloomberg Barclays Quality	September	3mo	YTD
AAA	-0.65%	-0.30%	-0.77%
AA	-0.65%	-0.20%	-0.51%
A	-0.64%	-0.08%	-0.26%
BBB	-0.66%	0.21%	0.61%
High Yield	-0.40%	0.76%	4.45%
HY, ex-Puerto Rico	-0.49%	0.44%	3.40%

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.