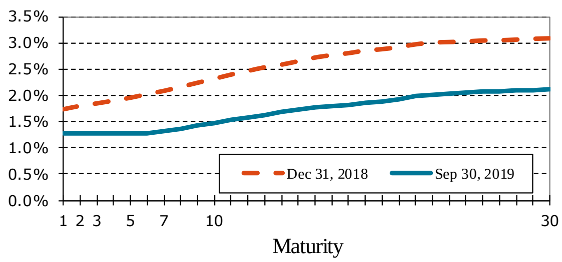
Baird Advisors
Municipal Fixed Income Market Commentary
September 2019

Rates Rose in September But Were Lower For The Quarter

Tax-free yields rose in September, but were lower for the full quarter after falling sharply in both July and August. Weaker U.S. and global economic data, combined with rising trade and political tensions led the Fed to lower the federal funds rate by 25 bps in September (to 1.75% - 2.0%), the second rate cut this year which occurred in back-to-back FOMC meetings. Although the Fed cut short-term rates, the tax-free yield curve flattened over the quarter as intermediate and long-term rates fell more than short-term yields. Strong demand for tax-free funds continued throughout the quarter, extending the period of positive inflows to 38 consecutive weeks with total YTD inflows of over $67B. Municipal supply also rose, increasing by 18% in Q3 relative to the same quarter last year and bringing YTD supply 9% above last year's pace. Part of the supply gains were due to a boost in taxable municipal issuance (see below), but tax-exempt issuance is also up 4% YoY. Even with the improved supply levels, the total amount of municipal debt outstanding likely contracted once again in Q3 as more money rolled off during the summer months than was issued. If so, this would be the seventh consecutive quarter of shrinking municipal debt outstanding, which stands in contrast to the steady increase of U.S. Treasury supply outstanding given the persistent federal budget deficits.

AAA Municipal Yields



Maturity	Dec 31, 2018	Jun 30, 2019	Aug 31, 2019	Sep 30, 2019	1Mo	Q3	YTD
1	1.74%	1.28%	1.00%	1.27%	0.27%	-0.01%	-0.47%
2	1.80%	1.29%	1.01%	1.27%	0.26%	-0.02%	-0.53%
3	1.85%	1.30%	1.01%	1.27%	0.26%	-0.03%	-0.58%
5	1.96%	1.34%	1.01%	1.28%	0.27%	-0.06%	-0.68%
7	2.09%	1.43%	1.10%	1.32%	0.22%	-0.11%	-0.77%
10	2.32%	1.62%	1.27%	1.47%	0.20%	-0.15%	-0.85%
30	3.09%	2.40%	1.97%	2.11%	0.14%	-0.29%	-0.98%

Taxable Municipal Supply Rises

The taxable sector of the municipal market understandably receives less focus than the tax-exempt segment since taxable municipals represent just 13% of total outstanding municipal debt. Also, outside of the dramatic increase in taxable municipal issuance in the post-crisis era with the Build America Bond (BAB) program, taxable municipal supply typically represents just 5% - 10% of total municipal issuance. Taxable municipal issuance, however, has picked up this year, increasing 45% YoY through September, to $32B, comprising 12% of total municipal volume YTD. While still a small percentage of total municipal issuance, and certainly modest in relation to the nominal level of issuance in either the taxable Treasury or corporate markets, investor appetite for taxable municipals is strong. Both individual and institutional investors find the taxable municipal market attractive from a valuation perspective and an effective way to diversify risk. After all, taxable municipal credits are supported by domestically-centered taxes and revenues that differ from corporate credits. One reason that taxable municipal issuance has increased this year is due, in part, to the decline in rates, encouraging municipalities to finance projects that don't qualify for the tax-exempt exclusion. In addition, taxable issuance has also been used to refinance higher cost *tax-exempt* debt; an unusual situation that is available now because of how far rates have fallen. The Tax Cuts and Jobs Act of 2017 disallowed the advance refunding of municipal debt in the tax-exempt market. The taxable municipal market, therefore, allows issuers an opportunity to effectively swap a portion of their tax-exempt debt into taxable, and still achieve a desired level of cost savings. As long as rates remain relatively low additional taxable refunding activity is likely to continue.

Negative September Returns, But Solidly Positive Quarterly Results

The rise in rates in September led to the first negative monthly return for the municipal market since October 2018. Yet, the negative month only served to dampen the solidly positive Q3 performance. In September, short-term maturities held in best as rates rose, which also helped the relatively short average maturity of the Pre-re sector outperform. However, both short-term debt and Pre-re's lagged for the quarter. In Q3, long-term maturities outperformed as yields fell and lower quality credits led other rating categories as credit spreads narrowed. The High Yield municipal sector was the best performer across all three of the time periods displayed below.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	September	Q3	YTD
Municipal Bond Index	-0.80%	1.58%	6.75%
General Obligation bonds	-0.82%	1.47%	6.44%
Revenue bonds	-0.82%	1.70%	7.17%
Prerefunded bonds	-0.49%	0.35%	2.80%
Long maturities (22+ yrs.)	-0.76%	2.64%	9.67%
Intermediate maturities (1 - 17 yrs.)	-0.81%	1.13%	5.58%
Short maturities (1 - 5 yrs.)	-0.49%	0.33%	2.80%

Bloomberg Barclays Quality	September	Q3	YTD
AAA	-0.88%	1.35%	5.97%
AA	-0.79%	1.49%	6.36%
A	-0.77%	1.73%	7.34%
BBB	-0.83%	2.05%	8.82%
High Yield	-0.20%	2.84%	9.69%
HY, ex-Puerto Rico	-0.30%	2.35%	8.77%

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.