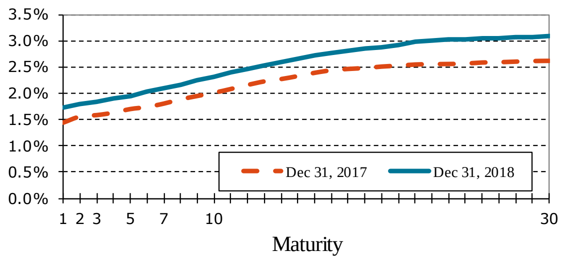
Baird Advisors
Municipal Fixed Income Market Commentary
2018 – Year in Review

Higher Tax-Free Yields and Steeper Curve in 2018

2018 was a year in which the fundamental backdrop for municipal credit improved, interest rates moved modestly higher, but investors received positive returns across all segments of the market. Municipal yields were pulled higher by strong U.S. growth and rising Treasury yields. Although broad inflation measures remained at or below the Fed’s 2.0% target, the faster pace of economic growth provided sufficient cover for the Fed to raise the federal funds rate four times in 2018. Short and intermediate term municipal yields rose 25 – 30 bps, less than 47 bp increase in long-term tax-free yields. The steepening of the municipal yield curve was due primarily to varying levels of demand across the curve. For example, individual investors, whose tax rates were little changed by the 2017 tax bill, demonstrated steady demand for much of the year with purchases focused primarily in the 1 – 10 year maturity range, helping to mute the upward yield trend in that segment. Individual demand waned in the fourth quarter as investors sought to harvest tax losses through the sale of municipal funds and individual bonds. Institutional investors, on the other hand, which are typically less duration sensitive than individuals and invest on the longer end of the curve, were less committed to the municipal market in 2018 following the significant cut in corporate income tax rates in late-2017. Banks reduced their allocation to municipals over the course of the year, redirecting a portion of both maturing debt and sale proceeds into taxable alternatives instead. The most recent data show bank holdings fell by $40B YTD through September, or roughly 7%. In contrast, municipal holdings for property and casualty insurers actually rose by $9B, or nearly 3%, over the same time frame. While some of the largest P&C insurance companies were net sellers of tax-free bonds, in total, the diversification benefits of municipals apparently were viewed as sufficient to offset the reduced tax benefits.

AAA Municipal Yields



Maturity	Dec 31, 2017	Sep 30, 2018	Nov 30, 2018	Dec 31, 2018	1Mo	Q4	2018
1	1.44%	1.92%	1.87%	1.74%	-0.13%	-0.18%	0.30%
2	1.56%	1.98%	1.98%	1.80%	-0.18%	-0.18%	0.24%
3	1.59%	2.07%	2.03%	1.85%	-0.18%	-0.22%	0.26%
5	1.70%	2.23%	2.16%	1.96%	-0.20%	-0.27%	0.26%
7	1.80%	2.42%	2.31%	2.09%	-0.22%	-0.33%	0.29%
10	2.01%	2.62%	2.55%	2.32%	-0.23%	-0.30%	0.31%
30	2.62%	3.26%	3.27%	3.09%	-0.18%	-0.17%	0.47%

Light Supply Year

New municipal supply throughout 2018 was consistently below prior year levels, as expected, following the passage of the tax reform bill which eliminated the advanced refunding of outstanding debt. Partially offsetting the decline in supply was a rise in new money borrowing, which rose by $33B YoY (+16%), helping to finance infrastructure spending needs. Nonetheless, total supply for 2018 fell by $110B (from $448B to $338B), or -24%. The largest YoY drop occurred in the fourth quarter where supply fell by $69B alone from the record pre-tax reform issuance late in 2017. Some of the largest issuing states, such as California, had noticeably less issuance last year than in 2017. California supply fell by nearly $21B, or -30% YoY, which caused California debt to trade at relatively rich valuations compared to debt in other states throughout the year. Strengthening fundamentals also contributed to California’s trading value as strong tax revenues and a conservative fiscal focus by outgoing Gov. Jerry Brown limited new borrowing. Certain market sectors experienced notable declines in issuance as well. Two sectors that stood out for their decrease in supply were Education (-33%) and Healthcare (-43%). Both sectors face near-term margin pressures as well as longer term secular challenges, the combination of which has restricted recent borrowing.

Strong Tax Revenues Led to Strengthening Municipal Credits and Stable Credit Spreads

Another favorable development in the municipal market last year was the strengthening of municipal credits and the relative stability of municipal credit spreads. State and local tax revenues are leveraged to the pace of economic growth and with growth estimated at 3.0% for all of 2018, combined with the near record length of this expansion, municipalities continued to benefit. State and local tax revenues have grown in 32 of the last 35 quarters and according to the National Association of State Budget Officers (NASBO), state general fund revenues grew 6.4% in fiscal year 2018. The largest contributor to this was a 9.8% increase in personal income tax revenues, reflecting the strong labor market and rising income levels. Some of the strongest revenue growth occurred in fossil fuel focused states, such as Alaska, where revenues grew nearly 30% YoY, and North Dakota, which saw revenues rise over 28%. This benefit may work against these same states in 2019 if oil/energy prices remain near the lower closing levels at year-end (~$45/bbl for WTI). Nonetheless, the tax revenue boost last year was broad based, evidenced by solid improvements even in some of the more fiscally challenged states, such as Connecticut (+13.6%), Illinois (+5.8%) and New Jersey (+4.8%). State rainy day reserves as a percentage of general fund expenditures also grew 6.4% in fiscal year 2018 to reach a new all-time high. The solid credit backdrop and favorable market technical led to relatively stable municipal credit spreads, particularly in contrast to the widening spreads which occurred in the taxable corporate market. According to Bloomberg data, the yield differential between BBB and AAA municipal yields in the 10-year maturity widened by 13 bps in Q4 in the midst of the heightened volatility in the financial markets, but ended the year 1 bp tighter than where they began (+93 vs. +94).

Other Key Municipal Developments in 2018

- In November, Democrats regained control of the House, while Republicans increased their majority in the Senate. A divided Congress makes additional tax changes less likely over the next two years. In addition, the new Chairman of the House Ways and Means Committee, Richard Neal (D-MA), is the former mayor of Springfield, MA and has expressed support for the municipal market. He has also pledged to give municipal market advocates a voice in how the 2017 tax reform may have negatively impacted municipalities to see if revisions are needed.

- Several rulings from the U.S. Supreme Court proved favorable to the municipal market. In May, the Court legalized gambling on sports, providing a new potential revenue source for states inclined to allow this activity. Then in June, the Court ruled that states can now collect sales tax on online transactions from retailers who do not have a physical presence in the state. Finally, the Court ruled in a third case that non-union government employees can opt-out of paying union dues, which may provide municipalities more flexibility in future labor negotiations.

- One other notable item that did not happen was passage of a bipartisan federal infrastructure plan. While both political parties continue to realize the need for a plan and the benefits that would accrue from passing a comprehensive infrastructure bill, unfortunately the two sides remain far apart as to the funding approach. Instead, state and local governments continue to take the lead on the most necessary and worthy projects. In the midterm elections $31B of new borrowing was authorized to help finance infrastructure needs, of this $8.7B alone was approved in the rapidly growing state of Texas.

Positive Returns Across the Market

The strong rally in Q4 helped to push all municipal returns into positive territory for the year. Intermediate and long-term maturities moved into the black despite a steepening of the curve in 2018, but shorter maturities were the performance leader for the year. Lower quality credits underperformed in Q4, particularly High Yield municipals, as credits spreads widened modestly. Yet, for the full year lower quality, investment grade credits (BBB's) were the performance leaders. The Prerefunded sector benefited both from its growing scarcity value given the lack of new advance refundings, but also from the shorter average maturity focus relative to other market sectors.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	December	Q4	2018	Bloomberg Barclays Quality	December	Q4	2018
Municipal Bond Index	1.20%	1.69%	1.28%	AAA	1.22%	1.84%	1.05%
General Obligation bonds	1.23%	1.82%	1.33%	AA	1.21%	1.74%	1.22%
Revenue bonds	1.22%	1.67%	1.20%	A	1.21%	1.60%	1.34%
Prerefunded bonds	0.70%	1.19%	1.67%	BBB	1.06%	1.35%	1.96%
Long maturities (22+ yrs.)	1.37%	1.49%	0.34%	High Yield	0.86%	0.30%	4.76%
Intermediate maturities (1 - 17 yrs.)	1.11%	1.71%	1.58%	HY, ex-Puerto Rico	0.96%	0.28%	3.70%
Short maturities (1 - 5 yrs.)	0.64%	1.10%	1.77%				

2019 Outlook

The municipal market enters 2019 with a solid fundamental and supply/demand technical backdrop. Although the economy is expected to grow, albeit at a slower pace, we expect state and local tax revenues to continue to rise. A slower pace of growth, combined with moderate inflation expectations has moved the market's base case forecast to an unchanged federal funds rate this year, although probabilities of either a cut or rate hike are also assigned. Fortunately, most municipalities have been relatively frugal regarding borrowing in recent years and are not highly levered if the economy does slow; however, rising pension and healthcare costs continue to present long-term fiscal challenges. Pension reforms have been enacted where the political will has existed and courts have allowed, and further reforms are likely. To meet these rising fiscal challenges, there will likely be ongoing pressure to find additional tax and other revenues to offset them. Demand for municipal debt should remain steady. The aging demographics in the U.S. and the relative safety of municipals when compared to other, more volatile asset classes should provide solid support for the market. It is our view that the municipal market has largely adjusted to less corporate demand following the 2017 tax reform, and the steeper municipal curve that has resulted will be a draw for investors of all types seeking to capitalize on the roll-down benefits the municipal curve offers. From a supply perspective, issuance levels will likely rise an estimated 10% YoY, which would be very manageable for investors to digest. Within the 2019 supply, taxable municipal issuance is also expected to increase, perhaps as much as 20% YoY. While the taxable municipal sector remains a small component of the total municipal market (roughly 10% of the total debt outstanding), new taxable supply in 2019 could rise to $45B next year even without a federal infrastructure plan, or approximately 12% of the estimated $370B of total municipal issuance this year. With interest rates higher than a year ago, the curve steeper, a modest increase in supply expected, along with solid credit fundamentals, the backdrop for the municipals in 2019 is favorable.

Disclosures

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.

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.

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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.