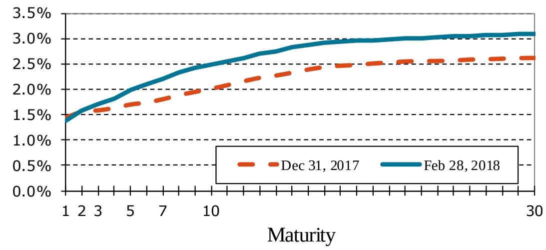
Baird Advisors
Municipal Fixed Income Market Comments
February 2018

Higher and Steeper Curve

The muni curve continued to steepen in February as intermediate- and long-term yields rose by as much as 16bps. The strong demand for short-term, tax-free debt was particularly evident relative to rising short-term Treasury yields, as short-term rates were unchanged to lower. For comparison, 2-year Treasury yields rose 12 bps in February, and are up 38 bps YTD, while 2-year tax-exempts were up 1 bp over both time periods. The relative richness of the short end of the municipal curve compared to taxables is likely to remain given the desire of some to minimize price volatility until rates stabilize. Cash flow into tax-free funds remains positive, with net inflows occurring in six of the eight weeks this year, demonstrating that individual investors continue to see value in the tax-free market even after the recent tax cuts. Institutional investor demand from banks and insurance companies, however, has been more tepid. Many firms continue to evaluate the relative appeal of tax-free debt in light of the lower corporate tax rate and it may be months before the full market impact is known. On the supply side, fixed-rate issuance was down 17% in February and is down 31% YTD, largely due to the loss of advance refundings which are prohibited under the new tax law.

AAA Municipal Yields



Maturity	Nov 30, 2017	Dec 31, 2017	Jan 31, 2018	Feb 28, 2018	1Mo Change	YTD Change	3Mo Change
1	1.32%	1.44%	1.41%	1.38%	-0.03%	-0.06%	0.06%
2	1.52%	1.56%	1.56%	1.57%	0.01%	0.01%	0.05%
3	1.61%	1.59%	1.65%	1.71%	0.06%	0.12%	0.10%
5	1.78%	1.70%	1.84%	1.99%	0.15%	0.29%	0.21%
7	1.96%	1.80%	2.05%	2.21%	0.16%	0.41%	0.25%
10	2.21%	2.01%	2.38%	2.49%	0.11%	0.48%	0.28%
30	2.86%	2.62%	2.96%	3.10%	0.14%	0.48%	0.24%

Infrastructure Update

Hopes for a boost in municipal supply from the Trump Administration's recently released infrastructure plan outline are unlikely to be realized anytime soon. Under the long-anticipated plan, the federal government would provide $200B of funds, $20B per year for ten years, which they believe would stimulate up to $1.5 trillion of new infrastructure investment; the rest of the funding to be provided by private investors and state and local governments. The plan faces several significant hurdles. First, the federal spending deficits resulting from the corporate and personal tax cuts, plus the recently passed budget agreement which lifts spending caps by roughly $300B over the next two years, make it harder to find the additional funding support in Congress. In addition, state and local governments, while stronger today than at any time since the recession, face rising pension and Medicaid costs. Identifying new revenue sources for massive infrastructure needs will be challenging. Private funds are abundant, however, investors need a return on their capital and for many projects there is no natural revenue stream. That said, there are some creative ideas being considered, including the "recycling" concept. Used successfully in Australia, the federal government would provide a bonus payment to a state or local government that privatizes or leases a municipal asset and agrees to reinvest the proceeds into other infrastructure projects. The federal government is also considering the sale or lease of some of its own assets, such as: Reagan National Airport, the Tennessee Valley Authority (TVA), and Bonneville Power Administration (BPA), among others, to provide additional funds. For progress to be made on advancing an infrastructure plan, however, the federal government will likely need to take on more funding responsibility. Projects that occur through the Federal Highway Trust Fund, for example, are funded 80% by the federal government and 20% by state and local governments. The plan outline from the White House reverses that funding ratio, putting a much higher funding burden on state and local governments.

Second Month of Negative Returns

The rising market rates and a steepening yield curve pushed returns into negative territory for the second month in a row. The prevailing market sentiment was "risk-off" given the heightened volatility across the financial markets. The longest segments of the curve underperformed the shortest maturities due to the steepening trend and the Prerefunded sector led all others. There was, however, little difference in performance across the credit categories as AAA's and BBB's performed similarly.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	February	YTD	3Mo	Bloomberg Barclays Quality	February	YTD	3Mo
Municipal Bond Index	-0.30%	-1.47%	-0.44%	AAA	-0.32%	-1.52%	-0.53%
General Obligation bonds	-0.32%	-1.53%	-0.54%	AA	-0.29%	-1.46%	-0.46%
Revenue bonds	-0.32%	-1.62%	-0.49%	A	-0.28%	-1.47%	-0.40%
Prerefunded bonds	-0.01%	0.01%	0.26%	BBB	-0.33%	-1.46%	-0.28%
Long maturities (22+ yrs.)	-0.42%	-2.26%	-0.74%	High Yield	0.07%	-0.87%	0.42%
Intermediate maturities (1 - 17 yrs.)	-0.26%	-1.13%	-0.31%	HY, ex-Puerto Rico	0.06%	-0.91%	0.44%
Short maturities (1 - 5 yrs.)	0.03%	0.17%	0.37%				

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.