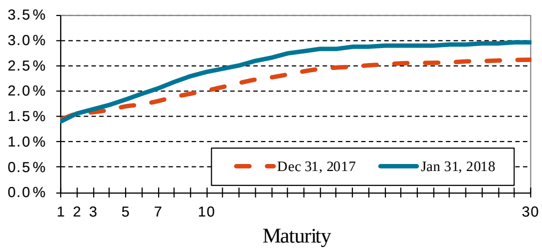
Baird Advisors
Municipal Fixed Income Market Comments
January 2018

Digesting the Impact of Tax Reform

The municipal market struggled to find its footing in the first month following passage of the tax reform bill. Expectations for higher growth and inflation pushed Treasury yields higher and municipal yields did the same in all but the shortest maturities. Strong demand on the front end of the municipal curve allowed tax-free rates to remain unchanged even as short-term taxable rates rose (e.g. 2-year Treasury yields rose 26 bps). The solid demand for municipals was evident, even with the lower marginal rates in place, as $3.3B of new money flowed into tax-free funds in January according to Lipper. We expect aging demographics to be a tailwind for fixed income demand for many years due to the supplemental income needs of aging baby boomers. According to the Investment Company Institute, the median age for investors with fixed income holdings, both individual bonds and funds/ETFs, is 53 years old, up from 47 in 2007. On the institutional side, both buying and selling occurred among corporate investors who are working through what the new lower corporate tax means for their respective portfolios. Modest selling from a few select banks and P&C insurers helped to offset the sharp 58% year-over-year decline in new supply last month. With advance refundings no longer allowed under the new tax law, and a funding plan for national infrastructure needs still undetermined, municipal supply in 2018 is likely to remain light relative to 2017.

AAA Municipal Yields



Maturity	Dec 31, 2016	Oct 31, 2017	Dec 31, 2017	Jan 31, 2018	1Mo Change	3Mo Change	2017 Change
1	1.00%	0.99%	1.44%	1.41%	-0.03%	0.42%	0.44%
2	1.23%	1.09%	1.56%	1.56%	0.00%	0.47%	0.33%
3	1.43%	1.21%	1.59%	1.65%	0.06%	0.44%	0.16%
5	1.80%	1.45%	1.70%	1.84%	0.14%	0.39%	-0.10%
7	2.05%	1.70%	1.80%	2.05%	0.25%	0.35%	-0.25%
10	2.35%	2.03%	2.01%	2.38%	0.37%	0.35%	-0.34%
30	3.08%	2.89%	2.62%	2.96%	0.34%	0.07%	-0.46%

Other Municipal News

The tax bill capped the deductibility of state and local taxes at $10,000 for individuals, which most directly impacts wealthier residents in higher taxed states. A few states (NY, NJ, and CA) have openly discussed work-arounds which would allow state residents to maintain part, or all, of the deduction. None have yet gone as far as California, however, where the state Senate recently passed a bill allowing residents to pay taxes through a state-run charity which would provide an 85% tax credit for the "donation." Gov. Brown would likely sign the bill if it reaches his desk, but the U.S. Treasury Department and the IRS would certainly fight such a plan. Stay tuned for a potential legal battle between the states and Washington DC over the new tax policy.

Unfunded public pension liabilities remain a focus for investors. The poorly funded state and local plans receive the most market attention, but some states have fully funded plans (e.g. WI, NY, and SD) and several others had a funded status of over 80% as of the end of 2016 (WA, OR, ID, UT, NE, IA, TN, NC, and FL). Funding status increasingly impacts the relative yields between state and local government debt, with the market increasingly penalizing municipalities with large unfunded liabilities through higher borrowing costs. A study from the Center for Retirement Research at Boston College (CRR) on "How Have Municipal Bond Markets Reacted To Pension Reform" found the same result. In analyzing the pension funding status of more than 17,000 plans over the 2009 – 2014 period, they found that for each one standard deviation increase in unfunded liabilities as a percentage of plan revenues, borrowing costs also rose by 7 and 8 bps for state and local plans respectively. Market efficiency in delineating pension funded status among municipalities continues to improve, allowing investors clearer risk/reward choices.

Negative Returns to Start the Year

Rising rates and a steepening yield curve pushed returns into negative territory in all but the shortest maturities last month. Shorter maturities and the Prerefunded sector, which has a lower average duration than other sectors, provided positive returns. The longest maturities lagged all other segments of the yield curve. Lower quality credits held in marginally better than higher quality issues with the additional yield among High Yield tax-free credits helping to offset the price decline as rates rose.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	January	3Mo	2017	Bloomberg Barclays Quality	January	3Mo	2017
Municipal Bond Index	-1.18%	-0.68%	5.45%	AAA	-1.20%	-0.88%	4.45%
General Obligation bonds	-1.21%	-0.86%	5.24%	AA	-1.17%	-0.76%	4.96%
Revenue bonds	-1.30%	-0.63%	6.00%	A	-1.19%	-0.57%	6.16%
Prerefunded bonds	0.03%	-0.52%	1.37%	BBB	-1.13%	-0.11%	8.74%
Long maturities (22+ yrs.)	-1.84%	-0.12%	8.19%	High Yield	-0.94%	0.60%	9.69%
Intermediate maturities (1 - 17 yrs.)	-0.87%	-0.86%	4.33%	HY, ex-Puerto Rico	-0.97%	0.69%	12.86%
Short maturities (1 - 5 yrs.)	0.14%	-0.49%	1.61%				

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.