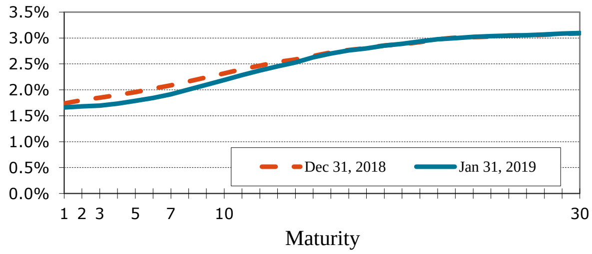
Baird Advisors
Municipal Fixed Income Market Commentary
January 2019

Tax-Free Yields Fall and Curve Steepens on Strong Demand

The municipal market jumped out to a strong start in January led by the intermediate segment of the curve, where yields fell as much as 17 bps. As short and intermediate term yields fell long-term rates were unchanged to slightly higher, leading to a steeper tax-free curve. A dovish shift by the Fed and softening economic data led to lower yields in the Treasury market as well, but tax-free yields fell even more on strong individual demand and modest new supply. Fund flows were positive in four of the first five weeks of the year, highlighting the renewed interest in the municipal market following investor tax-loss harvesting in Q4 2018. New issuance rose 3% YoY in January, but we expect 2019 to be another year in which the outstanding supply of municipal debt declines. Bloomberg estimates that $416B of municipal debt will either mature or be called in 2019, while new issuance of $370B is estimated, leaving a negative net supply expectation of -$46B for the year.

AAA Municipal Yields



Maturity	Dec 31, 2017	Sep 30, 2018	Nov 30, 2018	Dec 31, 2018	Jan 31, 2019	1Mo
1	1.44%	1.92%	1.87%	1.74%	1.66%	-0.08%
2	1.56%	1.98%	1.98%	1.80%	1.68%	-0.12%
3	1.59%	2.07%	2.03%	1.85%	1.70%	-0.15%
5	1.70%	2.23%	2.16%	1.96%	1.79%	-0.17%
7	1.80%	2.42%	2.31%	2.09%	1.92%	-0.17%
10	2.01%	2.62%	2.55%	2.32%	2.19%	-0.13%
30	2.62%	3.26%	3.27%	3.09%	3.10%	0.01%

Teacher Strikes, State Reserves, and Infrastructure Bills

- Teachers in the Los Angeles School District went on strike last month, their first since 1989, seeking higher pay and other work rule modifications. The district reached a settlement with the teachers after 6 days, agreeing to an average annual pay increase of 2% over the next three years, a cap on class sizes, commitments to hire more nurses and librarians, fewer standardized tests and a willingness to explore limiting charter school growth. While the L.A. district is currently in a strong financial position, with $1.8B in reserves, like other municipalities they face rising pension and healthcare costs. L.A. is just one of several teachers unions across the country that has either gone on strike or is threatening to do so in an effort to raise wages and awareness on other measures of support.

- According to Moody's, most states are in better fiscal condition now than they were a year ago, but many still have insufficient reserves even for a modest recession. Their stress-test analysis showed that 23 states have sufficient reserves for a moderate recession, up from 16 states at the end of 2017. But 17 states, 2 more than a year ago, are still under-reserved by 5 percentage points or more from what may be needed in a typical recession. This should incentivize states to continue to direct a portion of their tax revenues toward reserves to prepare for the next economic slowdown.

- Infrastructure bills are emerging in both the House and Senate, primarily from Democrat sponsors. Some are narrowly focused, targeting, for example, just K-12 grade schools that serve low-income students. Others would allow a broader array of projects to qualify for funding. A common theme among them is the leveraging of federal money through public and private partnerships and the use of tax credit financing; none yet have sufficient bipartisan support to pass.

Strong Performance for Municipals in January

The municipal market began the new year with strong performance, building upon the solid year-end rally. Intermediate maturities outperformed both shorter and longer segments of the curve thanks to steady demand from individual investors. There was little differentiation in performance across market sectors or investment grade rating categories, all of which provided positive returns for the month. The High Yield market segment lagged as lower quality credit spreads widened modestly.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	January	2018	Bloomberg Barclays Quality	January	2018
Municipal Bond Index	0.76%	1.28%	AAA	0.80%	1.05%
General Obligation bonds	0.79%	1.33%	AA	0.73%	1.22%
Revenue bonds	0.76%	1.20%	A	0.76%	1.34%
Prerefunded bonds	0.56%	1.67%	BBB	0.80%	1.96%
Long maturities (22+ yrs.)	0.56%	0.34%	High Yield	0.67%	4.76%
Intermediate maturities (1 - 17 yrs.)	0.85%	1.58%	HY, ex-Puerto Rico	0.65%	3.70%
Short maturities (1 - 5 yrs.)	0.56%	1.77%			

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.