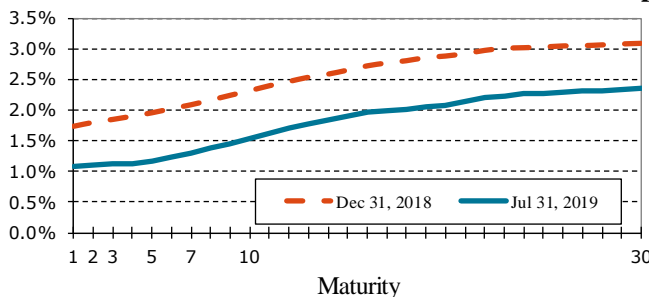


Baird Advisors
Municipal Fixed Income Market Commentary
July 2019

Curve Steepens as Rates Fall Driving Strong Municipal Returns

Tax-free yields fell in July as supportive supply/demand conditions led to strong nominal returns as well as solid relative performance to Treasuries. To illustrate the cross-market outperformance of municipals, 2Yr Treasury yields rose 15 bps last month while 2Yr municipal yields fell 18 bps, a 33 bps yield divergence. Intermediate and longer tax-free yields also fell, but less than short yields, creating a steeper slope for the municipal curve. Supply levels remained muted as July issuance fell 10% from the same month last year, leaving YTD tax-free volume virtually unchanged relative to last year's pace. Demand, on the other hand, has been impressive even as rates have fallen. Positive fund flows occurred in July, as they have in every month this year, bringing YTD municipal fund inflows of \$52B through July, well ahead of the \$9B pace at the same point last year. The favorable technical backdrop for the municipal market is likely to continue over the next several weeks as the total volume of bonds maturing in August is the highest for any August on record.

AAA Municipal Yields



| Maturity | Dec 31, 2018 | Jun 30, 2019 | Jul 31, 2019 | 1Mo | YTD |
|----------|--------------|--------------|--------------|--------|--------|
| 1 | 1.74% | 1.28% | 1.09% | -0.19% | -0.65% |
| 2 | 1.80% | 1.29% | 1.11% | -0.18% | -0.69% |
| 3 | 1.85% | 1.30% | 1.12% | -0.18% | -0.73% |
| 5 | 1.96% | 1.34% | 1.17% | -0.17% | -0.79% |
| 7 | 2.09% | 1.43% | 1.30% | -0.13% | -0.79% |
| 10 | 2.32% | 1.62% | 1.54% | -0.08% | -0.78% |
| 30 | 3.09% | 2.40% | 2.35% | -0.05% | -0.74% |

Credit Updates: Puerto Rico Political Turmoil and Municipal Focus on Climate Change

Protests amid political turmoil in Puerto Rico last month led to the resignation of the governor and significant uncertainty as to who would replace him. Governor Ricardo Rossello was forced to resign after text messages between him and his aides were released (a.k.a. "Ricky Leaks") in which he disparaged his opponents as well as ordinary Puerto Rican residents. In addition, two former Puerto Rico government officials and the head of an accounting firm were arrested by the FBI. The second in line to the governor, the Secretary of State, resigned prior to the recent events leaving no natural successor. Other possible replacements for Governor Rossello do not yet seem to have sufficient support to assume the role. The leadership vacuum on the island threatens to delay ongoing negotiations with creditors over the billions of Puerto Rico debt yet to be restructured.

Moody's announced the acquisition of Four Twenty Seven, Inc. a firm which, according to their website, "is the leading provider of market intelligence on the economic risk of climate change." Moody's, along with the other major rating agencies are beginning to take climate risks more seriously, with an increased focus on the potential long-term impact of climate change on both corporate and municipal debt. While there are obvious environmental risks along U.S. coastlines where heightened risk of tropical storms, hurricanes and rising sea levels are a financial threat, the interior of the country is not immune. Although the total costs are not yet known, Accuweather estimates that damages in the Midwest this spring from heavy rains and flooding may total \$12.5B, the highest damage level since 2008.

Continuation of Strong Municipal Returns

The decline in tax-free rates in July led to another month of strong municipal returns, adding to the impressive YTD market performance. Although short-term rates fell more than longer dated issues last month, long maturities still outperformed other segments of the curve. The unrest in Puerto Rico caused High Yield to lag investment grade credit categories, which all performed similarly, from AAAs to BBBs. Prerefunded issues lagged other sectors given their shorter relative duration.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

| <u>Bloomberg Barclays Index/Sector</u> | <u>July</u> | <u>YTD</u> | <u>Bloomberg Barclays Quality</u> | <u>July</u> | <u>YTD</u> |
|--|-------------|------------|-----------------------------------|-------------|------------|
| Municipal Bond Index | 0.81% | 5.94% | AAA | 0.81% | 5.40% |
| General Obligation bonds | 0.81% | 5.75% | AA | 0.80% | 5.64% |
| Revenue bonds | 0.82% | 6.25% | A | 0.82% | 6.38% |
| Prerefunded bonds | 0.51% | 2.97% | BBB | 0.80% | 7.49% |
| Long maturities (22+ yrs.) | 0.86% | 7.77% | High Yield | 0.63% | 7.33% |
| Intermediate maturities (1 - 17 yrs.) | 0.79% | 5.22% | HY, ex-Puerto Rico | 0.66% | 6.97% |
| Short maturities (1 - 5 yrs.) | 0.55% | 3.03% | | | |

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.