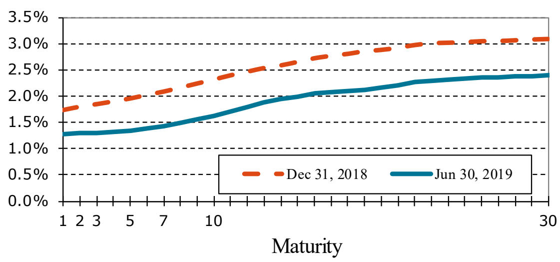
Baird Advisors
Municipal Fixed Income Market Commentary
June 2019

Municipal Yields Fall in Q2 on Modest Supply and Strong Demand

Tax-free yields continued to trend lower both in June and for the full quarter. The backdrop for the municipal market was favorable from both a fundamental credit perspective, with rising state and local tax revenues, as well as from a supply/demand perspective. The market strength led rates to fall during the quarter with a flattening bias, as long yields fell more than short-term yields. However, the opposite was true in June, as the municipal curve, following the lead of the Treasury market, steepened last month; 2yr tax-free yields fell 12 bps while the 10yr yield fell 4 bps and 30yr yield was unchanged. In Q2, supply fell 11% compared to the same quarter last year, leaving YTD issuance up a modest 1% YoY. Demand was impressive as tax-free funds experienced positive flows every week during the quarter, a pattern which has persisted since the second week of the year despite falling interest rates. The favorable backdrop for the market is expected to continue through the summer months with net negative supply in July and August, as was the case in June.

AAA Municipal Yields



Maturity	Dec 31, 2018	Mar 31, 2019	May 31, 2019	Jun 30, 2019	1Mo	Q2	YTD
1	1.74%	1.51%	1.40%	1.28%	-0.12%	-0.23%	-0.46%
2	1.80%	1.52%	1.41%	1.29%	-0.12%	-0.23%	-0.51%
3	1.85%	1.53%	1.42%	1.30%	-0.12%	-0.23%	-0.55%
5	1.96%	1.59%	1.44%	1.34%	-0.10%	-0.25%	-0.62%
7	2.09%	1.69%	1.51%	1.43%	-0.08%	-0.26%	-0.66%
10	2.32%	1.89%	1.66%	1.62%	-0.04%	-0.27%	-0.70%
30	3.09%	2.72%	2.40%	2.40%	0.00%	-0.32%	-0.69%

Elimination of SALT Cap Workarounds and the State of IL Budget

The cap on state and local tax (SALT) deductions at $10,000, part of the Tax Cuts and Jobs Act (TCJA) of 2017, most significantly impacted high income earners in states with high income and property taxes. A few such states, including NY, NJ and CT created ways to offset the impact of the tax cap, including the establishment of a charitable giving tax credit program that allowed a workaround to the deduction cap. As many expected, last month the IRS and Treasury Department issued new federal regulations that disallowed these charitable deductions beyond the $10,000 cap, ending the state loophole programs. Given the amount of revenue at stake to the federal government, additional restrictions are likely on other remaining state-created workarounds.

With a Democratic governor and Democratic-controlled super-majority in each legislative body, Illinois passed a new $40B state budget on time, ahead of the 2020 fiscal year beginning July 1. The new budget increases spending by approximately $1B, with more money targeted for local governments, including $379M for public schools and $150M for higher education. The budget also fully funds this year's $9B pension contribution. A number of new taxes and fees were included in the budget that will pay for a six-year, $45B Rebuild Illinois public works program. The infrastructure plan will be funded by revenues from: 1) four new casinos including revenue from legalized sports betting, 2) higher taxes on cigarette sales while also raising to 21 the minimum purchase age, 3) a doubling of gasoline taxes to 38 cents/gal, the 3rd highest in the nation which will also be indexed to inflation annually, and 4) higher vehicle registration fees such that the owner of a standard vehicle will pay a $148 annual fee, up from $98. The state also legalized recreational marijuana, but no revenues were assumed from sales in this year's budget. Governor Pritzker also signed legislation providing for a constitutional amendment on the 2020 ballot to change the state's flat income tax to a graduated tax.

Strong Month and Positive Quarter and YTD Municipal Returns

The rally in short-term rates set the pace in June as the curve steepened, but for the quarter and YTD, longer maturities were the best performing curve segment. The decline in short rates last month helped boost the performance of the Prerefunded sector, but Revenue bonds are the YTD leader. Finally, BBB rated and lower quality credits outperformed across all reported time periods as credit spreads narrowed as interest rates fell.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

Bloomberg Barclays Index/Sector	June	Q2	YTD	Bloomberg Barclays Quality	June	Q2	YTD
Municipal Bond Index	0.37%	2.14%	5.09%	AAA	0.36%	1.83%	4.56%
General Obligation bonds	0.35%	2.06%	4.89%	AA	0.34%	2.01%	4.80%
Revenue bonds	0.37%	2.25%	5.38%	A	0.40%	2.31%	5.52%
Prerefunded bonds	0.44%	1.08%	2.44%	BBB	0.46%	2.94%	6.63%
Long maturities (22+ yrs.)	0.24%	2.89%	6.85%	High Yield	0.52%	2.73%	6.66%
Intermediate maturities (1 - 17 yrs.)	0.41%	1.84%	4.40%	HY, ex-Puerto Rico	0.48%	2.68%	6.26%
Short maturities (1 - 5 yrs.)	0.44%	1.12%	2.46%				

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.