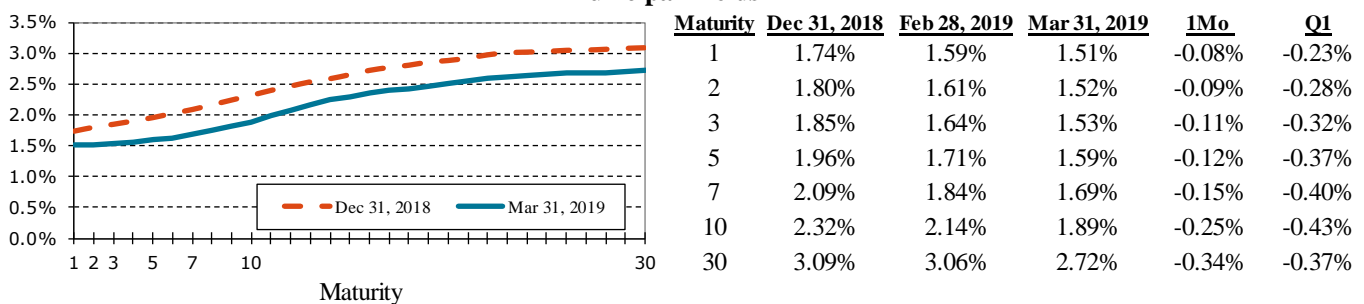


Baird Advisors
Municipal Fixed Income Market Commentary
March 2019

Fed Pivot and Record Demand Push Municipal Yields Lower

Municipal yields fell in March and over the first quarter, thanks both to record inflows to tax-free mutual funds and a dovish pivot from the Fed, which now projects no rate hikes in 2019. Long municipal yields fell 34 bps last month while short rates declined 8 bps, flattening the curve for the month and quarter. A total of \$27B of new cash flowed into municipal funds in Q1, the largest quarterly amount since records began back in 1992; an appreciation of the benefit of tax-exempt income in light of the new \$10,000 cap on state and local (SALT) deductions is partly responsible. Even banks slowed their pace of selling, after liquidating \$73B of tax-exempt debt (13% of their total municipal holdings) in 2018 due to the cut in the corporate income tax rate. On the supply side, new municipal issuance rose 14% YoY in Q1, but this was against very light, post-tax reform comparisons a year ago. The strong demand and modest supply lowered the yield on a 10-year AAA tax-free bond to 1.89% at quarter end, only slightly higher than the recent low yield point of 1.83% in June 2017. When compared to taxable Treasury yields, tax-exempt yields across the curve are currently on the richer side of recent valuations. Although seasonal weakness often occurs around the April 15th tax payment deadline, the favorable supply/demand balance appears likely to persist, continuing to provide a supportive backdrop for the market going forward.

AAA Municipal Yields



The State of the States

The U.S. economic expansion will soon be ten years in duration and, not surprisingly, the fiscal condition of most states is solid. Currently, 17 states, plus the District of Columbia, have a AAA rating from at least one of the nationally recognized rating agencies. Economic growth of 3% last year plus some likely non-recurring factors helped state tax collections grow nearly 10% YoY in 2018. This strong tax revenue allowed states to add to reserves and/or lower income tax rates, as seven states did at the start of 2019. However, not all states are equally positioned. States with no state income tax, such as Texas and Florida (both AAA-rated), continue to attract people from states with a higher tax burden. In addition, infrastructure and pension-related costs remain ongoing challenges, but these too vary across the country. Fortunately, rising tax revenues help all states to better meet increasing pension and healthcare costs, but infrastructure projects are often delayed. Skepticism over additional federal infrastructure support has forced states to look for new/alternative revenue sources. For example, more than half the states have raised gasoline taxes in the past five years. Alabama is the latest, as the governor agreed to a 10-cent per gallon gas tax increase, to be phased in over three years. Only three states are consistently rated in the “A” category, or lower, (IL, NJ, and CT), with Illinois barely hanging on the edge of investment grade (Baa3/BBB-). Illinois’ new governor has proposed a graduated income tax. The top rate would rise to 7.95% in order to shore up state finances, but the earliest this could be implemented, if approved, would be 2021.

Strong Monthly and Quarterly Returns for Municipals

Risk-seeking strategies have been rewarded so far in 2019 as both duration and credit exposure have been important performance factors. Long maturities have outperformed both intermediate and short-term debt, just as lower-rated, or High Yield municipal issues have outperformed higher quality bonds. Pre-refunded bonds have lagged other market sectors as a result.

Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors

<u>Bloomberg Barclays Index/Sector</u>	<u>March</u>	<u>Q1</u>	<u>Bloomberg Barclays Quality</u>	<u>March</u>	<u>Q1</u>
Municipal Bond Index	1.58%	2.90%	AAA	1.39%	2.67%
General Obligation bonds	1.44%	2.78%	AA	1.48%	2.74%
Revenue bonds	1.72%	3.07%	A	1.74%	3.13%
Prerefunded bonds	0.47%	1.35%	BBB	2.11%	3.59%
Long maturities (22+ yrs.)	2.62%	3.85%	High Yield	2.58%	3.83%
Intermediate maturities (1 - 17 yrs.)	1.16%	2.51%	HY, ex-Puerto Rico	2.32%	3.48%
Short maturities (1 - 5 yrs.)	0.44%	1.33%			

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.