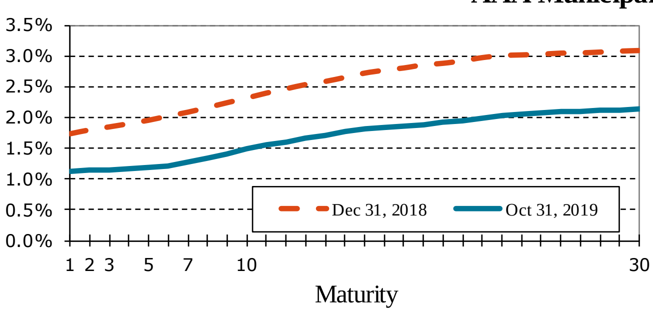
**Baird Advisors**
**Municipal Fixed Income Market Commentary**
**October 2019**

## Short-term Rates Rally, Municipal Curve Steepens in October

Following the lead of the U.S. Treasury curve, the municipal curve also steepened in October as short-term tax-free yields fell and intermediate and long-term yields were steady to slightly higher. The Fed's actions directly influenced the decline in short-term rates this month, first, by lowering the federal funds rate 25 bps for the third time this year (to 1.50% - 1.75%) and second, by announcing the purchase of $60B Treasury bills per month to provide additional liquidity for the repo market. The municipal market also benefited from continued inflows into tax-free mutual funds. The streak of consecutive weekly inflows stretched to 42 with YTD total inflows of $74B, more than 10X the $7B level at this point last year. New supply has also picked up with October issuance 38% higher than the same month last year and total municipal supply YTD 14% ahead of last year's pace. Breaking the supply down further, tax-exempt issuance has risen 6% YoY, but taxable issuance is up nearly 90%. An estimated one-half of the taxable supply this year has been issued to refund tax-exempt debt. With the decline in market rates, even after swapping from tax-exempt to taxable yields many municipalities are still able to realize a cost savings on their debt. Not surprisingly, the increase in taxable municipal supply has caused a widening of credit spreads relative to taxable corporate alternatives. According to Bloomberg Barclays index data, credit spreads between the Intermediate Taxable Municipal sector (+87 OAS) and Intermediate Taxable Corporates (+83 OAS) widened 8 bps in October and are 49 bps wider for the year. For non-taxpaying or low marginal rate investors who have the ability and inclination to diversify into the municipal sector, the value of taxable municipals have certainly improved with the boost in supply.

**AAA Municipal Yields**




| Maturity | 12/31/18 | 9/30/19 | 10/31/19 | 1Mo Chg | YTD |
|---|---|---|---|---|---|
| 1 | 1.74% | 1.27% | 1.13% | -0.14% | -0.61% |
| 2 | 1.80% | 1.27% | 1.14% | -0.13% | -0.66% |
| 3 | 1.85% | 1.27% | 1.15% | -0.12% | -0.70% |
| 5 | 1.96% | 1.28% | 1.19% | -0.09% | -0.77% |
| 7 | 2.09% | 1.32% | 1.28% | -0.04% | -0.81% |
| 10 | 2.32% | 1.47% | 1.48% | 0.01% | -0.84% |
| 30 | 3.09% | 2.11% | 2.14% | 0.03% | -0.95% |

## New Chicago Mayor Handles Fiscal Challenges

Chicago's new mayor, Lori Lightfoot, guided both the city and the Chicago Board of Education through two significant fiscal challenges in October, just five months after taking office. Assuming the state legislature approves some of the city's budget balancing measures, Mayor Lightfoot will be able to close an estimated $838 million budget shortfall through a combination of fee increases and cost savings, including the restructuring of some debt, while avoiding a property tax increase. In addition, she helped to reach a tentative agreement with the Chicago Teachers Union after an 11 day strike which was keeping 300,000 students at home. The agreement increases teacher pay 16% over the five-year term of the contract, provides funding to reduce class sizes and seeks to have at least one social worker and nurse in every school by 2023. Given the rising pension, healthcare and infrastructure costs the mayor faces there was very little room for spending increases in either case and the rating agencies were obviously also paying close attention to the measures taken by the new mayor. So far, no rating action has been taken for either the city or school district, allowing each more time to manage through their challenges.

## Short-term Outperforms Long-term Maturities in October

The steepening of the municipal curve impacted the relative performance of different segments of the yield curve in October. The rally in short-term rates led to the outperformance of the shorter maturity segment relative to intermediate and long-term issues. Not surprisingly, Prerefunded issues, with its shorter average maturity when compared to other market sectors, was the best performing sector last month. From a quality perspective, there was very little differentiation across the credit spectrum as both High Yield municipals and AAA-rated issues performed alike.

**Total Returns of Selected Bloomberg Barclays Municipal Indices and Subsectors**

| Bloomberg Barclays Index/Sector | October | YTD | Bloomberg Barclays Quality | October | YTD |
|---|---|---|---|---|---|
| Municipal Bond Index | 0.18% | 6.94% | AAA | 0.20% | 6.18% |
| General Obligation bonds | 0.22% | 6.67% | AA | 0.20% | 6.57% |
| Revenue bonds | 0.15% | 7.33% | A | 0.15% | 7.50% |
| Prerefunded bonds | 0.38% | 3.19% | BBB | 0.12% | 8.95% |
| Long maturities (22+ yrs.) | -0.02% | 9.65% | High Yield | 0.21% | 9.92% |
| Intermediate maturities (1 - 17 yrs.) | 0.26% | 5.86% | HY, ex-Puerto Rico | 0.23% | 9.02% |
| Short maturities (1 - 5 yrs.) | 0.42% | 3.22% | | | |

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.