Municipal Insights

#Munigood

We would like to briefly address the municipal headlines that come across your screen (or printed paper for some of us) from time-to-time. Fortunately, there have not been many over the past quarter and we like it that way.

Municipal bonds have been a reliable and largely worry free investment for decades and we believe they will continue this course. However, as the headlines point out, mismanagement is not unknown to public entities. Despite the struggles of a handful of highly publicized tax-exempt issuers over the past few years, we would argue that the overall quality of municipal debt is significantly higher than in the corporate world. As such, problems in repayment of debt have become and continue to be drastically lower.

For example, a June 2017 report by Moody's showed that municipal defaults are still a rare occurrence. The report encompassed their rated universe of municipal issues from 1970-2016. The municipal default rate over the entire period was 0.07% while the five-year municipal default rate since 2007 was 0.15% — an uptick, but still a rarity. Compare this to the corporate default rate of 6.92% for the same five-year period. Additionally, Moody's rated municipal issuers have a significantly higher average rating than rated global corporate credits. Looking at the rating distribution of municipal versus corporate issuers, only 1.4% of all municipals are rated Baa3 and lower compared to 49.6% of global corporate credits.

Over the past few years, the growth in revenues from personal income taxes, sales taxes, and the recovery of property valuations has supported state and local governments, providing political leaders the ability to offset growth in fixed costs and rebuild reserves. The flexibility afforded municipal officials to manage budgets is evidenced by the continued favorable rating actions. For example, Moody's reported that, for the third year in a row, rating upgrades (774) exceeded downgrades (461) in 2017. Albeit, on a dollar value basis the amount of debt downgraded exceeded that of debt upgraded due to rating downgrades on several large issuers including the State of New Jersey, the Commonwealth of Puerto Rico, the State of Illinois and the State of Connecticut.

Municipal fixed income

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We are not arguing that life in Muniland will be all peaches and cream. There will be winners and losers. Moody's cites growth in government leverage (borrowing) as the single largest factor in rating downgrades. Municipal borrowing is a growing percentage of governmental fixed costs and is crowding out essential services as revenue growth fails to keep pace. Unfunded pension liabilities for state and local governments were minimal fifteen years ago; today, it's a primary concern for municipal credit analysts. However, a government's ability to cut expenses and adjust revenues has provided the sector the ability to avoid significant rating erosion.

As in all investments, you need to be vigilant. Our approach is to maintain a high level of diversification in combination with a seasoned staff of credit analysts.

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Market recap

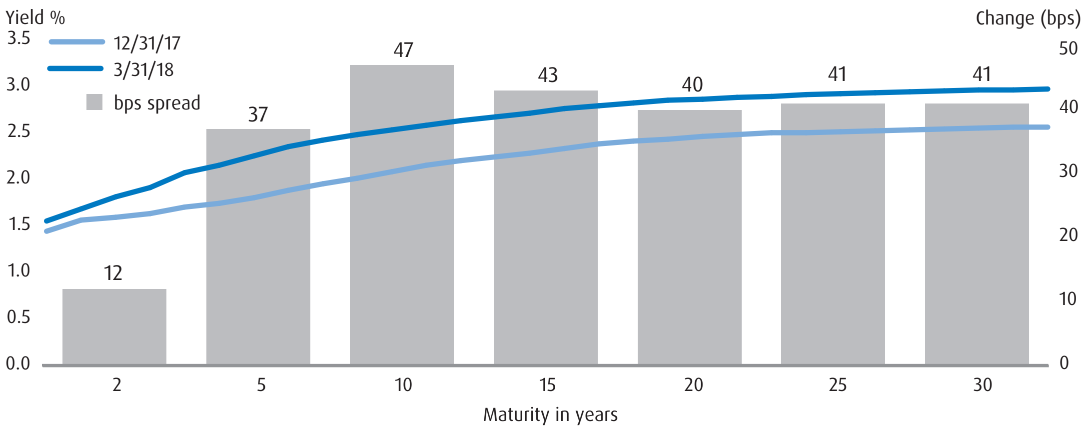
U.S. fixed income markets remain focused on the policy moves of the U.S. Federal Reserve. Last month, the Fed hiked its Fed Funds target rate by 25 basis points for the sixth time this cycle (now 1.50-1.75%). This was the first meeting under new Chairman Jerome Powell. We saw a mix of investor reactions, both hawkish and dovish reads on the overall meeting and comments. The Fed's "dot plot" did project a steeper path for the target rate over the next two years, however, inflation remains under the Fed's 2% target and wage increases are not signaling undue stress on that front. Two additional hikes this year appear likely, with the potential for a third if inflation perks up. For now, we would say business as usual with gradual and data-dependent hikes, as has been the case for the past two years. With short rates moving higher, the U.S. Treasury yield curve continued to flatten and municipal bonds largely followed suit. The U.S. Treasury yield curve's spread between 2 and 10 year rates, at about 50 bps, is at its lowest level in over ten years. The Bloomberg Barclays Municipal Bond Index was able to eke out a positive 0.37% for March, but was unable to offset losses in the first two months of the year. The first quarter return for the Index was -1.11%, leaving trailing twelve months returns at 2.66%. This compares favorably to the total return of the primary taxable fixed income benchmark, the Bloomberg Barclays Aggregate Bond Index, which returned -1.46% for the quarter and 1.20% for the last twelve months.

With a supportive technical situation of limited new issuance and positive flows into the asset class, negative first quarter municipal returns were disappointing. Broadly, domestic fixed income returns were challenged as inflationary fears forced bond yields higher. After the record supply in December 2017, the first quarter saw municipal bond issuance down approximately 30%, well below its ten-year average. Despite negative returns over the quarter, municipal bond funds saw over $10 Billion in net flows during the period—only two weeks saw outflows over the quarter. However, most of the inflows occurred in the first few weeks of the quarter and were attributable to investor reallocations out of equities and into muni bond funds. This was tempered to some degree by decreased demand and selling by banks and insurance companies which saw their income tax rate decline to 21% as a result of last year's tax reform legislation. Bank and insurance companies hold approximately 30% of outstanding municipal bonds. While we don't expect heavy selling, early indications are that there is diminished demand from corporate buyers. We will continue to monitor this, particularly if retail muni fund flows turn negative.

Despite negative returns over the quarter, municipal bond funds saw over $10 Billion in net flows during the period — only two weeks saw outflows over the quarter.

For retail investors, municipal bond yields continue to look very attractive on a taxable equivalent basis. For example, an investor in the 35% income tax bracket could currently realize a tax adjusted yield of about 3.75% for a ten-year, AAA rated muni—about 100 basis points over the ten-year Treasury yield. And with the volatility we have been seeing in the equity markets, all the more reason to revisit overall portfolio diversification.

AAA Government Obligation yield curve 12/31/17 to 3/31/18



Source: Thomson Municipal Market Monitor

Strategy overview

Duration

- We will continue to be shorter duration than our benchmark and peers.
- Fixed income markets have been driven to higher yields by heightened concerns of inflation, potential for increased Treasury issuance, and an active Fed. US Treasury 10-year yields have risen 35 basis points year-to-date.

Curve

- Overweight municipal floating-rate notes, avoiding fixed-coupon bonds on the shorter end of the yield curve due to expected Fed rate hikes. Continue to monitor inflation and expectations. Fed has indicated a continuation of policy normalization and has steepened the two-year forecast for rate hikes via the "dot plot".
- The weekly municipal floating rate index (SIFMA rate) is at 1.60% (4/4/2018) versus 0.88% a year ago. SIFMA has been climbing as we go into tax season, a seasonal occurrence in the municipal market. Look for this weekly rate to decline over the next month.

Credit and structure

- The only notable outlier for credit returns last month was municipal high yield. The Bloomberg Barclays Muni High Yield Index returned 1.46% in March driven, higher by tobacco bonds and some recovery in Puerto Rico bonds.
- We continue to be wary of BBB and lower quality bonds with quality spreads at very tight levels.

Sector

- We like prepaid gas bonds at this time. These tax-exempt bonds can be issued as floating rate notes with credit support from financial institutions. These institutions are in strong capital positions and benefit from rising interest rates.

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Performance

Fund performance as of March 31, 2018

Fund/Index	Share class	Inception date	Ticker	Returns as of March 31, 2018 (%) 1-month	Q1	YTD	1-year	3-year	5-year	10-year	Since inception	Expense ratios (%)[1] Gross	Net
BMO Ultra Short Tax-Free Fund[2]	A NAV	05/27/14	BAU.S.X	0.08	0.34	0.34	0.89	0.57	0.58	—	0.93	0.64	0.55
BMO Ultra Short Tax-Free Fund[2]	A OFFER[3]			-1.96	-1.71	-1.71	-1.17	-0.12	0.17	—	0.70		
BMO Ultra Short Tax-Free Fund[2]	I	09/30/09	MUISX	0.11	0.30	0.30	1.15	0.82	0.83	—	1.17	0.39	0.30
Blended Benchmark[4]				0.00	0.28	0.28	0.56	0.45	0.41	—			
BMO Short Tax-Free Fund[2]	A NAV	05/27/14	BASFX	0.02	0.06	0.06	1.13	0.92	1.26	—	1.49	0.76	0.55
BMO Short Tax-Free Fund[2]	A OFFER[3]			-2.01	-1.97	-1.97	-0.92	0.24	0.85	—	1.12		
BMO Short Tax-Free Fund[2]	I	11/29/12	MTFIX	0.03	0.10	0.10	1.29	1.08	1.44	—	1.66	0.51	0.40
Bloomberg Barclays Short (1-5 Year) Municipal Index				-0.07	0.10	0.10	0.50	0.86	0.98	—			
BMO Intermediate Tax-Free Fund[5]	A NAV	05/27/14	BITAX	0.22	-0.74	-0.74	2.62	1.90	2.36	4.32	4.32	0.58	0.56
BMO Intermediate Tax-Free Fund[5]	A OFFER[3]			-3.25	-4.22	-4.22	-0.93	0.70	1.63	3.94	4.17		
BMO Intermediate Tax-Free Fund[5]	Y	02/01/94	MITFX	0.22	-0.74	-0.74	2.62	1.90	2.36	4.32	4.32	0.58	0.56
BMO Intermediate Tax-Free Fund[5]	I	12/27/10	MIITX	0.24	-0.69	-0.69	2.86	2.13	2.58	4.46	4.38	0.33	0.33
Bloomberg Barclays U.S. 1-15 Year Blend Municipal Bond Index				0.22	-0.91	-0.91	1.81	1.78	2.20	3.80			

Other benchmarks as of March 31, 2018	Returns as of March 31, 2018 (%) 1-month	Q3	YTD	1-year	3-year	5-year	10-year
Bloomberg Barclays U.S. 1-10 Year Blend Municipal Bond Index	0.09	-0.71	-0.71	1.19	1.41	1.77	3.34
Bloomberg Barclays U.S. Municipal Bond Index	0.37	-1.11	-1.11	2.66	2.25	2.73	2.64

Source: Bloomberg Barclays and BMO Global Asset Management

Performance data quoted represents past performance and past performance is not a guarantee of future results. Investment returns and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Mutual fund performance changes over time and current performance may be lower or higher than what is stated. To receive the most recent month-end performance, call 1-800-236-3863. Returns quoted are pre-tax. Investor should consider his or her current and anticipated investment horizon and income tax bracket when making an investment decision as the illustration above does not reflect these factors. For more information about performance, please contact your investment professional. Total returns for periods of less than one year are cumulative.

[1] **Expenses for Class A shares are based on estimated amounts for the current fiscal year. Net expense ratios reflect contractual fee waivers and/or expense reimbursements if applicable, made by BMO Asset Management Corp., the investment adviser (Adviser). The Adviser may not terminate these fee waivers and/or expense reimbursements prior to December 31, 2017 without the consent of the Board of Directors, unless the investment advisory agreement is terminated. Without these contractual waivers, the Fund's returns would have been lower.**

[2] Performance data quoted prior to the inception of the Class A shares is the performance of the Fund's Investor Class (Class Y). Class A Offer reflects a sales load charged at the time of initial investment. On June 2, 2017, the Fund's Class Y shares were converted to Class A shares. The Fund no longer offers Class Y shares.

[3] Offering Price (MOP) returns for the BMO Ultra Short Tax-Free Fund and the BMO Short Tax-Free Fund include the maximum sales charge of 2.00%. Offering Price (MOP) returns for the BMO Intermediate Tax-Free Fund include the maximum sales charge of 3.75%. Net Asset Value (NAV) returns exclude this charge, which would have reduced returns.

[4] The Blended Benchmark: 50% Bloomberg Barclays 1-Year Municipal Bond Index and 50% iMoneyNet Money Fund Tax Free National Retail Index.

[5] Performance data quoted prior to the inception of the Class A shares is the performance of the Fund's Investor Class (Class Y). Class A Offer reflects a sales load charged at the time of initial investment. Performance data quoted prior to 12/27/10 (inception of Class I of the Fund) is the performance of the Fund's Investor Class (Class Y), not adjusted for any differences in the expenses of the classes.

Market data for the journey

Valuation data as of March 31, 2018

AAA yields (%)				
		Change		
Year	Current	1-month	3-month	1-year
2	1.65	0.13	0.09	0.63
5	2.04	0.07	0.36	0.49
10	2.42	-0.05	0.44	0.17
30	2.95	-0.11	0.41	-0.10

Source: InvestorTools® Perform

Cross-market values (%)[1]		
	Current (1-year averages)	
Year	Muni/treasury	Muni/corporate
2	73 (72)	68 (69)
5	80 (72)	77 (71)
10	88 (86)	79 (79)
30	99 (97)	85 (84)

Sources: InvestorTools® Perform and Bloomberg

Yield curve data as of March 31, 2018

Slope changes (%)				
		Change		
	Current	1-month	3-month	1-year
Wkly - 2s	0.69	-0.49	0.13	-0.67
2 - 5s	-0.23	0.07	0.36	0.49
2 - 10s	0.77	-0.18	0.35	-0.46
2 - 30s	1.30	-0.24	0.32	-0.73

Source: InvestorTools® Perform

Performance by maturity (%)			
Year	1-month	3-month	1-year
3	-0.07	0.11	0.45
5	-0.04	-0.56	0.60
10	0.35	-1.61	2.29
22+	0.71	-1.59	4.69

Source: Barclays Point

Credit data as of March 31, 2018

Current rating spreads (%)[2]		
	Current (1-year averages)	
Year	AAA–A	AAA–BBB
2	0.21 (0.20)	0.48 (0.47)
5	0.43 (0.40)	0.74 (0.71)
10	0.50 (0.52)	0.85 (0.87)
30	0.51 (0.53)	0.83 (0.85)

Source: InvestorTools® Perform

Performance by quality (%)			
Rating	1-month	3-month	1-year
AAA	0.33	-1.20	1.73
AA	0.35	-1.12	2.30
A	0.40	-1.10	3.23
BBB	0.47	-0.96	5.12

Source: Barclays Point

BMO Funds Tax-Free Suite

	Ticker			
Fund name	Class A	Class Y	Class I	Premier Class
BMO Tax-Free Money Market Fund	—	MTFXX	—	MFIXX
BMO Ultra Short Tax-Free Fund	BAUSX	MUYSX	MUISX	—
BMO Short Tax-Free Fund	BASFX	MTFYX	MTFIX	—
BMO Intermediate Tax-Free Fund	BITAX	MITFX	MIITX	—

[1] Cross-market values represent the ratio of tax-free municipal yields to taxable Treasury yields. The percentage in the parentheses represents that average of this ratio over the prior twelve months.

[2] The current rating spread is the difference between the benchmark AAA municipal yield curve and the associated rating benchmark (either A or BBB) for the appropriate maturity time frame. The percentage in the parentheses represents the spread over the prior twelve months.

All investments involve risk, including the possible loss of principal.

You should consider the Fund's investment objectives, risks, charges, and expenses carefully before investing. For a prospectus and/or summary prospectus, which contain this and other information about the BMO Funds, call 1-800-236-3863. Please read it carefully before investing.

BMO Asset Management Corp. is the investment adviser to the BMO Funds. **BMO Investment Distributors, LLC is the distributor of the BMO Funds**. Member FINRA/SIPC

Keep in mind that as interest rates rise, prices for bonds with fixed interest rates may fall. This may have an adverse effect on a Fund's portfolio.

Interest income from Tax-Free Fund investments may be subject to the federal alternative minimum tax (AMT) for individuals and corporations, and state and local taxes.

Credit risk is the possibility that an issuer will default on a security by failing to pay interest or principal when due. Lower credit ratings correspond to higher credit risk.

Municipal bonds are subject to risks including economic and regulatory developments in the federal and state tax structure, deregulation, court rulings, and other factors.

An investment in money market funds is neither insured nor guaranteed by the Federal Deposit Insurance Corporation. You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. The Fund may impose a fee upon sale of your shares or temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not a deposit of BMO Harris Bank N.A., or any of its affiliates, and is not insured or guaranteed by the FDIC or any other government agency. The Adviser has no legal obligation to provide financial support to the Fund, and you should not expect that the Adviser will provide financial support to the Fund at any time.

Bloomberg Barclays 1-10 Year Blend Municipal Bond Index is an unmanaged index of municipal bonds rated BBB or better with 1 to 12 years to maturity.

Bloomberg Barclays U.S. Municipal Bond Index is an unmanaged index of a broad range of investment-grade municipal bonds that measures the performance of the general municipal bond market.

Blended Benchmark consists of 50% Bloomberg Barclays 1 Year Municipal Bond Index and 50% iMoneyNet Money Fund Tax Free National Retail Index. Money Fund Report Averages™ is an arithmetic average of performance for all money market mutual funds tracked within this category. Money Fund Report Averages™ is a service of iMoneyNet, Inc. (formerly IBC Financial Data). The Bloomberg Barclays 1-Yr Municipal Bond Index is the 1-year component of the Bloomberg Barclays Municipal Bond Index, which is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa.

Bloomberg Barclays Short (1-5 Year) Municipal Index includes investment-grade tax-exempt bonds that are issued by state and local governments and have maturities of 1 to 5 years.

Bloomberg Barclays U.S. 1-15 Year Blend Municipal Bond Index is the 1-15 year Blend component of the Bloomberg Barclays Municipal Bond Index, which is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa and a range of maturities between 1 and 17 years.

Investments cannot be made in an index.

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