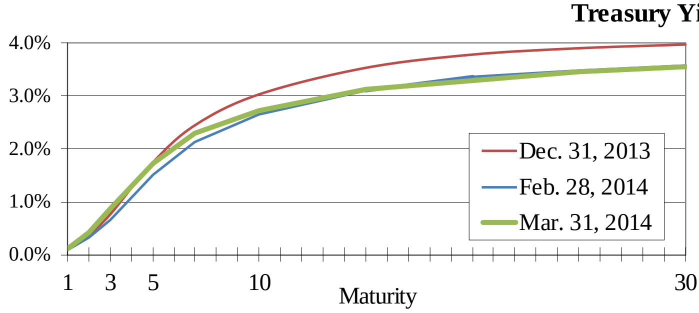
Baird Advisors
Fixed Income Market Comments
March 2014

Yield Curve Flattens

The yield curve flattened significantly this quarter as the 30-year Treasury yield fell 41 bps and the 2-year rose 4 bps. Weakness in weather-impacted US economic data, emerging market turmoil, and escalating geopolitical risks (i.e. Russia/Ukraine crisis) pushed intermediate and long-term yields lower. The Fed continued tapering QE by $10 billion at each meeting, slowing the rate of purchases to $55 billion per month from the $85 billion peak in December. It is generally expected that the Fed has set a high hurdle to deviate from the anticipated path of tapering, which could conclude QE purchases by the end of the year. In the March 19th press conference after the Federal Open Market Committee meeting, Yellen was asked to predict how long of a gap there would be between the end of QE and the first Fed Funds rate hike. Yellen explained that “considerable” time was “hard to define” and “will be a complicated assessment” contingent upon inflation. However, she mentioned it could be “something on the order of or around 6 months.” Traders took the mention of 6 months as something definitive, positioning for an earlier than expected mid-2015 Fed Funds rate hike and pushing 1-3yr yields higher. We believe the market reaction was somewhat premature as inflation measures remain benign and Yellen has since spoken publicly affirming her commitment to an accommodative rate policy.

Treasury Yields



Maturity	Dec 31, 2013	Feb 28, 2014	Mar 31, 2014	Q1 Change
1	0.11%	0.10%	0.11%	0.00
2	0.38%	0.32%	0.42%	0.04
3	0.76%	0.67%	0.87%	0.11
5	1.74%	1.50%	1.72%	-0.02
7	2.45%	2.12%	2.30%	-0.15
10	3.03%	2.65%	2.72%	-0.31
30	3.97%	3.58%	3.56%	-0.41

CMBS and Credit Spreads Tighten, MBS Spreads Widen

Spreads were greatly influenced by demand this quarter, with CMBS (19 bp tighter for the quarter) and Investment Grade Corporates (8 bps tighter) benefitting from a strong base of investors looking for high quality non-Government bonds with solid to improving fundamentals. However, Agency Mortgage Pass-throughs are starting to show signs of weakening demand, as the Fed tapers MBS purchases and money managers require additional compensation to hold Agency MBS. Demand from investors reaching for yield caused spreads on High Yield Corporates to end the quarter at the tightest level (358 bps) since 2007.

Option-Adjusted Spreads (in bps)

	12/31/13	2/28/14	3/31/14	Q1 Change
U.S. Aggregate Index	45	44	44	-1
U.S. Agency (non-mortgage)	17	18	16	-1
Mortgage and ABS Sectors				
U.S. Agency Pass-throughs	34	35	38	4
Asset-Backed Securities	55	52	50	-5
CMBS	126	108	107	-19
Corporate Sectors				
U.S. Investment Grade	114	109	106	-8
Industrial	114	110	105	-9
Utility	125	122	118	-7
Financial Institutions	109	104	103	-6
U.S. High Yield	382	363	358	-24

Source: Barclays

Long Duration, Spread Sectors Outperform for the Quarter

The flattening of the Treasury yield curve from the long end drove strong performance for longer duration bonds, while spread tightening enhanced returns across many sectors. Investment Grade Corporates (+2.94%) finished the quarter with strong demand, whereas MBS (+1.59%) saw less demand given the Fed’s tapering of purchases. Municipals (+3.32%) led the pack, benefitting from limited new supply as well as improving demand for this sector in the quarter.

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	March 2014	Q1 2014
U.S. Aggregate Index	-0.17%	1.84%
U.S. Gov’t/Credit Index	-0.11%	1.98%
U.S. Intermediate Gov’t/Credit Index	-0.30%	1.00%
U.S. 1-3 Yr. Gov’t/Credit Index	-0.09%	0.23%
U.S. Treasury	-0.29%	1.34%
U.S. Agency	-0.17%	1.02%
MBS (Mortgage Backed Securities)	-0.32%	1.59%
CMBS (Commercial Mortgage Backed Securities)	-0.10%	1.29%
ABS (Asset-Backed Securities)	-0.14%	0.54%
U.S. Corporate - Investment Grade	0.07%	2.94%
Corporate High Yield	0.24%	2.98%
Municipal Bond Index	0.17%	3.32%
TIPS (Treasury Inflation Protected Securities)	-0.47%	1.95%

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 declines and conversely, in a falling interest rate environment, the value of fixed-income securities generally increases. 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 Barclays Aggregate Bond Index is an index comprised of approximately 6000 publicly traded bonds including U.S. Government, mortgage backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

The Barclays Government/Credit Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt.

The Barclays Intermediate Government/Credit Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt with maturities between one and ten years.

The Barclays Government/Credit Intermediate Index (1 – 3 yr) is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt with maturities between zero and three years.

The Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint of at least one year but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting. Securities in the Index roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices. The U.S. Treasury Index was launched on January 1, 1973.

U.S. Agency: This index is the U.S. Agency component of the U.S. Government/Credit index. Publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities). The largest issues are Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLB). The index includes both callable and non-callable agency securities.

U.S Corporate – Investment Grade: This index is the Corporate component of the U.S. Credit index. It includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

CMBS (Commercial Mortgage Backed Securities): This index is the CMBS component of the U.S. Aggregate index. The Barclays CMBS ERISA-Eligible Index is the ERISA-eligible component of the Barclays CMBS Index. This index, which includes investment grade securities that are ERISA eligible under the underwriter's exemption, is the only CMBS sector that is included in the U.S. Aggregate Index.

MBS (Mortgage Backed Securities): This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates.

ABS (Asset Backed Securities): This index is the ABS component of the U.S. Aggregate index. The ABS index has three subsectors: credit and charge cards, autos, and utility. The index includes pass-through, bullet, and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche. The Manufactured Housing sector was removed as of January 1, 2008, and the Home Equity Loan sector was removed as of October 1, 2009.

Corporate High Yield: The Barclays U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The 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 Barclays TIPS Index consists of Treasury Inflation Protected Securities (TIPS). TIPS are securities whose principal is tied to the Consumer Price Index. TIPS pay interest semi-annually, based on the fixed rate applied to the adjusted principal.