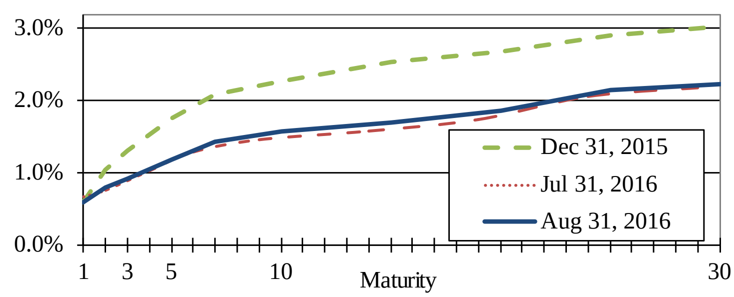
Baird Advisors
Fixed Income Market Comments
August 2016

Yields Rise Modestly as Odds of Fed Funds Rate Hike Increase; More Accommodative Policies around the Globe

Treasury yields rose modestly this month as the odds of a Fed Funds rate hike rose on improving economic data and more hawkish commentary from the usually dovish Fed Chair Yellen. July nonfarm payrolls came in stronger than expected (+255k vs +180k market expectation) while inflation remained well contained (July headline CPI +0.8% YoY). At the Fed's annual gathering in Jackson Hole, Yellen signaled growing support for a Fed Funds interest rate hike before the end of the year: "In light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the Federal Funds rate has strengthened in recent months." Market expectations for at least one Fed Funds rate hike by the end of 2016 rose to nearly 65% following Yellen's 8/23 speech, up from less than 10% at the start of the quarter. Globally, central banks continue to apply additional stimulus: the Bank of England halved its policy rate to 0.25% and increased its bond buying program, the European Central Bank continues buying corporate bonds as a part of its QE program, and the Bank of Japan continues buying assets including exchange-traded funds (ETFs). The People's Bank of China, however, opted not to ease further this month, citing concerns that additional easing of bank reserve requirements could have undesirable impacts on the Yuan's exchange rate.

Treasury Yields



Maturity	12/31/15	7/31/16	8/31/16	1Mo Chg	YTD Chg
1	0.60%	0.49%	0.59%	0.10%	-0.01%
2	1.05%	0.67%	0.80%	0.13%	-0.25%
3	1.31%	0.76%	0.91%	0.15%	-0.40%
5	1.76%	1.03%	1.18%	0.15%	-0.58%
7	2.09%	1.29%	1.44%	0.15%	-0.65%
10	2.27%	1.46%	1.57%	0.11%	-0.70%
30	3.02%	2.18%	2.23%	0.05%	-0.79%

Spread Tightening Continues

Spreads continued to grind tighter as investors reached for yield including foreign investors who continue to buy U.S. Dollar-denominated assets. Strong demand drove U.S. fixed-rate investment grade corporates 10 bps tighter to 135 bps in spite of a record-setting $110B of new supply (as measured by Barclays) for the seasonally slow month of August. In contrast to active corporate supply, asset-backed securities and commercial mortgage-backed securities (CMBS) saw relatively little issuance in August, helping spreads tighten 7 bps in each sector.

Option-Adjusted Spreads (in bps)

	12/31/15	6/30/16	7/31/16	8/31/16	1Mo Chg	YTD Chg
U.S. Aggregate Index	56	55	52	47	-5	-9
U.S. Agency (non-mortgage)	21	21	23	22	-1	1
Mortgage and ABS Sectors						
U.S. Agency Pass-throughs	24	27	24	15	-9	-9
Asset-Backed Securities	72	61	66	59	-7	-13
CMBS	121	98	85	78	-7	-43
Corporate Sectors						
U.S. Investment Grade	165	156	145	135	-10	-30
Industrial	183	159	148	138	-10	-45
Utility	150	142	136	130	-6	-20
Financial Institutions	134	152	141	131	-10	-3
U.S. High Yield	660	594	540	490	-50	-170

Sources: Barclays

Returns Slow from Strong YTD Pace, Treasuries Lag

Most segments of the fixed income markets gave back a portion of the very strong returns posted in the first seven months of the year as Treasury yields rose off the all-time lows witnessed in July. Treasuries had the weakest returns of the month (-0.55%) while U.S. corporates delivered the highest returns of all investment grade sectors in August (+0.20%). High yield corporates stood out and delivered the strongest returns of the month (+2.09%) as investors stretched for yield in lower quality issues. Agency mortgage-backed securities also generated positive returns (+0.12%) as interest rate volatility dropped markedly, easing investor concerns about prepayment risks.

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	August	YTD
U.S. Aggregate Index	-0.11%	5.86%
U.S. Gov't/Credit Index	-0.20%	6.86%
U.S. Intermediate Gov't/Credit Index	-0.26%	4.10%
U.S. 1-3 Yr. Gov't/Credit Index	-0.11%	1.56%
U.S. Treasury	-0.55%	5.21%
U.S. Agency	-0.16%	3.33%
MBS (Mortgage-Backed Securities)	0.12%	3.44%
CMBS (Commercial Mortgage-Backed Securities)	-0.17%	6.77%
ABS (Asset-Backed Securities)	0.01%	2.47%
U.S. Corporate - Investment Grade	0.20%	9.47%
Corporate High Yield	2.09%	14.35%
Municipal Bond Index	0.13%	4.54%
TIPS (Treasury Inflation Protected Securities)	-0.45%	6.68%

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 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.