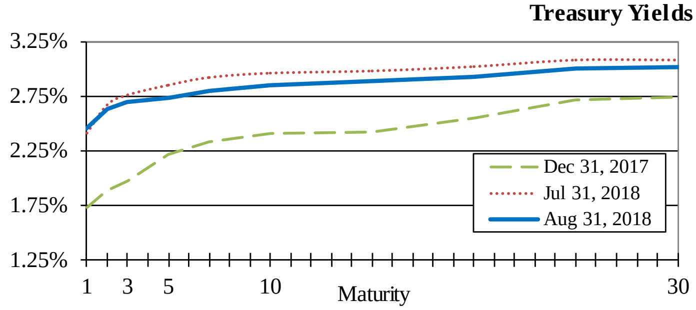
**Baird Advisors**
**Fixed Income Market Commentary**
**August 2018**

### Rates Fall on Emerging Market Worries, Curve Flattens, Powell Advocates Gradual Approach

Investors were drawn to safe-haven assets such as US Treasuries on weakness in Emerging Markets and the 10yr yield fell 11bps to 2.85%. The Argentinian Peso and Turkish Lira dropped 29% and 25% respectively vs. the US Dollar in August as concerns that slower global growth coupled with a rising US dollar would disproportionally hurt EM countries. Argentina and Turkey in particular have taken on significant US dollar-denominated debt over the last decade and run large current account deficits that require external funding. The threat of a broader contagion across emerging markets is a primary risk factor in the current global macro risk environment. Markets also continue to focus on the heightened trade tension between the US and key trade partners. The 2-30yr segment of the yield curve flattened an additional 3 bps in August to +38 bps. US economic data pointed to continued solid growth, although signs of moderation emerged in hiring (July nonfarm payrolls +157K vs. +248K the prior month) and in housing, where the pace of existing and new homes sales slowed. Inflation data remain well contained as Core Personal Consumption Expenditures came in at the Fed's 2.0% target rate, after remaining below 2.0% for over six years. Additional support for bond prices came from Fed Chair Jay Powell's speech at the Jackson Hole Economic Policy Symposium where he focused on risk management, advocating for a gradual approach to monetary policy, noting "when unsure of the potency of a medicine, start with a somewhat smaller dose" and reiterating that "the gradual process of normalization remains appropriate."

**Treasury Yields**




| Maturity | 12/31/17 | 7/31/18 | 8/31/18 | 1Mo Chg | YTD Chg |
|---|---|---|---|---|---|
| 1 | 1.73% | 2.41% | 2.45% | 0.04% | 0.72% |
| 2 | 1.88% | 2.67% | 2.63% | -0.04% | 0.75% |
| 3 | 1.97% | 2.76% | 2.69% | -0.07% | 0.72% |
| 5 | 2.21% | 2.85% | 2.73% | -0.12% | 0.52% |
| 7 | 2.33% | 2.92% | 2.80% | -0.12% | 0.47% |
| 10 | 2.41% | 2.96% | 2.85% | -0.11% | 0.44% |
| 30 | 2.74% | 3.08% | 3.01% | -0.07% | 0.27% |

### Corporates Widen Out the Curve, Shorter Maturities Hold In

Heightened global market volatility put some pressure on Investment Grade Corporate spreads, which moved 5 bps wider in August to 114 bps, although performance differed by various segments of the curve. Corporates with maturities greater than 10 years were 10bps wider in the month while 1-3yr maturities were 1 bp tighter. Stress in emerging markets caused a Bloomberg Barclays index of mostly below investment grade emerging market debt to widen 103bps to 551 bps, or almost 200 bps wider YTD (see table at right.) Non-Agency CMBS tightened 2 bps to +80 bps as demand for high-quality securitized sectors remained strong and new issue supply continues to run at a very modest pace.

### Positive Returns Across Sectors, Except for Emerging Markets

All major sectors with the exception of Emerging Market bonds posted positive returns in August, benefitting from the decline in rates and fairly stable spreads. However, EM returns were negative (-3.69%) on EM currency weakness versus the US dollar, heightened trade pressures, and a strong U.S. economy, which has allowed the Fed to gradually raise short term rates and reduce its balance sheet.

**Option-Adjusted Spreads (in bps)**

| | 12/31/17 | 7/31/18 | 8/31/18 | 1Mo Chg | YTD Chg |
|---|---|---|---|---|---|
| U.S. Aggregate Index | 36 | 40 | 42 | 2 | 6 |
| U.S. Agency (non-mortgage) | 14 | 14 | 13 | -1 | -1 |
| Mortgage and ABS Sectors | | | | | |
| U.S. Agency Pass-throughs | 25 | 27 | 29 | 2 | 4 |
| U.S. Agency CMBS | 35 | 40 | 40 | 0 | 5 |
| U.S. Non-Agency CMBS | 79 | 82 | 80 | -2 | 1 |
| Asset-Backed Securities | 36 | 42 | 42 | 0 | 6 |
| Corporate Sectors | | | | | |
| U.S. Investment Grade | 93 | 109 | 114 | 5 | 21 |
| Industrial | 98 | 111 | 117 | 6 | 19 |
| Utility | 92 | 109 | 112 | 3 | 20 |
| Financial Institutions | 85 | 105 | 108 | 3 | 23 |
| Other Govt. Related | 68 | 73 | 76 | 3 | 8 |
| U.S. High Yield Corporates | 343 | 336 | 338 | 2 | -5 |
| Emerging Market Debt | 352 | 448 | 551 | 103 | 199 |

*Source: Bloomberg Barclays Indices*

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

| Bloomberg Barclays Index/Sector | August | YTD 2018 | Effective Duration (yrs) |
|---|---|---|---|
| U.S. Aggregate Index | 0.64% | -0.96% | 6.00 |
| U.S. Gov't/Credit Index | 0.65% | -1.19% | 6.45 |
| U.S. Intermediate Gov't/Credit Index | 0.59% | -0.36% | 3.92 |
| U.S. 1-3 Yr. Gov't/Credit Index | 0.35% | 0.49% | 1.92 |
| U.S. Treasury | 0.76% | -0.74% | 6.10 |
| U.S. Agency (non-mortgage) | 0.60% | -0.11% | 3.91 |
| U.S. Agency Pass-throughs | 0.61% | -0.46% | 5.02 |
| CMBS (Commercial Mortgage Backed Securities) | 0.98% | -0.44% | 5.29 |
| ABS (Asset-Backed Securities) | 0.43% | 0.56% | 2.15 |
| U.S. Corporate Investment Grade | 0.49% | -1.98% | 7.27 |
| U.S. High Yield Corporates | 0.74% | 2.00% | 3.77 |
| Emerging Market Debt | -3.69% | -6.63% | 4.52 |
| Municipal Bond Index | 0.26% | 0.25% | 6.06 |
| TIPS (Treasury Inflation Protected Securities) | 0.72% | 0.21% | 6.18 |

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 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 Bloomberg 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 Bloomberg 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 Bloomberg 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 Bloomberg 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 Bloomberg Barclays CMBS ERISA-Eligible Index is the ERISA-eligible component of the Bloomberg 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 Bloomberg 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.

Emerging Market: Bloomberg uses a fixed list of countries defined as emerging markets countries for index inclusion purposes that is based on World Bank Income group definitions (Low/Middle), IMF country classifications (Non-Advanced Economies), and other advanced economies that may be less accessible or investable for global debt investors.

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 Bloomberg 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.

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.