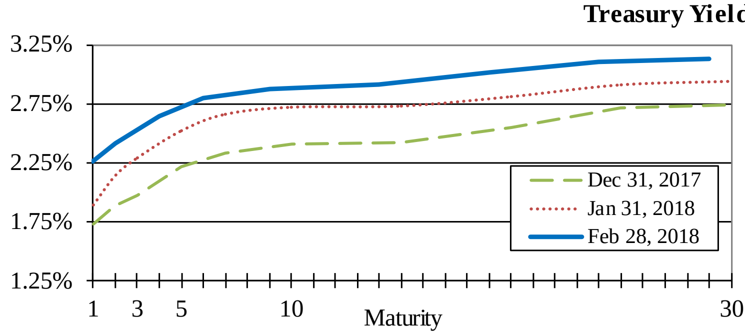
Baird Advisors
Fixed Income Market Commentary
February 2018

Yields Higher on Expectations for Inflation and More Fed Hikes, Market Volatility Spikes

Treasury yields trended higher across the yield curve for a second consecutive month in February. The upward pressure on rates was fueled by a confluence of factors, including stronger growth, an uptick in inflation, and greater expected Treasury supply. The January employment report showed average hourly earnings rose at a faster-than-expected +2.9% YoY (vs. +2.6% consensus) and CPI rose +2.1% YoY (vs. +1.9% consensus). Fiscal policy concerns also emerged, with markets anticipating higher fiscal deficits due to both tax cuts and the new two year budget deal, which boosts spending caps by approximately $300B over the next two years. The S&P 500 Index fell roughly 10% in just nine days and the VIX index, which is a measure of the stock market's expected volatility, more than doubled in just one day. While more muted than equity markets, bond market volatility also rose, with 10-year Treasury yields reaching an intra-day level of 2.95% before closing the month at 2.87%, up 15 bps MoM and 46 bps YTD. Fed Chair Jerome Powell's testimony before the House Financial Services Committee contributed to rising rates, as he indicated the Fed can continue gradually raising interest rates, as he and the Fed "do not see these developments", referring to market volatility and higher rates, "as weighing heavily on the outlook for economic activity." "Fiscal policy has become more stimulative" Powell said, and "some of the headwinds the U.S. economy faced in previous years have turned into tailwinds." By month end, market-implied odds of 3 or 4 rate hikes in 2018 rose to 73% and 35% respectively, up from 38% and 12% at year end.

Treasury Yields



Maturity	12/31/17	1/31/18	2/28/18	1Mo Chg	YTD Chg
1	1.73%	1.89%	2.06%	0.17%	0.33%
2	1.88%	2.14%	2.26%	0.12%	0.38%
3	1.97%	2.29%	2.42%	0.13%	0.45%
5	2.21%	2.52%	2.65%	0.13%	0.44%
7	2.33%	2.66%	2.80%	0.14%	0.47%
10	2.41%	2.72%	2.87%	0.15%	0.46%
30	2.74%	2.94%	3.13%	0.19%	0.39%

Spreads Widen on Market Volatility

Fixed income spread sectors weren't immune from market volatility as Investment Grade Corporate spreads widened 10 bps in February to 96 bps. Shorter maturity segments of the market saw more pronounced widening as concerns grew that companies such as Apple that are "repatriating" cash would begin liquidating short corporate bond and ABS holdings: 1-3yr corporates were 11 bps wider, while 10+yr corporates were 8bps wider. A slowdown of fixed income fund flows from the very strong pace seen in January also contributed to the widening of spreads.

Negative Returns in February, YTD

Rising Treasury yields and wider spreads pushed all investment grade sectors into negative territory for a second consecutive month. Investment Grade Corporates were the worst performing sector overall (-1.62%), whereas shorter-duration sectors such as ABS (-0.27%) had more favorable returns.

Option-Adjusted Spreads (in bps)

	12/31/17	1/31/18	2/28/18	1Mo Chg	YTD Chg
U.S. Aggregate Index	36	34	37	3	1
U.S. Agency (non-mortgage)	14	12	13	1	-1
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	25	25	26	1	1
U.S. Agency CMBS	35	34	36	2	1
U.S. Non-Agency CMBS	79	70	73	3	-6
Asset-Backed Securities	36	33	45	12	9
Corporate Sectors					
U.S. Investment Grade	93	86	96	10	3
Industrial	98	89	99	10	1
Utility	92	85	91	6	-1
Financial Institutions	85	80	91	11	6
U.S. High Yield	343	319	336	17	-7

Source: Bloomberg Barclays Indices

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	February	YTD 2018	*2017*
U.S. Aggregate Index	-0.95%	-2.09%	*3.54%*
U.S. Gov't/Credit Index	-1.08%	-2.22%	*4.00%*
U.S. Intermediate Gov't/Credit Index	-0.46%	-1.34%	*2.14%*
U.S. 1-3 Yr. Gov't/Credit Index	-0.09%	-0.36%	*0.84%*
U.S. Treasury	-0.75%	-2.10%	*2.31%*
U.S. Agency	-0.36%	-1.09%	*2.06%*
MBS (Mortgage Backed Securities)	-0.66%	-1.82%	*2.47%*
CMBS (Commercial Mortgage Backed Securities)	-0.62%	-1.70%	*3.35%*
ABS (Asset Backed Securities)	-0.27%	-0.56%	*1.55%*
U.S. Corporate - Investment Grade	-1.62%	-2.56%	*6.42%*
Corporate High Yield	-0.85%	-0.26%	*7.50%*
Municipal Bond Index	-0.30%	-1.47%	*5.45%*
TIPS (Treasury Inflation Protected Securities)	-0.97%	-1.82%	*3.01%*

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.

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.