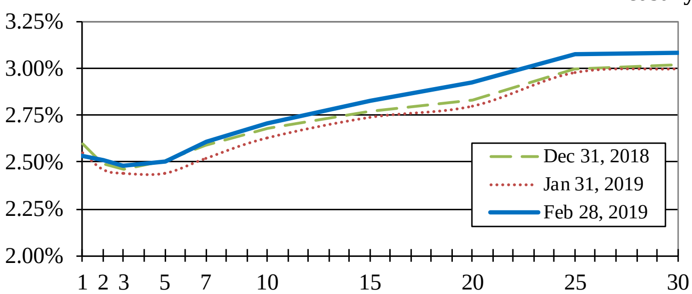
Baird Advisors
Fixed Income Market Commentary
February 2019

Treasury Yields Move Modestly Higher as Volatility Remains Low

The 10yr Treasury yield moved 8 bps higher to end February at 2.71% while volatility remained benign thanks to a “patient” Fed and limited economic and political surprises. The slope of the curve was little changed, with the largest move occurring in the 7yr maturity which rose 9 bps to 2.61%. The modest increase in rates occurred despite slower (and shutdown-delayed) economic data - December Retail Sales came in much lower than expected, declining 1.2%, and Industrial Production slipped 0.6% in January. However, the first estimate of 4Q GDP surprised to the upside, at +2.6% vs. a +2.2% consensus forecast, as capital expenditures rose 6.2%. Helping to mute rate volatility last month was the continuation of the more dovish tone from the Fed that started in early January. The minutes from the January FOMC meeting emphasized that the Fed will remain patient on further rate hikes and flexible with the balance sheet unwind, which is now likely to end by year end with a terminal balance of approximately $3.5 trillion. The Fed anticipates continued runoff of mortgage-backed securities beyond 2019 with the proceeds reinvested back into Treasuries. Outside the U.S., uncertainty continues regarding Brexit, which is scheduled for March 29th, but no deal has been approved nor is there a back-up plan at this point. President Trump and North Korean leader Kim Jong-un met to discuss nuclear disarmament, but did not reach an agreement. Citing “substantial progress” in the negotiations with China, President Trump delayed the March 1st tariff increase. Nevertheless, trade tensions weighed on global growth as China’s Purchasing Managers’ Index fell for the third straight month.

Treasury Yields



Maturity	12/31/17	12/31/18	1/31/19	2/28/19	1Mo Chg	YTD Chg
1	1.73%	2.60%	2.55%	2.53%	-0.02%	-0.07%
2	1.88%	2.49%	2.46%	2.51%	0.05%	0.02%
3	1.97%	2.46%	2.44%	2.48%	0.04%	0.02%
5	2.21%	2.51%	2.44%	2.51%	0.07%	0.00%
7	2.33%	2.59%	2.52%	2.61%	0.09%	0.02%
10	2.41%	2.68%	2.63%	2.71%	0.08%	0.03%
30	2.74%	3.02%	3.00%	3.08%	0.08%	0.06%

Spreads Tighten Further

Spreads tightened further in February as investor demand continued to rebound in 2019. Non-Agency Commercial Mortgage-Backed Securities (CMBS) tightened 13 bps this month, ending February at 83 bps as demand has been strong with limited issuance and commercial real estate fundamentals remain stable. Investment Grade Corporates also tightened 7 bps, now 32 bps tighter YTD. Agency Pass-throughs were the exception, widening 3 bps to 35 bps as the Fed’s portfolio runoff continues and investors grew more concerned about prepayment risks in the coming months.

Spread Sectors Outperform Treasuries and MBS

Fixed income returns were mixed in February but remain in positive territory YTD. Treasuries (-0.27%) and Agency Pass-throughs (-0.09%) posted negative returns as interest rates rose while investors saw better value outside of government sectors. CMBS (+0.41%) ended the month as the top-performing investment-grade sector, while High Yield (+1.66%) posted the highest return overall.

Option-Adjusted Spreads (in bps)

	12/31/17	12/31/18	1/31/19	2/28/19	1Mo Chg	YTD Chg
U.S. Aggregate Index	36	54	47	45	-2	-9
U.S. Agency (non-mortgage)	14	16	17	14	-3	-2
Mortgage and ABS Sectors						
U.S. Agency Pass-throughs	25	35	32	35	3	0
U.S. Agency CMBS	35	55	51	43	-8	-12
U.S. Non-Agency CMBS	79	107	96	83	-13	-24
Asset-Backed Securities	36	53	46	37	-9	-16
Corporate Sectors						
U.S. Investment Grade	93	153	128	121	-7	-32
Industrial	98	157	133	127	-6	-30
Utility	92	144	127	118	-9	-26
Financial Institutions	85	147	119	110	-9	-37
Other Govt. Related	68	90	84	77	-7	-13
U.S. High Yield Corporates	343	526	423	379	-44	-147
Emerging Market Debt	352	560	476	458	-18	-102

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	February	YTD	Effective Duration (yrs)
U.S. Aggregate Index	-0.06%	1.00%	5.91
U.S. Gov’t/Credit Index	-0.06%	1.12%	6.44
U.S. Intermediate Gov’t/Credit Index	0.09%	0.95%	3.88
U.S. 1-3 Yr. Gov’t/Credit Index	0.16%	0.55%	1.91
U.S. Treasury	-0.27%	0.20%	6.10
U.S. Agency (non-mortgage)	0.02%	0.41%	3.98
U.S. Agency Pass-throughs	-0.09%	0.70%	4.74
CMBS (Commercial Mortgage Backed Securities)	0.41%	1.46%	5.27
ABS (Asset-Backed Securities)	0.28%	0.76%	2.13
U.S. Corporate Investment Grade	0.22%	2.57%	7.25
U.S. High Yield Corporates	1.66%	6.26%	3.52
Emerging Market Debt	1.02%	5.65%	4.60
Municipal Bond Index	0.54%	1.30%	6.35
TIPS (Treasury Inflation Protected Securities)	-0.01%	1.33%	4.95

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 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.