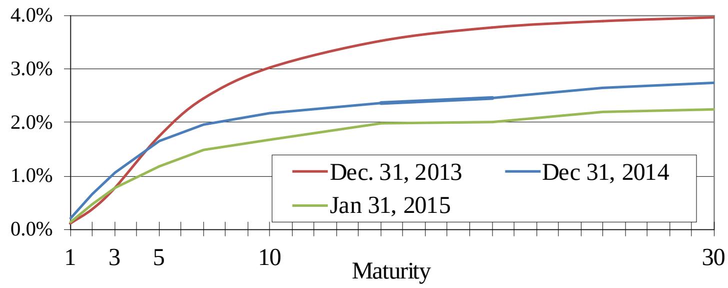
Baird Advisors
Fixed Income Market Comments
January 2015

Yields Fall, Curve Flattens - European QE Announced

The yield on the 30-year Treasury fell 50 bps to 2.25% and the yield curve flattened significantly in January as the European Central Bank (ECB) announced a long awaited, large scale quantitative easing (QE) program, which helped push global bond yields lower (see next section). The 60 billion Euros per month will purchase investment-grade sovereign bonds as well as European agency debt, asset-backed securities, and covered bonds. Meanwhile, the U.S. Fed acknowledged that "international developments" could impact its assessment of when to raise rates. Lower oil prices had an immediate impact on U.S. inflation, which remains well below the Fed's 2.0% target (Dec. CPI +0.8% year over year); however, the expected boost to the consumer has not yet materialized (Dec. Retail sales -0.9% month over month vs. -0.1% consensus expectation). Moderate growth and tepid inflation in the U.S. along with increasing international headwinds have pushed out market expectations for the first Fed Funds rate hike from mid-2015 to late-2015 or beyond.

Treasury Yields



Maturity	Dec 31, 2013	Dec 31, 2014	Jan 31, 2015	1Mo Change
1	0.11%	0.21%	0.14%	-0.07%
2	0.38%	0.66%	0.47%	-0.19%
3	0.77%	1.07%	0.77%	-0.30%
5	1.74%	1.65%	1.19%	-0.46%
7	2.45%	1.97%	1.49%	-0.48%
10	3.03%	2.17%	1.68%	-0.49%
30	3.97%	2.75%	2.25%	-0.50%

More Global Bond Yields Go Negative, U.S. Dollar Appreciates

The extraordinary central bank policies undertaken by developed economies (e.g. Eurozone, Japan) to combat deflation coupled with stubbornly slow growth outside the U.S. drove global bond yields to extremely low levels (even negative) in January. In fact, 16% of bonds in the J.P. Morgan Global Government Bond Index are now trading with negative yields following the sharp market move in January (see table at right). The divergence in global central bank policies, with the U.S. preparing to tighten while other developed central banks ease aggressively, has driven global capital flows into U.S. markets. As such, the U.S. Dollar Index rose 5% in January, adding to a nearly 19% appreciation of the Dollar since July 2014.

10-Year Global Benchmark Sovereign Bonds

	12/31/2014	1/31/2015	Change
United States	2.17	1.68	-0.49
Canada	1.79	1.25	-0.54
United Kingdom	1.76	1.33	-0.43
Germany	0.54	0.30	-0.24
France	0.82	0.54	-0.28
Switzerland	0.31	-0.08	-0.39
Italy	1.88	1.59	-0.29
Japan	0.32	0.27	-0.05

Source: Bloomberg

Falling Yields Boost Returns

Declining yields contributed to strong returns in January, especially in longer maturities. Treasuries (+2.59%) generated impressive one month returns, with the 10+ year Treasury component returning 8.56%, and TIPS (+3.15%) rebounding after a weak fourth quarter. Investment Grade Corporates (+3.03%) fared well in spite of modest spread widening pressures, whereas High Yield (+0.66%) was one of the weakest performing sectors overall. Mortgage-Backed Securities (+0.85%) also underperformed in the month as lower mortgage rates heightened prepayment risks on premium dollar priced securities.

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	January	4Q 2014	2014
U.S. Aggregate Index	2.10%	1.79%	5.97%
U.S. Gov't/Credit Index	2.64%	1.82%	6.01%
U.S. Intermediate Gov't/Credit Index	1.66%	0.89%	3.13%
U.S. 1-3 Yr. Gov't/Credit Index	0.52%	0.17%	0.77%
U.S. Treasury	2.59%	1.93%	5.05%
U.S. Agency	1.54%	1.16%	3.58%
MBS (Mortgage-Backed Securities)	0.85%	1.79%	6.08%
CMBS (Commercial Mortgage-Backed Securities)	1.78%	1.45%	3.86%
ABS (Asset-Backed Securities)	0.87%	0.55%	1.88%
U.S. Corporate - Investment Grade	3.03%	1.77%	7.46%
Corporate High Yield	0.66%	-1.00%	2.45%
Municipal Bond Index	1.77%	1.37%	9.05%
TIPS (Treasury Inflation Protected Securities)	3.15%	-0.03%	3.64%

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.