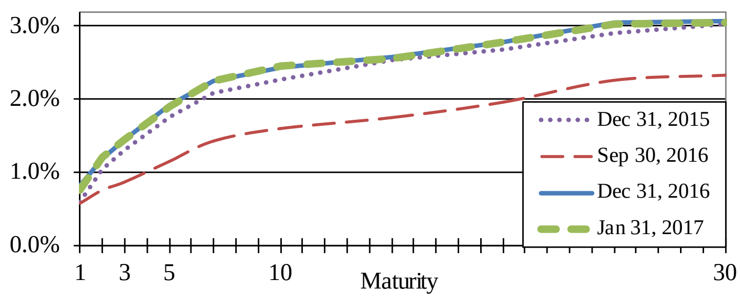
Baird Advisors
Fixed Income Market Comments
January 2017

Modest Volatility in the Midst of Executive Orders

We expected heightened volatility in 2017 given the post-election uncertainty in the U.S., but January's yield changes proved to be relatively muted. In fact, the 10-year Treasury yield moved just 20 bps from low to high last month, relatively modest adjustments by recent standards, and ended just 1 bps above the starting level. For that matter, yields were little-changed across the entire curve in January as investors sought to digest the daily news and announcements from Washington and the new administration. President Trump's focus in his first days post-inauguration was less on key legislative issues, such as healthcare reform and fiscal stimulus measures (e.g. tax reform and infrastructure) and instead took the form of a series of executive orders intended to fulfill populist campaign pledges. Trade and immigration actions received the most attention, causing uncertainty as to the impact on growth. At the same time, below consensus 4Q U.S. economic growth of 1.6% reduced expectations for the number of rate increases by the Fed to just two 25 bps moves, down from perhaps three moves in 2017. The Fed's December meeting minutes also revealed a discussion of whether additional fiscal stimulus might "have implications for the reinvestment" of interest payments and maturities into agency mortgage-backed securities – a decision which could have significant market implications.

Treasury Yields



Maturity	12/31/15	9/30/16	12/31/16	1/31/17	1Mo Chg
1	0.60%	0.58%	0.81%	0.76%	-0.05%
2	1.05%	0.76%	1.19%	1.20%	0.01%
3	1.31%	0.87%	1.45%	1.46%	0.01%
5	1.76%	1.15%	1.93%	1.91%	-0.02%
7	2.09%	1.43%	2.25%	2.25%	0.00%
10	2.27%	1.60%	2.44%	2.45%	0.01%
30	3.02%	2.33%	3.07%	3.05%	-0.02%

Agency Pass-through Spreads Widen; CMBS, Credit Tighten

The Fed's mention of the eventual end of reinvestment in agency mortgage-backed securities contributed to spreads widening 7 bps in January; the Fed bought more than $30B in MBS last month which continues to provide support for this sector. Fixed-rate, gross investment grade corporate issuance exceeded $184B according to Barclays, one of the highest months on record, but strong demand and solid fundamentals helped spreads tighten 2 bps to 121 bps. CMBS spreads narrowed 6 bps last month as investor demand was met with limited issuance.

Option-Adjusted Spreads (in bps)

	12/31/15	9/30/16	12/31/16	1/31/17	1Mo Chg
U.S. Aggregate Index	56	47	43	44	1
U.S. Agency (non-mortgage)	21	21	21	16	-5
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	24	14	15	22	7
Asset-Backed Securities	72	55	59	56	-3
CMBS	121	84	75	69	-6
Corporate Sectors					
U.S. Investment Grade	165	138	123	121	-2
Industrial	183	140	125	123	-2
Utility	150	132	117	114	-3
Financial Institutions	134	137	120	119	-1
U.S. High Yield	660	480	409	388	-21

Sources: Bloomberg Barclays Indices

Positive January Returns, Except for MBS

Fixed income sector returns were positive with the exception of MBS (-0.03%) which lagged due to Fed reinvestment and prepayment concerns. TIPS (+0.84%) outperformed as investors were drawn to the sector for inflation protection. Corporate High Yield (+1.45%) generated the highest total returns on a solid equity market and strong investor demand for yield.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	January	2016
U.S. Aggregate Index	0.20%	2.65%
U.S. Gov't/Credit Index	0.28%	3.05%
U.S. Intermediate Gov't/Credit Index	0.27%	2.08%
U.S. 1-3 Yr. Gov't/Credit Index	0.19%	1.28%
U.S. Treasury	0.23%	1.04%
U.S. Agency	0.33%	1.39%
MBS (Mortgage-Backed Securities)	-0.03%	1.67%
CMBS (Commercial Mortgage-Backed Securities)	0.61%	3.32%
ABS (Asset-Backed Securities)	0.22%	2.03%
U.S. Corporate - Investment Grade	0.31%	6.11%
Corporate High Yield	1.45%	17.13%
Municipal Bond Index	0.66%	0.25%
TIPS (Treasury Inflation Protected Securities)	0.84%	4.68%

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 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.