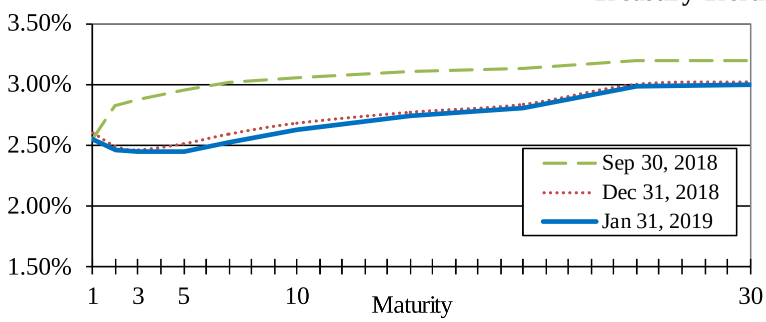
Baird Advisors
Fixed Income Market Commentary
January 2019

From "Gradual" to "Patient": Fed Shifts Stance and Markets Regain Appetite for Risk

The 10-year Treasury yield declined 5 bps in January to 2.63% as the Fed clarified it will be "patient" with future rate hikes, and flexible with the pace of balance sheet runoff. This dovish pivot in tone buoyed risk assets (S&P +8% YTD) even as expectations for U.S. and global growth moderated. Despite December's strong nonfarm payrolls (+312k actual vs 184k consensus market forecast), growth expectations for the first quarter continued to be lowered. This was in part due to the federal government shutdown as approximately 800,000 federal employees were furloughed, along with thousands of independent contractors. Furthermore, recent declines in consumer and business confidence also suggested slower growth going forward. The slope of the Treasury curve was little changed in January as the 2 – 10's yield spread narrowed just 2 bps, to +17 bps from +19 bps at year end. The post-meeting FOMC statement and press conference in January went even further than Fed members had telegraphed throughout the month in shifting toward a more dovish policy. Citing slower global economic growth, muted inflation pressures and elevated political uncertainty the Fed removed the reference to "further gradual increases" in the federal funds rate, which had been part of every Fed statement since 2015, and inserted guidance that the Fed will be "patient as it determines what future adjustments…may be appropriate." It also confirmed market expectations that the gradual runoff of the Fed's QE purchases will be completed sooner and with a larger remaining balance sheet than previously estimated.

Treasury Yields



Maturity	12/31/17	9/30/18	12/31/18	1/31/19	1Mo Chg
1	1.73%	2.56%	2.60%	2.55%	-0.05%
2	1.88%	2.82%	2.49%	2.46%	-0.03%
3	1.97%	2.88%	2.46%	2.44%	-0.02%
5	2.21%	2.95%	2.51%	2.44%	-0.07%
7	2.33%	3.02%	2.59%	2.52%	-0.07%
10	2.41%	3.06%	2.68%	2.63%	-0.05%
30	2.74%	3.20%	3.02%	3.00%	-0.02%

Spreads Tighten and Fixed Income Flows Turn Positive

Chair Powell's favorable comments boosted the market's risk appetite and helped Investment Grade Corporate spreads tighten 25 bps, ending the month at 128 bps. Spreads also tightened on high-quality mortgage and asset-backed sectors with Agency Pass-throughs tightening 3 bps to 32 bps. The clarity in Fed policy helped rekindle investor demand as industry-level fixed income flows turned positive in January. High Yield Corporates especially benefitted as spreads tightened a remarkable 103 bps to end January at 423 bps.

Fixed Income Market Returns Positive to Start the Year

Fixed income returns were positive across all sectors as the December weakness in investor demand largely reversed in the month. Corporates (+2.35%) posted the highest total return among investment-grade sectors, nearly reversing the negative returns of 2018 (-2.51%). Non-investment grade sectors outperformed and posted the highest returns overall, led by Emerging Market debt (+4.58%).

Option-Adjusted Spreads (in bps)

	12/31/17	9/30/18	12/31/18	1/31/19	1Mo Chg
U.S. Aggregate Index	36	39	54	47	-7
U.S. Agency (non-mortgage)	14	12	16	17	1
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	25	28	35	32	-3
U.S. Agency CMBS	35	39	55	51	-4
U.S. Non-Agency CMBS	79	73	107	96	-11
Asset-Backed Securities	36	38	53	46	-7
Corporate Sectors					
U.S. Investment Grade	93	106	153	128	-25
Industrial	98	108	157	133	-24
Utility	92	106	144	127	-17
Financial Institutions	85	102	147	119	-28
Other Govt. Related	68	69	90	84	-6
U.S. High Yield Corporates	343	316	526	423	-103
Emerging Market Debt	352	485	560	476	-84

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	January 2019	2018	Effective Duration (yrs)
U.S. Aggregate Index	1.06%	0.01%	5.86
U.S. Gov't/Credit Index	1.18%	-0.42%	6.44
U.S. Intermediate Gov't/Credit Index	0.87%	0.88%	3.88
U.S. 1-3 Yr. Gov't/Credit Index	0.39%	1.60%	1.90
U.S. Treasury	0.47%	0.86%	6.09
U.S. Agency (non-mortgage)	0.39%	1.34%	3.99
U.S. Agency Pass-throughs	0.79%	0.99%	4.56
CMBS (Commercial Mortgage Backed Securities)	1.05%	0.78%	5.29
ABS (Asset-Backed Securities)	0.47%	1.77%	2.12
U.S. Corporate Investment Grade	2.35%	-2.51%	7.24
U.S. High Yield Corporates	4.52%	-2.08%	3.67
Emerging Market Debt	4.58%	-4.39%	4.59
Municipal Bond Index	0.76%	1.28%	6.37
TIPS (Treasury Inflation Protected Securities)	1.35%	-1.26%	4.96

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.