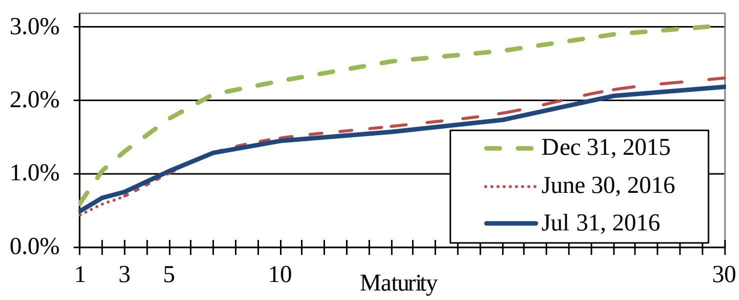
Baird Advisors
Fixed Income Market Comments
July 2016

More Yield Curve Flattening: Focus Remains on Global Central Bank Policy, Long Treasuries in Demand

The Treasury yield curve flattened in the month driven by very strong global demand for long Treasuries as investors continue to focus on the amount and effectiveness of extremely accommodative policy by global central banks. In the U.S. the 10-year and 30-year Treasury yields hit new all-time lows of 1.37% and 2.11% in July, with the 30-year ending the month 13 bps lower at 2.18%. Meanwhile the 2-year rose 8 bps to 0.67% as the Fed kept open the possibility of a hike later this year. As expected, the Fed left rates unchanged at the July meeting but noted in its statement that “near-term risks to the economic outlook have diminished” lifting expectations for at least one Fed Funds rate hike by the end of 2016. A strong June nonfarm payroll report (+287k vs. +180k market expectation) eased growth concerns, but after a weaker-than expected +1.2% annualized 2Q GDP, markets still assign a less than 50% chance of a 2016 hike. Away from the U.S., the Bank of Japan this month disappointed those expecting significant additional stimulus, leading many to suspect the Japanese government may instead look to spending for additional fiscal stimulus.

Treasury Yields

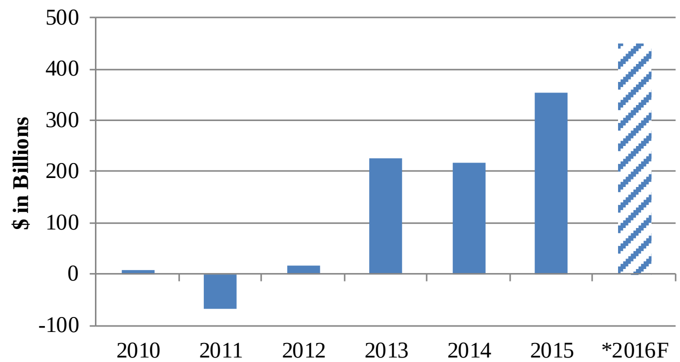


Maturity	12/31/15	6/30/16	7/31/16	1Mo Chg	YTD Chg
1	0.60%	0.44%	0.49%	0.05%	-0.11%
2	1.05%	0.59%	0.67%	0.08%	-0.39%
3	1.31%	0.70%	0.76%	0.06%	-0.55%
5	1.76%	1.01%	1.03%	0.02%	-0.73%
7	2.09%	1.29%	1.29%	0.00%	-0.80%
10	2.27%	1.49%	1.46%	-0.03%	-0.81%
30	3.02%	2.31%	2.18%	-0.13%	-0.84%

Foreign Buying of U.S. Corporates on the Rise

With an increasing number of foreign sovereign bonds trading at negative yields (the German 10-year ended the month at -0.12%), global investors are increasingly coming to the U.S. in search of positive yields. The net foreign buying of U.S. corporate bonds exceeded $350B in 2015 and could reach $450B this year (see chart at right). For context, last year’s net issuance of U.S. investment grade credit narrowly exceeded $600B. The large influx of foreign demand helped drive U.S. investment grade corporate spreads 11 bps tighter in July (to 145 bps) and 20 bps tighter YTD.

Foreign Net Buying of U.S. Corporate Bonds



Very Strong YTD Returns Led by Corporates

Strong demand helped U.S. corporates deliver the highest returns of all investment grade sectors in July (+1.46%). Only high yield corporates delivered a higher return (+2.70%), as the sector exhibited a high correlation with equity markets that performed well in July. Asset-Backed securities were the only segment of the market with negative returns (-0.08%) as yields rose on the 1-3 year segment of the Treasury curve and spreads widened modestly to absorb an elevated level of new issue activity. Solid July returns added to remarkably strong year-to-date returns (U.S. Aggregate index +5.98%) across all sectors.

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	July	YTD
U.S. Aggregate Index	0.63%	5.98%
U.S. Gov’t/Credit Index	0.80%	7.08%
U.S. Intermediate Gov’t/Credit Index	0.28%	4.36%
U.S. 1-3 Yr. Gov’t/Credit Index	0.02%	1.67%
U.S. Treasury	0.41%	5.79%
U.S. Agency	0.21%	3.50%
MBS (Mortgage-Backed Securities)	0.20%	3.32%
CMBS (Commercial Mortgage-Backed Securities)	0.97%	6.95%
ABS (Asset-Backed Securities)	-0.08%	2.46%
U.S. Corporate - Investment Grade	1.46%	9.26%
Corporate High Yield	2.70%	12.01%
Municipal Bond Index	0.06%	4.40%
TIPS (Treasury Inflation Protected Securities)	0.87%	7.16%

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.