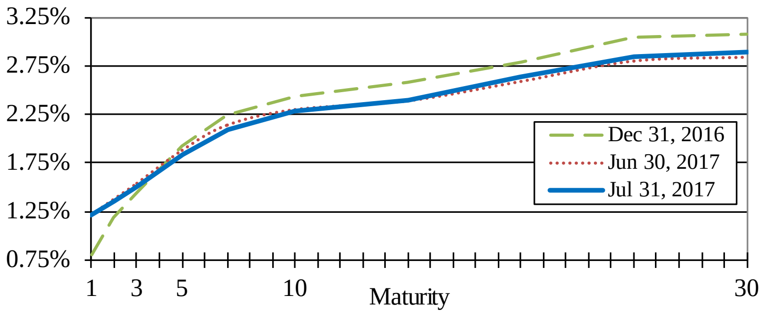
Baird Advisors
Fixed Income Market Comments
July 2017

Narrow Trading Range and Narrower Credit Spreads

Treasury yields traded in a relatively narrow band in July and closed with rates marginally lower out to 10-years, but 6 bps higher in 30-years, leading to a steeper curve. The low yield volatility occurred despite stronger 2Q growth of 2.6%, better than the 1.2% revised pace in 1Q. Much of the market's stability was due to lower inflation data and the gradual path of monetary policy normalization. In her semiannual testimony before Congress last month, Chair Janet Yellen reiterated the Fed's desire to begin reducing its balance sheet "relatively soon," even as rate hike expectations have moderated. The Fed's steady messaging was in contrast to high drama elsewhere in Washington. The Senate failed to repeal the Affordable Care Act after numerous attempts. At the same time, key members of the White House staff were being removed and replaced, including the Director of Communications and the President's Chief of Staff. Last month, the dollar fell 2.6% against a basket of 10 major global currencies and ended nearly 10% below its January peak as views on domestic issues shifted (e.g. future rate hikes and little progress on major GOP policy initiatives). Overseas, an improved outlook for Eurozone growth and inflation combined with the prospect that the ECB may soon consider reducing bond purchases also contributed to a stronger euro relative to the U.S. dollar.

Treasury Yields



Maturity	12/31/16	6/30/17	7/31/17	1Mo Chg	YTD Chg
1	0.81%	1.22%	1.21%	-0.01%	0.40%
2	1.19%	1.38%	1.35%	-0.03%	0.16%
3	1.45%	1.54%	1.50%	-0.04%	0.05%
5	1.93%	1.88%	1.83%	-0.05%	-0.10%
7	2.25%	2.14%	2.10%	-0.04%	-0.15%
10	2.44%	2.30%	2.29%	-0.01%	-0.15%
30	3.07%	2.84%	2.90%	0.06%	-0.17%

Corporate Credit Spreads Tighten

Investment Grade corporate credit spreads tightened 7 bps to +102 bps last month, inching closer to the post-crisis tights of +97 bps reached in June 2014. Fixed income mutual funds and ETFs continued the streak of steady inflows in place all year while corporate credit fundamentals remain solid on strong 2Q earnings. Although Agency Mortgage Pass-throughs are 13 bps wider YTD on the Fed's plans to normalize its balance sheet by tapering reinvestment in the sector, spreads tightened 4bps in July. Investor concerns over mortgage prepayment risks remained benign in a low-volatility rate environment.

Spread Sectors Outperform Treasuries

All sectors posted positive returns in July and all spread sector returns exceeded Treasuries (+0.17%). Investment Grade corporates (+0.73%) outperformed other higher quality sectors, while High Yield corporates (+1.11%) delivered the strongest performance overall, helped by strong equity markets.

Option-Adjusted Spreads (in bps)

	12/31/16	6/30/17	7/31/17	1Mo Chg	YTD Chg
U.S. Aggregate Index	43	43	40	-3	-3
U.S. Agency (non-mortgage)	21	15	15	0	-6
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	15	32	28	-4	13
U.S. Agency CMBS	47	44	44	0	-3
U.S. Non-Agency CMBS	93	94	89	-5	-4
Asset-Backed Securities	59	46	45	-1	-14
Corporate Sectors					
U.S. Investment Grade	123	109	102	-7	-21
Industrial	125	112	106	-6	-19
Utility	117	110	101	-9	-16
Financial Institutions	120	103	96	-7	-24
U.S. High Yield	409	364	352	-12	-57

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	July	YTD
U.S. Aggregate Index	0.43%	2.71%
U.S. Gov't/Credit Index	0.42%	3.09%
U.S. Intermediate Gov't/Credit Index	0.46%	2.20%
U.S. 1-3 Yr. Gov't/Credit Index	0.26%	0.98%
U.S. Treasury	0.17%	2.04%
U.S. Agency	0.26%	1.92%
MBS (Mortgage-Backed Securities)	0.45%	1.81%
CMBS (Commercial Mortgage-Backed Securities)	0.62%	2.82%
ABS (Asset-Backed Securities)	0.27%	1.41%
U.S. Corporate - Investment Grade	0.73%	4.56%
Corporate High Yield	1.11%	6.09%
Municipal Bond Index	0.81%	4.40%
TIPS (Treasury Inflation Protected Securities)	0.45%	1.30%

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.