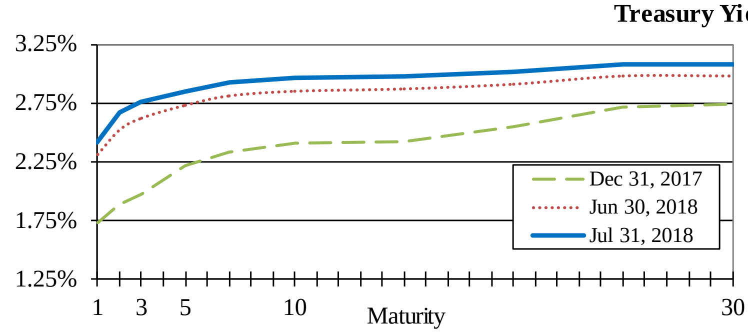
Baird Advisors
Fixed Income Market Commentary
July 2018

The Pace of Growth Quickens, Pushing Rates Higher

Stronger economic growth helped push interest rates higher in July and the curve flattened modestly as 2-year Treasury yields rose 15 bps while 10-year yields rose 11 bps to 2.96%. A strong rebound in consumer spending and continued improved business investment contributed to a 4.1% GDP growth rate in Q2, up from a revised 2.2% in Q1. Trade added 1.1% to Q2 GDP as exports, primarily soybeans to China, rose ahead of new tariffs taking effect. Reported nonfarm payrolls for June came in strong with 213K new jobs. While the unemployment rate rose to 4.0% from 3.8%, the labor force participation rate increased from 62.7% to 62.9% as 601K more individuals sought employment given the strong labor market. Inflation pressures remained moderate with average hourly earnings just +2.7% YoY and the core Personal Consumption Index +1.9% YoY. Positive momentum in U.S. growth stands in contrast to a slowdown in the Eurozone and China and contributed to a depreciation of the Renminbi versus the U.S. dollar. President Trump’s meeting with European Commission president Juncker appeared to thaw trade tensions as they agreed to hold off on immediate tariffs and work towards “zero tariffs”. The market fully anticipates the Fed will raise the fed funds target range 25 bps to 2.00%-2.25% at the September meeting, and is assigning approximately 70% odds of a second hike by year end, up from 50% odds at the start of the month.

Treasury Yields



Maturity	12/31/17	3/31/18	6/30/18	7/31/18	1Mo Chg	YTD Chg
1	1.73%	2.08%	2.31%	2.41%	0.10%	0.68%
2	1.88%	2.27%	2.52%	2.67%	0.15%	0.79%
3	1.97%	2.38%	2.62%	2.76%	0.14%	0.79%
5	2.21%	2.56%	2.73%	2.85%	0.12%	0.64%
7	2.33%	2.68%	2.81%	2.92%	0.11%	0.59%
10	2.41%	2.74%	2.85%	2.96%	0.11%	0.55%
30	2.74%	2.97%	2.98%	3.08%	0.10%	0.34%

Corporate Issuance Drops, Spreads Tighten

Investment-grade corporate spreads tightened 14 bps in July to 109 bps, completely reversing the widening that occurred in the second quarter. Supply/demand imbalances rather than changes in credit fundamentals continue to drive short term spread movements. Credit issuance in July fell to $62.9B, roughly half the monthly average so far this year according to Barclays data. Very strong demand for High Yield and limited supply combined to drive High Yield spreads 27 bps tighter in the month to 336 bps.

Option-Adjusted Spreads (in bps)

	12/31/17	3/31/18	6/30/18	7/31/18	1Mo Chg	YTD Chg
U.S. Aggregate Index	36	41	44	40	-4	4
U.S. Agency (non-mortgage)	14	12	14	14	0	0
Mortgage and ABS Sectors						
U.S. Agency Pass-throughs	25	29	28	27	-1	2
U.S. Agency CMBS	35	41	45	40	-5	5
U.S. Non-Agency CMBS	79	83	86	82	-4	3
Asset-Backed Securities	36	48	47	42	-5	6
Corporate Sectors						
U.S. Investment Grade	93	109	123	109	-14	16
Industrial	98	111	126	111	-15	13
Utility	92	104	118	109	-9	17
Financial Institutions	85	106	118	105	-13	20
U.S. High Yield Corporates	343	354	363	336	-27	-7

Source: Bloomberg Barclays Indices

Spread Sectors Outperform

Spread sectors outperformed Treasury and Agency securities in July. High Yield corporates (+1.09%) led the pack while Investment Grade credit (+0.83%) was a close follower with BBB-rated bonds (+1.03%) outperforming A-rated bonds (+0.66%). Shorter duration, high quality sectors such as ABS (+0.10%) posted modest positive returns while the Treasury index (-0.42%) fell the most in July.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	July	YTD 2018	Effective Duration (yrs)
U.S. Aggregate Index	0.02%	-1.59%	6.02
U.S. Gov’t/Credit Index	0.08%	-1.83%	6.41
U.S. Intermediate Gov’t/Credit Index	0.03%	-0.95%	3.91
U.S. 1-3 Yr. Gov’t/Credit Index	0.05%	0.13%	1.91
U.S. Treasury	-0.42%	-1.49%	6.03
U.S. Agency (non-mortgage)	-0.18%	-0.70%	3.80
U.S. Agency Pass-throughs	-0.11%	-1.06%	5.19
CMBS (Commercial Mortgage Backed Securities)	-0.03%	-1.40%	5.28
ABS (Asset-Backed Securities)	0.10%	0.12%	2.13
U.S. Corporate Investment Grade	0.83%	-2.47%	7.29
U.S. High Yield Corporates	1.09%	1.25%	3.87
Municipal Bond Index	0.24%	-0.01%	6.10
TIPS (Treasury Inflation Protected Securities)	-0.48%	-0.51%	5.57

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.