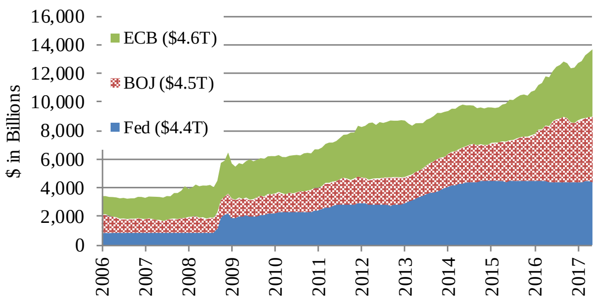
Baird Advisors
Fixed Income Market Comments
June 2017

Global Liquidity Keeps Rates Range-bound, Curve Flattens

In spite of modest upward pressure on Treasury rates in June, intermediate and long Treasury yields ended the quarter lower as the curve flattened - the 30 year Treasury yield declined 18 bps in the quarter to 2.84% as the 2 year rose 13 bps to 1.38% following the Fed's 25 bps federal funds rate hike in June. Investor demand has been extremely strong – according to ICI data YTD flows into fixed income mutual funds and ETFs have already surpassed $190B – the level of inflows seen in all of 2016. U.S. economic data continued to show benign inflation as both the PCE Deflator and Core PCE fell to a 1.4% YoY pace, down from recent peaks of 2.1% and 1.8% respectively. Employment and housing data were solid throughout the quarter, signaling that 2Q growth should exceed the +1.4% pace seen in Q1. The Fed outlined a detailed plan to reduce its balance sheet, tentatively starting before year end, by tapering the reinvestment of both Treasuries and MBS securities at a preset pace. In contrast, the European Central Bank and the Bank of Japan both continued to expand their respective balance sheets through ongoing asset purchases, which has helped reduce interest rate volatility to the lowest levels since 2013. Each central bank now holds more assets than the Fed's $4.4 trillion (see graph below left). Yet comments in late June by Mario Draghi from the ECB hinting at a normalization/reduction of bond buying caused rates to rise, highlighting the challenges all central banks face in transitioning away from extraordinary monetary policies.

Central Bank Balance Sheets



Treasury Yields

Maturity	12/31/16	3/31/17	5/31/17	6/30/17	1Mo Chg	3Mo Chg	YTD Chg
1	0.81%	1.02%	1.15%	1.22%	0.07%	0.20%	0.41%
2	1.19%	1.25%	1.27%	1.38%	0.11%	0.13%	0.19%
3	1.45%	1.49%	1.43%	1.54%	0.11%	0.05%	0.09%
5	1.93%	1.93%	1.75%	1.88%	0.13%	-0.05%	-0.05%
7	2.25%	2.22%	2.01%	2.14%	0.13%	-0.08%	-0.11%
10	2.44%	2.39%	2.20%	2.30%	0.10%	-0.09%	-0.14%
30	3.07%	3.02%	2.86%	2.84%	-0.02%	-0.18%	-0.23%

Pass-through Spreads Widen on Fed Balance Sheet Plans

The Fed's plans to taper and eventually end reinvestment in Agency mortgage-backed securities on a predetermined schedule contributed to a 5 bps spread widening this quarter while spreads tightened in all other sectors. The Fed purchased more than $60B of Agency MBS in the quarter and owns almost 1/3 of outstanding supply.

TIPS Lag, Corporates Outperform

All major sectors had positive returns for the quarter, with the exception of TIPS, which declined on falling inflation expectations. Investment Grade Corporates (+2.54%) had the highest quarterly total returns driven by robust demand and solid fundamentals - S&P 500 companies reported the strongest quarterly earnings growth in six years with improvement across most industries. Corporate High Yield still has the highest YTD returns (+4.93%) but issuers have started to see investor resistance as a handful of new bond offerings were cancelled due to weaker investor demand.

Option-Adjusted Spreads (in bps)

	12/31/16	3/31/17	5/31/17	6/30/17	1Mo Chg	3Mo Chg	YTD Chg
U.S. Aggregate Index	43	44	42	43	1	-1	0
U.S. Agency (non-mortgage)	21	18	16	15	-1	-3	-6
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	15	27	26	32	6	5	17
U.S. Agency CMBS	47	48	43	44	1	-4	-3
U.S. Non-Agency CMBS	93	96	94	94	0	-2	1
Asset-Backed Securities	59	54	45	46	1	-8	-13
Corporate Sectors							
U.S. Investment Grade	123	118	113	109	-4	-9	-14
Industrial	125	121	116	112	-4	-9	-13
Utility	117	116	113	110	-3	-6	-7
Financial Institutions	120	113	108	103	-5	-10	-17
U.S. High Yield	409	383	363	364	1	-19	-45

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	June	Q2	YTD
U.S. Aggregate Index	-0.10%	1.45%	2.27%
U.S. Gov't/Credit Index	0.03%	1.69%	2.66%
U.S. Intermediate Gov't/Credit Index	-0.18%	0.94%	1.73%
U.S. 1-3 Yr. Gov't/Credit Index	-0.04%	0.31%	0.72%
U.S. Treasury	-0.16%	1.19%	1.87%
U.S. Agency	-0.05%	0.90%	1.66%
MBS (Mortgage-Backed Securities)	-0.40%	0.87%	1.35%
CMBS (Commercial Mortgage-Backed Securities)	-0.34%	1.31%	2.18%
ABS (Asset-Backed Securities)	-0.07%	0.60%	1.14%
U.S. Corporate - Investment Grade	0.31%	2.54%	3.80%
Corporate High Yield	0.14%	2.17%	4.93%
Municipal Bond Index	-0.36%	1.96%	3.57%
TIPS (Treasury Inflation Protected Securities)	-0.95%	-0.40%	0.85%

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.