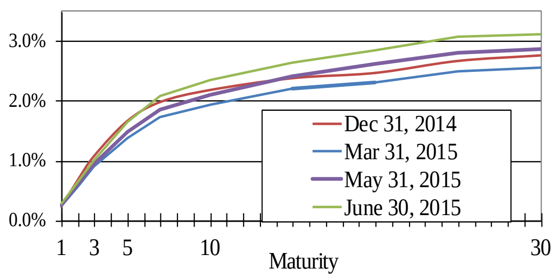
Baird Advisors
Fixed Income Market Comments
June 2015

Yields Rise, Curve Steepens in Reversal of Q1, Volatility High

In spite of a Greece-related flight to quality at quarter end, “dovish” comments from the Fed and benign inflation data (e.g. May Core CPI +1.7% YoY), U.S. intermediate and long-term yields rose for the quarter as U.S. economic activity reaccelerated (e.g. second quarter average monthly nonfarm payrolls +221K vs. +195K first quarter average). The rise in U.S. yields was also driven by higher global government bond yields (Germany 10yr yield +58 bps) as deflationary concerns in Europe abated. The Fed indicated that barring disappointing economic news the first Fed funds rate increase will take place later this year, but the committee anticipates that the pace of subsequent increases will be gradual. Nonetheless, the curve steepened significantly for the quarter as the yield on the 30yr Treasury ended 57 bps higher at 3.11%, while the yield on the 2yr Treasury ended just 7 bps higher at 0.63%. U.S. and global interest rates continued to exhibit a heightened state of volatility as U.S. 10yr government yields traded in a 63bp range (1.85% - 2.48%) while German 10yr government yields traded in a wider 91bp range (0.07% - 0.98%).



Treasury Yields

Maturity	Dec 31, 2014	Mar 31, 2015	May 31, 2015	Jun 30, 2015	1Mo Change	2Q Change	YTD Change
1	0.21%	0.23%	0.24%	0.26%	0.02%	0.03%	0.05%
2	0.66%	0.56%	0.60%	0.63%	0.03%	0.07%	-0.03%
3	1.07%	0.88%	0.92%	0.99%	0.07%	0.11%	-0.08%
5	1.65%	1.37%	1.47%	1.63%	0.16%	0.26%	-0.02%
7	1.97%	1.71%	1.84%	2.06%	0.22%	0.35%	0.09%
10	2.17%	1.92%	2.09%	2.33%	0.24%	0.41%	0.16%
30	2.75%	2.54%	2.85%	3.11%	0.26%	0.57%	0.36%

Yield Spreads Widen Sharply in June on Greece Uncertainty

Yield spreads widened sharply in June (e.g. U.S. High Yield spreads 43bps wider) as markets reacted to higher interest rate volatility and the macro uncertainty centered on Greece and China. Heavy Investment Grade Corporate issuance (gross issuance of $155B in May set an all-time record) also contributed to wider spreads in this sector (+16bps). In contrast, spreads on Agency MBS, and Asset-Backed Securities held relatively steady in the quarter as these sectors’ shorter durations and higher quality bias helped insulate the sector from the volatility.

Option-Adjusted Spreads (in bps)

	12/31/14	3/31/15	5/31/15	6/30/15	1Mo Change	2nd Qtr Change	YTD Change
U.S. Aggregate Index	48	46	46	51	5	5	3
U.S. Agency (non-mortgage)	16	17	16	18	2	1	2
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	27	20	18	26	8	6	-1
Asset-Backed Securities	58	62	60	62	2	0	4
CMBS	98	95	94	101	7	6	3
Corporate Sectors							
U.S. Investment Grade	131	129	133	145	12	16	14
Industrial	140	136	141	153	12	17	13
Utility	119	121	129	137	8	16	18
Financial Institutions	117	118	119	133	14	15	16
U.S. High Yield	483	466	433	476	43	10	-7

Source: Barclays

Negative Returns in June and Second Quarter

Higher yields and wider spreads in June pushed returns into negative territory for most sectors for the quarter. Shorter duration sectors, such as Asset-Backed Securities and the U.S. 1-3 Yr. Gov’t/Credit Index, were able to generate positive returns (+0.17% and +0.13% respectively). U.S. Investment Grade Corporates (-3.16%) were hit the hardest for the quarter, trailing behind U.S. Treasuries (-1.58%), CMBS (-1.06%) and TIPS (-1.84%). Closely tracking the volatility and returns in the equity markets, Corporate High Yield ended the quarter flat. Despite the negative returns for the quarter, most sectors and indices remain positive through the first half of 2015.

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	June	2nd Qtr	YTD
U.S. Aggregate Index	-1.09%	-1.68%	-0.10%
U.S. Gov’t/Credit Index	-1.23%	-2.10%	-0.30%
U.S. Intermediate Gov’t/Credit Index	-0.60%	-0.62%	0.82%
U.S. 1-3 Yr. Gov’t/Credit Index	-0.03%	0.13%	0.72%
U.S. Treasury	-0.88%	-1.58%	0.03%
U.S. Agency	-0.44%	-0.56%	0.60%
MBS (Mortgage-Backed Securities)	-0.76%	-0.74%	0.31%
CMBS (Commercial Mortgage-Backed Securities)	-1.02%	-1.06%	0.69%
ABS (Asset-Backed Securities)	-0.06%	0.17%	1.08%
U.S. Corporate - Investment Grade	-1.84%	-3.16%	-0.92%
Corporate High Yield	-1.49%	0.00%	2.53%
Municipal Bond Index	-0.09%	-0.89%	0.11%
TIPS (Treasury Inflation Protected Securities)	-0.97%	-1.06%	0.34%

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.