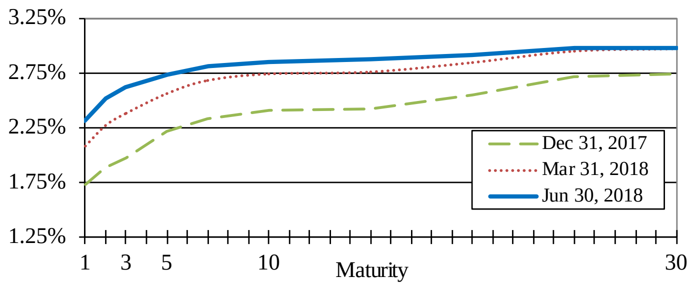
Baird Advisors
Fixed Income Market Commentary
June 2018

Curve Flattens as Trade Tensions Rise

Short and intermediate Treasury yields rose early in June and the yield curve continued to flatten in 2Q. In mid-May the 10-year Treasury yield rose to 3.11%, the highest level since 2011, before falling and remaining back below 3.00% for the balance of the quarter. Solid growth and modest inflation led the Fed to raise the federal funds rate target another 25 bps in June to 1.75%-2.00%. This was the second increase of the year, and while the market fully expects a third increase later this year, odds of a fourth hike have risen to 50%. Escalating trade tensions put downward pressure on yields later in the month as the U.S. imposed 25% tariffs on imported steel and aluminum. China, Canada, Mexico, and the European Union have all threatened retaliatory tariffs, igniting concerns over a potential global trade war that could dampen growth. Nevertheless, second quarter GDP is expected to nearly double from the revised 2.0% pace of growth in Q1. In contrast to the Fed, the Bank of Japan maintained its bond-buying program, while the European Central Bank announced plans to taper and then end asset purchases at year end, but will continue to reinvest maturing securities "for an extended period of time" while also keeping interest rates "at their present levels at least through the summer of 2019."

Treasury Yields



Maturity	12/31/17	3/31/18	5/31/18	6/30/18	1Mo Chg	3Mo Chg	YTD Chg
1	1.73%	2.08%	2.22%	2.31%	0.09%	0.23%	0.58%
2	1.88%	2.27%	2.41%	2.52%	0.11%	0.25%	0.64%
3	1.97%	2.38%	2.53%	2.62%	0.09%	0.24%	0.65%
5	2.21%	2.56%	2.66%	2.73%	0.07%	0.17%	0.52%
7	2.33%	2.68%	2.77%	2.81%	0.04%	0.13%	0.48%
10	2.41%	2.74%	2.82%	2.85%	0.03%	0.11%	0.44%
30	2.74%	2.97%	2.99%	2.98%	-0.01%	0.01%	0.24%

Supply/Demand Imbalances Widen IG Corporate Spreads

Investment-grade corporate spreads widened 14 bps in the quarter, to +123 bps, due primarily to supply/demand imbalances rather than deterioration in credit fundamentals. Corporate issuance rebounded in June on an increase in debt-funded merger and acquisition (M&A) activity. Markets are watching for more M&A deals after the AT&T/Time Warner merger was approved. Corporate spread widening was most pronounced out the curve, as 10+ year maturities widened 27 bps, while 1-5 year spreads were 1 bp wider. Foreign demand for IG corporates has moderated as currency hedging costs for overseas buyers have risen with a stronger U.S. dollar and higher short-term rates. In contrast, the supply/demand picture for High Yield has been more favorable as demand is more U.S.-based and issuance has declined more than 30% YTD.

Option-Adjusted Spreads (in bps)

	12/31/17	3/31/18	5/31/18	6/30/18	1Mo Chg	3Mo Chg	YTD Chg
U.S. Aggregate Index	36	41	42	44	2	3	8
U.S. Agency (non-mortgage)	14	12	13	14	1	2	0
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	25	29	28	28	0	-1	3
U.S. Agency CMBS	35	41	42	45	3	4	10
U.S. Non-Agency CMBS	79	83	82	86	4	3	7
Asset-Backed Securities	36	48	44	47	3	-1	11
Corporate Sectors							
U.S. Investment Grade	93	109	115	123	8	14	30
Industrial	98	111	117	126	9	15	28
Utility	92	104	108	118	10	14	26
Financial Institutions	85	106	112	118	6	12	33
U.S. High Yield Corporates	343	354	362	363	1	9	20

Source: Bloomberg Barclays Indices

Mixed Quarterly Returns

Rising Treasury yields and wider spreads detracted from total returns, pushing several sectors into negative territory for the month and quarter. Investment-grade corporates fell the most for the quarter (-0.98%), whereas High Yield corporates managed to post positive returns (+1.03%), aided by a shorter duration and more stable spreads.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	June	2Q 2018	YTD 2018	Effective Duration (yrs)
U.S. Aggregate Index	-0.12%	-0.16%	-1.62%	6.01
U.S. Gov't/Credit Index	-0.19%	-0.33%	-1.90%	6.44
U.S. Intermediate Gov't/Credit Index	-0.07%	0.01%	-0.97%	3.93
U.S. 1-3 Yr. Gov't/Credit Index	0.01%	0.28%	0.08%	1.93
U.S. Treasury	0.02%	0.10%	-1.08%	6.10
U.S. Agency (non-mortgage)	-0.04%	0.00%	-0.53%	3.82
U.S. Agency Pass-throughs	0.05%	0.24%	-0.95%	5.10
CMBS (Commercial Mortgage Backed Securities)	-0.17%	-0.06%	-1.38%	5.31
ABS (Asset-Backed Securities)	0.05%	0.42%	0.03%	2.11
U.S. Corporate Investment Grade	-0.58%	-0.98%	-3.27%	7.26
U.S. High Yield Corporates	0.40%	1.03%	0.16%	3.94
Municipal Bond Index	0.09%	0.87%	-0.25%	5.99
TIPS (Treasury Inflation Protected Securities)	0.40%	0.77%	-0.02%	4.89

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.