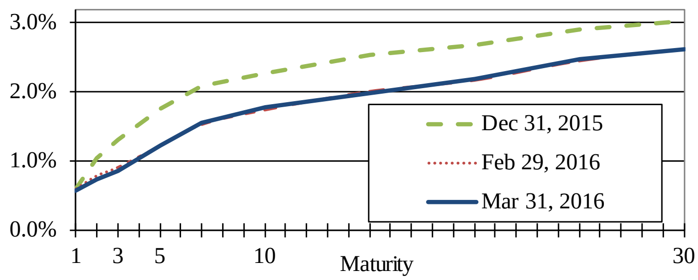
**Baird Advisors**
**Fixed Income Market Comments**
**March 2016**

## Yields Decline in Volatile First Quarter

The yield on the 10-year Treasury fell 49 bps to 1.78% during a very volatile quarter that saw stocks plunge and credit spreads widen significantly through mid-February. The causes were: global growth concerns centered in China, the continued decline in oil prices, and heightened uncertainty over the divergence and general effectiveness of global central bank policies. The markets recovered dramatically in the back half of February and through March on positive comments and actions by global central banks and a rebound in oil prices. In early March, the European Central Bank exceeded expectations with an announcement of additional monetary stimulus that included an expanded QE bond buying program that would now allow market purchases of corporate bonds going forward to directly influence (and tighten) corporate credit spreads. On the home front, the Fed kept its target for the Fed Funds rate unchanged (0.25%-0.50%) and lowered its outlook for subsequent rate hikes in 2016 at its FOMC policy meeting in mid-March. In late March, Fed Chair Yellen highlighted "the potential fallout from recent global and financial developments" and the potential negative impact on the U.S. economy as the reason why "caution was especially warranted" in the Fed's plan to normalize rates. Meanwhile, U.S. economic data continued to affirm a durable but modest pace of growth (4Q revised GDP +1.4% annualized, February nonfarm payrolls +242k) while inflation remains contained (February CPI +1.4% YoY).

**Treasury Yields**




| Maturity | 12/31/15 | 2/29/16 | 3/31/16 | 1Mo Chg | YTD Chg |
|---|---|---|---|---|---|
| 1 | 0.60% | 0.60% | 0.58% | -0.02% | -0.02% |
| 2 | 1.05% | 0.79% | 0.73% | -0.06% | -0.32% |
| 3 | 1.31% | 0.91% | 0.86% | -0.05% | -0.45% |
| 5 | 1.76% | 1.22% | 1.22% | 0.00% | -0.54% |
| 7 | 2.09% | 1.53% | 1.55% | 0.02% | -0.54% |
| 10 | 2.27% | 1.74% | 1.78% | 0.04% | -0.49% |
| 30 | 3.02% | 2.62% | 2.62% | 0.00% | -0.40% |

## Spreads Narrowed in March; Mixed for the Quarter

Markets came under significant pressure in the quarter: global growth fears and the resulting market turmoil drove the 10 year Treasury yield, S&P 500, and oil prices down sharply and investment grade corporate spreads reached multi-year wides by mid-quarter (see Feb 11 spreads in chart right). However, as growth fears abated, oil prices rebounded and the ECB and Fed made accommodative responses, corporates tightened from the wides by more than 50 bps, ending the quarter 2 bps tighter at 163 bps. High yield corporates exhibited more equity-like behavior, widening all the way to 839bps before tightening 183 bps from the 2/11 wides to end the quarter 4 bps tighter.

**Option-Adjusted Spreads (in bps)**

| | 12/31/15 | 2/11/16 | 2/29/16 | 3/31/16 | 1Mo Chg | YTD Chg | Chg from Feb 11th |
|---|---|---|---|---|---|---|---|
| U.S. Aggregate Index | 56 | 68 | 64 | 56 | -8 | 0 | -12 |
| U.S. Agency (non-mortgage) | 21 | 21 | 20 | 20 | 0 | -1 | -1 |
| Mortgage and ABS Sectors | | | | | | | |
| U.S. Agency Pass-throughs | 24 | 21 | 21 | 22 | 1 | -2 | 1 |
| Asset-Backed Securities | 72 | 68 | 69 | 74 | 5 | 2 | 6 |
| CMBS | 121 | 135 | 131 | 109 | -22 | -12 | -26 |
| Corporate Sectors | | | | | | | |
| U.S. Investment Grade | 165 | 214 | 197 | 163 | -34 | -2 | -51 |
| Industrial | 183 | 235 | 210 | 168 | -42 | -15 | -67 |
| Utility | 150 | 165 | 163 | 151 | -12 | 1 | -14 |
| Financial Institutions | 134 | 185 | 178 | 155 | -23 | 21 | -30 |
| U.S. High Yield | 660 | 839 | 726 | 656 | -70 | -4 | -183 |

*Sources: Barclays*

## Strong Month and Quarter for Returns

All major bond indices posted positive March returns and strong returns for the quarter as yields declined across the curve. Investment grade corporates (+3.97%) and CMBS (+3.61%) posted some of the strongest returns for the quarter as spreads tightened. Treasury inflation protected securities (TIPS) had the strongest quarterly returns (+4.46%) as inflation expectations rose from very low levels.

**Total Returns of Selected Barclays Indices and Subsectors**

| Barclays Index/Sector | March | YTD |
|---|---|---|
| U.S. Aggregate Index | 0.92% | 3.03% |
| U.S. Gov't/Credit Index | 1.17% | 3.47% |
| U.S. Intermediate Gov't/Credit Index | 0.72% | 2.45% |
| U.S. 1-3 Yr. Gov't/Credit Index | 0.36% | 0.98% |
| U.S. Treasury | 0.16% | 3.20% |
| U.S. Agency | 0.20% | 2.04% |
| MBS (Mortgage-Backed Securities) | 0.30% | 1.98% |
| CMBS (Commercial Mortgage-Backed Securities) | 1.25% | 3.61% |
| ABS (Asset-Backed Securities) | 0.12% | 1.36% |
| U.S. Corporate - Investment Grade | 2.77% | 3.97% |
| Corporate High Yield | 4.44% | 3.35% |
| Municipal Bond Index | 0.32% | 1.67% |
| TIPS (Treasury Inflation Protected Securities) | 1.80% | 4.46% |

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.