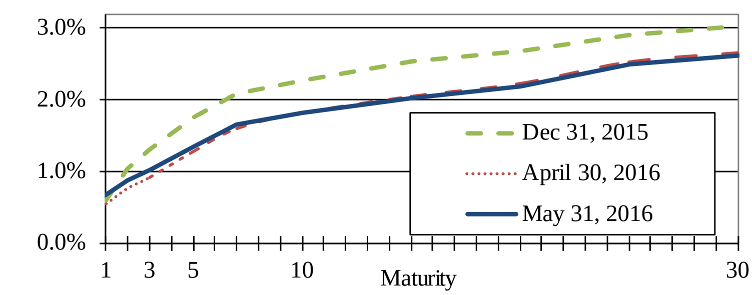
Baird Advisors
Fixed Income Market Comments
May 2016

Yields Rise, Curve Flattens as Market Anticipates Rate Hike

Treasury yields generally rose and the curve flattened as the probability of a near-term Fed Funds rate hike rose significantly due to Fed messaging that the U.S. economy is making sufficient progress to merit a hike. After a tepid start to the year (1Q GDP +0.8%), recent U.S. economic data has been somewhat stronger than expected (e.g. advance retail sales +1.3% vs. 0.8% consensus). The Fed's April meeting minutes showed discussion that it "…likely would be appropriate for the committee to increase the target range for the Federal Funds rate in June." The message was echoed by multiple Fed committee members and chair Yellen while speaking at Harvard University emphasized that it's appropriate for the Fed to "gradually increase [the] overnight interest rate over time" and that the next interest rate increase may be warranted "in the coming months." The market implied probability of a 25bp Fed Funds rate hike to a 50-75bps range at the June or July Fed meeting rose to over 50% at month end, up from roughly 25% in April *[Note: upon the June 3rd release of a much weaker-than-expected +38K nonfarm payroll report, the implied probability of a June or July rate hike dropped considerably]*. Additional policy normalization by the Fed would create further divergence from other major global central banks, which continue to implement extraordinarily accommodative monetary policies.

Treasury Yields



Maturity	12/31/15	4/30/16	5/31/16	1Mo Chg	YTD Chg
1	0.60%	0.55%	0.68%	0.13%	0.08%
2	1.05%	0.77%	0.87%	0.10%	-0.18%
3	1.31%	0.92%	1.02%	0.10%	-0.29%
5	1.76%	1.28%	1.36%	0.08%	-0.40%
7	2.09%	1.60%	1.65%	0.05%	-0.44%
10	2.27%	1.82%	1.83%	0.01%	-0.44%
30	3.02%	2.66%	2.63%	-0.03%	-0.39%

Record Corporate Issuance, Spreads Mixed

Credit spreads have been relatively stable in spite of the prospect of a Fed move. Yield spreads inched wider on investment grade corporates (+3 bps, see table at right) as monthly gross issuance of $190B set an all-time record, surpassing the previous record of $163B, set in September 2013. The bulk of the issuance came from industrials, contributing to the modest widening (+7 bps) in the sector, whereas financials and utilities tightened 1bp and 9bps respectively. Spreads tightened across mortgage and asset-backed sectors as fundamentals remain solid and limited supply was met with strong investor demand.

Option-Adjusted Spreads (in bps)

	12/31/15	4/30/16	5/31/16	1Mo Chg	YTD Chg
U.S. Aggregate Index	56	50	51	1	-5
U.S. Agency (non-mortgage)	21	21	19	-2	-2
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	24	20	18	-2	-6
Asset-Backed Securities	72	68	60	-8	-12
CMBS	121	101	94	-7	-27
Corporate Sectors					
U.S. Investment Grade	165	146	149	3	-16
Industrial	183	148	155	7	-28
Utility	150	142	133	-9	-17
Financial Institutions	134	142	141	-1	7
U.S. High Yield	660	577	566	-11	-94

Sources: Barclays

Muted Monthly Returns

Treasuries posted a flat, 0.00% return in the month as interest earned was offset by lower prices. Corporate high yield was the one sector to generate a larger positive return in May (+0.62%) as strong demand pushed prices higher. The TIPS (Treasury inflation protected securities) index was the only sector with significantly negative returns (-0.71%) as inflation expectations declined modestly. All major indices maintained strong year-to-date returns.

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	May	YTD	2015
U.S. Aggregate Index	0.03%	3.45%	0.55%
U.S. Gov't/Credit Index	-0.02%	3.94%	0.15%
U.S. Intermediate Gov't/Credit Index	-0.11%	2.60%	1.07%
U.S. 1-3 Yr. Gov't/Credit Index	-0.07%	1.04%	0.65%
U.S. Treasury	0.00%	3.09%	0.84%
U.S. Agency	0.04%	2.07%	1.01%
MBS (Mortgage-Backed Securities)	0.13%	2.27%	1.51%
CMBS (Commercial Mortgage-Backed Securities)	0.13%	4.13%	0.97%
ABS (Asset-Backed Securities)	0.09%	1.70%	1.25%
U.S. Corporate - Investment Grade	-0.08%	5.31%	-0.68%
Corporate High Yield	0.62%	8.06%	-4.47%
Municipal Bond Index	0.27%	2.70%	3.30%
TIPS (Treasury Inflation Protected Securities)	-0.71%	4.08%	-1.44%

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.