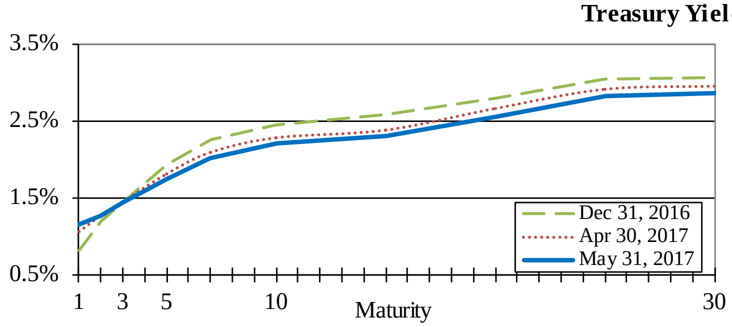
Baird Advisors
Fixed Income Market Comments
May 2017

Improving Economic Data, but Lower Yields and a Flatter Curve

Economic data improved in May yet yields moved lower across most of the curve. The month began with a solid April employment report showing an increase of 194,000 jobs, pulling the unemployment rate to a new cycle low of 4.4%. First quarter GDP growth was revised to 1.2% from the initial 0.7% estimate, and current estimates for 2Q growth are over 3.0%. Personal income and consumption both rose 0.4% last month and home prices continued to rise. Yet, inflation pressures eased as the core PCE fell -0.1% in April, lowering the YoY increase to 1.6% from 1.8% the prior month. The tame inflation data combined with the lack of progress on President Trump’s pro-growth fiscal agenda contributed to the modest decline in Treasury yields beyond the 2-year maturity, continuing the curve flattening trend prevalent since year end. The yield spread between the 2-year and 10-year Treasury, for example, has narrowed 44 bps from its late-December peak of +136 bps to +92 bps at the end of May. Strong demand for fixed income last month occurred even with near certainty of another one-quarter point rate hike in June and more detailed discussion of reducing the Fed’s balance sheet as early as this fall. Recent FOMC meeting minutes revealed discussion of allowing the Fed’s $4.5 trillion of assets to gradually roll off by reducing the amount reinvested each month at some pre-announced pace.

Treasury Yields



Maturity	12/31/16	4/30/17	5/31/17	1Mo Chg	YTD Chg
1	0.81%	1.06%	1.15%	0.09%	0.34%
2	1.19%	1.27%	1.27%	0.00%	0.08%
3	1.45%	1.45%	1.43%	-0.02%	-0.02%
5	1.93%	1.81%	1.75%	-0.06%	-0.18%
7	2.25%	2.09%	2.01%	-0.08%	-0.24%
10	2.44%	2.28%	2.20%	-0.08%	-0.24%
30	3.07%	2.95%	2.86%	-0.09%	-0.21%

Yield Spreads Grind Tighter in May

Yield spreads ended the month tighter across all major market sectors as credit fundamentals remained stable and investor demand remained very strong. In particular, robust investor demand for high quality investments with short maturities helped spreads on asset-backed securities tighten by 7 bps this month.

Munis Outperform Taxable Bonds, Followed by Corporates

With the exception of TIPS, all sectors of the market produced positive returns last month. Tax-exempt municipal bonds outperformed other market sectors as slow progress on the administration’s tax reform agenda led the market to reassess the size (less) and timing (later) of any tax reform. Investment grade corporates were not far behind thanks to strong demand and solid credit fundamentals. Recent reports showed that 1Q earnings for the S&P 500 companies were the strongest in six years, and the improvement was spread across most market sectors.

Option-Adjusted Spreads (in bps)

	12/31/16	4/30/17	5/31/17	1Mo Chg	YTD Chg
U.S. Aggregate Index	43	43	42	-1	-1
U.S. Agency (non-mortgage)	21	17	16	-1	-5
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	15	27	26	-1	11
Asset-Backed Securities	59	52	45	-7	-14
CMBS	75	78	74	-4	-1
Corporate Sectors					
U.S. Investment Grade	123	116	113	-3	-10
Industrial	125	119	116	-3	-9
Utility	117	115	113	-2	-4
Financial Institutions	120	111	108	-3	-12
U.S. High Yield	409	371	363	-8	-46

Sources: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	May	YTD
U.S. Aggregate Index	0.77%	2.38%
U.S. Gov’t/Credit Index	0.83%	2.63%
U.S. Intermediate Gov’t/Credit Index	0.50%	1.91%
U.S. 1-3 Yr. Gov’t/Credit Index	0.17%	0.76%
U.S. Treasury	0.65%	2.04%
U.S. Agency	0.43%	1.71%
MBS (Mortgage-Backed Securities)	0.62%	1.76%
CMBS (Commercial Mortgage-Backed Securities)	0.86%	2.54%
ABS (Asset-Backed Securities)	0.35%	1.21%
U.S. Corporate - Investment Grade	1.15%	3.48%
Corporate High Yield	0.87%	4.79%
Municipal Bond Index	1.59%	3.94%
TIPS (Treasury Inflation Protected Securities)	-0.04%	1.82%

<u>Disclosures</u>

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.