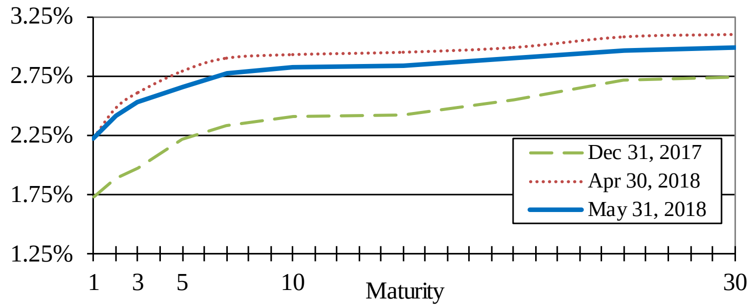
Baird Advisors
Fixed Income Market Commentary
May 2018

Rates Fall as Volatility Rises

Yields rose early in May, reaching an intra-month peak of 3.11%, the highest level since July, 2011, before reversing course and closing the month lower than where they started. The roller-coaster ride began with yields rising on supportive U.S. economic data, including the unemployment rate which fell to 3.9% in April, the first reading below 4% in 18 years. The catalyst for the reversal and decline in rates was the release of the Fed's May meeting minutes which suggested the FOMC was willing to take a less aggressive approach to subsequent rate hikes, allowing inflation to exceed its 2% target since it has persisted below that objective for some time. Market-implied odds of a fourth rate hike in 2018 declined from 50% to 32% over the month. Overseas, political developments in Italy also drove Treasury rates lower still as two populist, "Italy-first," parties finally formed a new government, raising concerns that political leaders might push for Italy to exit the European Union. Italian yields spiked relative to German bunds before buying emerged and Italian yields eased. Tumultuous foreign trade negotiations also contributed to volatility and global growth concerns as President Trump announced tariffs on a variety of imported goods, which spurred China, Canada, Mexico, and the EU to prepare retaliatory tariffs.

Treasury Yields



Maturity	12/31/17	4/30/2018	5/31/2018	1Mo Chg	YTD Chg
1	1.73%	2.23%	2.22%	-0.01%	0.49%
2	1.88%	2.48%	2.41%	-0.07%	0.53%
3	1.97%	2.61%	2.53%	-0.08%	0.56%
5	2.21%	2.79%	2.66%	-0.13%	0.45%
7	2.33%	2.90%	2.77%	-0.13%	0.44%
10	2.41%	2.93%	2.82%	-0.11%	0.41%
30	2.74%	3.10%	2.99%	-0.11%	0.25%

Spreads Widen, but Highest Quality Sectors Nearly Unchanged

Investment-grade corporate spreads widened 7 bps in May to 115 bps. The move was driven by 10+ year corporates, which widened 12 bps on concerns of rising economic and political uncertainty. In contrast, 1-10 year investment-grade corporates widened a modest 5 bps. High Yield Corporates more than gave back the tightening from the first four months of the year; widening 24 bps in May and now 19bps wider YTD at 362 bps. High-quality mortgage and asset-backed spreads, however, were nearly unchanged in the month.

Positive Returns in May, Except for High Yield

The decline in Treasury yields contributed to positive returns across all investment grade sectors in May; High Yield was the only sector with negative returns (-0.03%) as demand for low-quality sectors waned. The positive results in May chipped negative YTD returns with shorter benchmarks and sectors achieving/approaching positive territory (e.g. 1-3 Yr. Gov't/Credit index +0.07%; ABS -0.02%).

Option-Adjusted Spreads (in bps)

	12/31/17	4/30/18	5/31/18	1Mo Chg	YTD Chg
U.S. Aggregate Index	36	40	42	2	6
U.S. Agency (non-mortgage)	14	13	13	0	-1
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	25	28	28	0	3
U.S. Agency CMBS	35	41	42	1	7
U.S. Non-Agency CMBS	79	80	82	2	3
Asset-Backed Securities	36	43	44	1	8
Corporate Sectors					
U.S. Investment Grade	93	108	115	7	22
Industrial	98	110	117	7	19
Utility	92	102	108	6	16
Financial Institutions	85	103	112	9	27
U.S. High Yield Corporates	343	338	362	24	19

Source: Bloomberg Barclays Indices

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	May	YTD 2018	Effective Duration
U.S. Aggregate Index	0.71%	-1.50%	6.04 yrs
U.S. Gov't/Credit Index	0.72%	-1.71%	6.47 yrs
U.S. Intermediate Gov't/Credit Index	0.60%	-0.91%	3.95 yrs
U.S. 1-3 Yr. Gov't/Credit Index	0.37%	0.07%	1.94 yrs
U.S. Treasury	0.90%	-1.10%	6.12 yrs
U.S. Agency (non-mortgage)	0.64%	-0.49%	3.8 yrs
U.S. Agency Pass-throughs	0.70%	-1.00%	5.09 yrs
CMBS (Commercial Mortgage Backed Securities)	0.80%	-1.21%	5.34 yrs
ABS (Asset-Backed Securities)	0.41%	-0.02%	2.05 yrs
U.S. Corporate Investment Grade	0.54%	-2.70%	7.32 yrs
U.S. High Yield Corporates	-0.03%	-0.24%	3.96 yrs
Municipal Bond Index	1.15%	-0.33%	5.84 yrs
TIPS (Treasury Inflation Protected Securities)	0.43%	-0.42%	5.71 yrs

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.