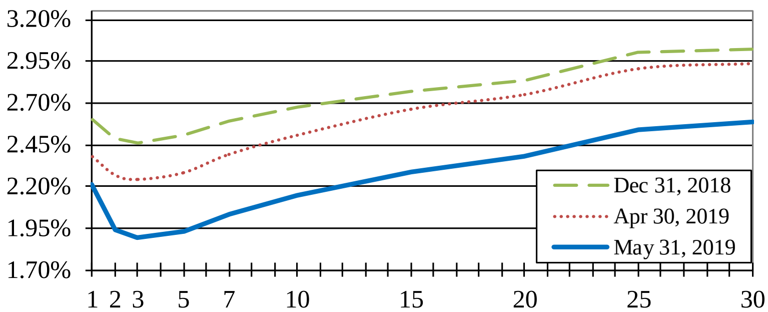
Baird Advisors
Fixed Income Market Commentary
May 2019

Treasury Yields Fall Sharply on Rising Trade Tension, Market Expecting Fed Funds Cuts

Rates declined across the board in May as investors sought the safe haven of U.S. Treasuries as risk assets repriced lower (U.S. equities down over 6%) amidst rising global trade tensions and signs of slowing economic growth. The U.S. yield curve inverted at various points. The 10yr Treasury yield fell 37 bps to end the month at 2.14%, 21 bps below 3mo T-bill rates (2.35%), a yield spread closely monitored by the Fed. There were clear signs of economic slowing in the U.S. in both hard and soft data, with capital goods orders, PMI Manufacturing and Services, as well as existing and new home sales all reporting as weaker than expected. The market has priced in with near certainty at least one fed funds rate cut in 2019, with the odds of 50 bps in cuts rising over 70%, up from 25% at the start of the month. Trade war uncertainty rose sharply in the month following President Trump's decision to raise tariffs on another $200 billion in Chinese imports from 10% to 25% after China backpedaled on earlier commitments in the trade negotiations. The blacklisting by the U.S. of the Chinese telecommunications equipment firm Huawei led to sharp rhetoric and threats of retaliation by China. In addition, at the end of May, Trump unexpectedly announced a 5% tariff on all imports from Mexico as a means to "encourage" Mexico to reduce illegal immigration into the U.S. Signs of economic slowing were also apparent outside the U.S., especially in Europe as the yield on the German 10yr reached an all-time low of *negative* 0.20%. Global leaders will meet at the G20 Summit at the end of June, providing a platform where progress on U.S./China trade may occur. Meanwhile, in Britain, the candidates seeking to succeed Theresa May as U.K. Prime Minister were discussing alternate Brexit strategies, trying to avoid a no-deal Brexit by the October 31st deadline, though a no-deal Brexit is now a real possibility.

Treasury Yields



Maturity	12/31/18	4/30/19	5/31/19	1Mo Chg	YTD
1	2.60%	2.38%	2.22%	-0.16%	-0.38%
2	2.49%	2.27%	1.94%	-0.33%	-0.55%
3	2.46%	2.24%	1.90%	-0.34%	-0.56%
5	2.51%	2.28%	1.93%	-0.35%	-0.58%
7	2.59%	2.39%	2.03%	-0.36%	-0.56%
10	2.68%	2.51%	2.14%	-0.37%	-0.54%
30	3.02%	2.94%	2.58%	-0.36%	-0.44%

Corporate Spreads Widen on Heightened Uncertainty

Heightened global macro uncertainty pushed corporate spreads 17 bps wider in May to 128 bps, although spreads are still 25 bps tighter YTD. Spreads only widened a handful of basis points in Mortgage-backed sectors, while Asset-Backed Securities (ABS) actually *tightened* 6 bps to 32 bps thanks to its high credit quality, U.S.-centric exposure and favorable supply-demand technicals. High Yield Corporates were hit hard by trade worries and a slowing global economy, widening 75 bps this month to end May at 433 bps.

Long Duration, High Quality Assets Outperform

Treasuries (+2.35%) were the top performing asset class in the month, followed by CMBS (+2.04%, a high-quality sector with a longer duration). Investment Grade Corporates (+1.43%) lagged equal-duration Treasuries but still posted positive returns. However, High Yield Corporates (-1.19%) dropped in value with the worst monthly return overall.

Option-Adjusted Spreads (in bps)

	12/31/18	4/30/19	5/31/19	1Mo Chg	YTD Chg
U.S. Aggregate Index	54	44	49	5	-5
U.S. Agency (non-mortgage)	16	13	12	-1	-4
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	35	41	44	3	9
U.S. Agency CMBS	55	44	46	2	-9
U.S. Non-Agency CMBS	107	79	80	1	-27
Asset-Backed Securities	53	38	32	-6	-21
Corporate Sectors					
U.S. Investment Grade	153	111	128	17	-25
Industrial	157	116	136	20	-21
Utility	144	108	122	14	-22
Financial Institutions	147	101	116	15	-31
Other Govt. Related	90	72	78	6	-12
U.S. High Yield Corporates	526	358	433	75	-93
Emerging Market Debt	560	509	549	40	-11

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	May	YTD	Effective Duration
U.S. Aggregate Index	1.78%	4.80%	5.73
U.S. Gov't/Credit Index	1.96%	5.34%	6.68
U.S. Intermediate Gov't/Credit Index	1.31%	3.86%	3.91
U.S. 1-3 Yr. Gov't/Credit Index	0.69%	2.14%	1.90
U.S. Treasury	2.35%	4.22%	6.35
U.S. Agency (Non-Mortgage)	1.55%	3.45%	4.01
U.S. Agency Pass-Throughs	1.29%	3.43%	3.38
CMBS (Commercial Mortgage Backed Securities)	2.04%	5.57%	5.29
ABS (Asset-Backed Securities)	0.97%	2.74%	2.17
U.S. Corporate Investment Grade	1.43%	7.23%	7.48
U.S. High Yield Corporates	-1.19%	7.49%	3.50
Emerging Market Debt	-0.13%	5.67%	4.63
Municipal Bond Index	1.38%	4.71%	5.40
TIPS (Treasury Inflation Protected Securities)	1.65%	5.25%	1.15

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.

Emerging Market: Bloomberg uses a fixed list of countries defined as emerging markets countries for index inclusion purposes that is based on World Bank Income group definitions (Low/Middle), IMF country classifications (Non-Advanced Economies), and other advanced economies that may be less accessible or investable for global debt investors.

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.