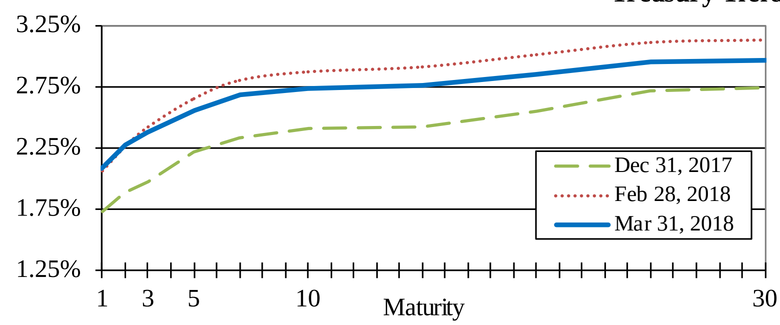
Baird Advisors
Fixed Income Market Commentary
March 2018

Treasury Yields Fall, Credit Spreads Widen

The 10yr Treasury yield fell 13 bps in March to 2.74% on rising trade policy uncertainty as Trump announced new tariffs, triggering concerns over possible trade wars that could negatively affect growth. However, the 10yr rate still rose 33 bps for the quarter. Last month yields on the shortest maturity Treasuries were nearly unchanged as the Fed implemented a much anticipated 25 bps Fed Funds rate hike at its March FOMC meeting, bringing the new Fed Funds target to 1.50% - 1.75%. Helping to soothe market inflation concerns in March was a modest 1.8% YoY increase in Core CPI, which was unchanged from the prior month. Moreover, in his first post-Fed meeting press conference, Fed Chair Jerome Powell commented that “There is no sense in the data that we are on the cusp of an inflation surge.” Nevertheless, the Fed’s updated Fed Funds rate forecast continued to project two more hikes this year. Concerns over a rising level of Treasury issuance to finance increased fiscal deficits contributed to higher rates in the quarter. However, strong demand from pension and other investors with long duration liabilities such as life insurance companies helped limit the increase in the 30y Treasury yield to +23 bps for the quarter, the smallest increase in yield along the yield curve.

Treasury Yields



Maturity	12/31/17	2/28/18	3/31/2018	1Mo Chg	YTD Chg
1	1.73%	2.06%	2.08%	0.02%	0.35%
2	1.88%	2.26%	2.27%	0.01%	0.39%
3	1.97%	2.42%	2.38%	-0.04%	0.41%
5	2.21%	2.65%	2.56%	-0.09%	0.35%
7	2.33%	2.80%	2.68%	-0.12%	0.35%
10	2.41%	2.87%	2.74%	-0.13%	0.33%
30	2.74%	3.13%	2.97%	-0.16%	0.23%

Spreads Widen on Policy Risk, Market Volatility, Waning Demand

Trade policy concerns, heightened equity market volatility, and weaker investor demand contributed to spread widening in the quarter. Investment Grade Corporate spreads widened 16 bps for the quarter to 109 bps as foreign demand weakened, industry fund flows slowed, and selling pressure grew as companies such as Apple, which are “repatriating” cash in response to the new tax code, began liquidating short corporate bond holdings. On the supply side, CVS brought the third-largest bond issuance of all time ($40B) in March to fund its acquisition of Aetna. In total, however, Investment Grade Credit supply for the quarter has slowed versus the same period in 2017 with YTD gross supply down 11% and net supply down 26%.

Option-Adjusted Spreads (in bps)

	12/31/17	2/28/18	3/31/18	1Mo Chg	YTD Chg
U.S. Aggregate Index	36	37	41	4	5
U.S. Agency (non-mortgage)	14	13	12	-1	-2
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	25	26	29	3	4
U.S. Agency CMBS	35	36	41	5	6
U.S. Non-Agency CMBS	79	73	83	10	4
Asset-Backed Securities	36	45	48	3	12
Corporate Sectors					
U.S. Investment Grade	93	96	109	13	16
Industrial	98	99	111	12	13
Utility	92	91	104	13	12
Financial Institutions	85	91	106	15	21
U.S. High Yield	343	336	354	18	11

Source: Bloomberg Barclays Indices

Negative Returns YTD in Spite of March Lift

While March was a reprieve from the negative returns in the first two months of the year, rising Treasury yields and wider spreads pushed all investment grade sectors into negative territory for the quarter. Investment Grade Corporates were the worst performing sector overall for the quarter (-2.32%), whereas shorter-duration sectors such as ABS (-0.39%) had more stable returns, although they were still negative.

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	March	YTD 2018	*2017*
U.S. Aggregate Index	0.64%	-1.46%	*3.54%*
U.S. Gov’t/Credit Index	0.65%	-1.58%	*4.00%*
U.S. Intermediate Gov’t/Credit Index	0.36%	-0.98%	*2.14%*
U.S. 1-3 Yr. Gov’t/Credit Index	0.16%	-0.20%	*0.84%*
U.S. Treasury	0.94%	-1.18%	*2.31%*
U.S. Agency	0.56%	-0.53%	*2.06%*
MBS (Mortgage Backed Securities)	0.64%	-1.19%	*2.47%*
CMBS (Commercial Mortgage Backed Securities)	0.39%	-1.32%	*3.35%*
ABS (Asset Backed Securities)	0.18%	-0.39%	*1.55%*
U.S. Corporate - Investment Grade	0.25%	-2.32%	*6.42%*
Corporate High Yield	-0.60%	-0.86%	*7.50%*
Municipal Bond Index	0.37%	-1.11%	*5.45%*
TIPS (Treasury Inflation Protected Securities)	1.05%	-0.79%	*3.01%*

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.