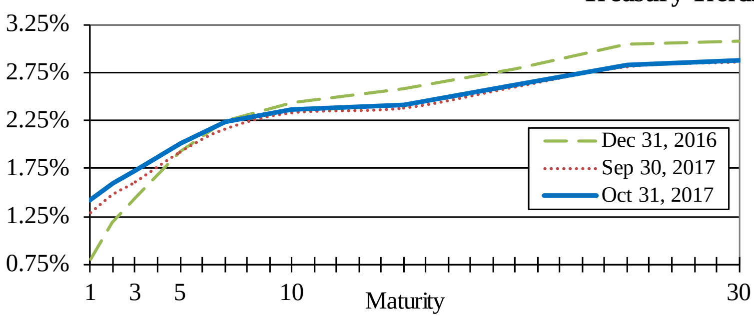
Baird Advisors
Fixed Income Market Comments
October 2017

Modestly Higher Yields on Stronger Growth

Treasury yields rose modestly in October despite an abundance of positive economic and pro-growth policy news. The full slate of information led to the continuation of a gradual but persistent flattening trend for the yield curve and marginally higher volatility as 10-year Treasury yields traded as high as 2.46% before ending the month at 2.37%. The strong post-election consumer and business sentiment is filtering into the hard economic data as U.S. GDP grew at a 3.0% annualized rate, the second consecutive quarter at or above 3.0%. Global growth also continued to improve as the IMF raised the global growth outlook to 3.6% for 2017 and 3.7% for 2018, up from 3.2% last year. In spite of this, U.S. inflation remains benign - the Core Personal Consumption Expenditure (PCE) Index rose just 0.1% last month and just 1.3% YoY. Adding to the market optimism were rising expectations of tax reform. The Congressional budget passed on a party-line vote, allowing for a $1.5 trillion tax cut over ten years. The House's tax bill will be released in early November and is certain to lead to significant debate on the merits and cost of the plan. The Fed remained in the news, beginning its very gradual balance sheet reduction process and broadcasting a high likelihood of an additional Fed Funds hike in December, all while investors await President Trump's choice for the next Fed Chair in early November. While the ECB announced plans to "downsize" their monthly asset purchases in January to €30B from €60B, it extended the timeline of QE purchases through September 2018, will continue to reinvest balance sheet maturities, and indicated that rates will "remain at their present levels…well past the horizon of our net asset purchases."

Treasury Yields



Maturity	12/31/16	9/30/17	10/31/17	1Mo Chg	YTD Chg
1	0.81%	1.29%	1.42%	0.13%	0.61%
2	1.19%	1.48%	1.59%	0.11%	0.40%
3	1.45%	1.61%	1.72%	0.11%	0.27%
5	1.93%	1.92%	2.01%	0.09%	0.08%
7	2.25%	2.16%	2.23%	0.07%	-0.02%
10	2.44%	2.33%	2.37%	0.04%	-0.07%
30	3.07%	2.86%	2.87%	0.01%	-0.20%

CMBS, Corporate Credit Spreads Tighten

Non-Agency CMBS and corporate credit spreads tightened 10 bps and 6 bps, respectively, in October on strong investor demand and solid underlying fundamentals. Demand for fixed income assets has been very robust as YTD mutual fund and ETF inflows through October exceeded $330B, up nearly 75% from the $190B of inflows for all of 2016.

Corporates, CMBS Outperform; Treasuries, MBS Drop

Heightened demand for spread sectors made Corporate credit (+0.40%) and CMBS (+0.39%) the top performing investment-grade sectors in October. However, the modest rise in interest rates pushed Treasury returns negative (-0.12%) and MBS (-0.03%) gave back prior performance as interest rate volatility ticked back up from very low levels. High Yield Corporates had solid returns in the month (+0.42%) and remain the strongest-performing sector overall YTD (+7.45%) as a down-in-quality bias continues to outperform.

Option-Adjusted Spreads (in bps)

	12/31/16	9/30/17	10/31/17	1Mo Chg	YTD Chg
U.S. Aggregate Index	43	38	35	-3	-8
U.S. Agency (non-mortgage)	21	15	13	-2	-8
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	15	22	21	-1	6
U.S. Agency CMBS	47	45	39	-6	-8
U.S. Non-Agency CMBS	93	88	78	-10	-15
Asset-Backed Securities	59	44	38	-6	-21
Corporate Sectors					
U.S. Investment Grade	123	101	95	-6	-28
Industrial	125	105	99	-6	-26
Utility	117	100	94	-6	-23
Financial Institutions	120	93	87	-6	-33
U.S. High Yield	409	347	338	-9	-71

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	October	YTD
U.S. Aggregate Index	0.06%	3.20%
U.S. Gov't/Credit Index	0.09%	3.58%
U.S. Intermediate Gov't/Credit Index	-0.01%	2.33%
U.S. 1-3 Yr. Gov't/Credit Index	-0.03%	1.03%
U.S. Treasury	-0.12%	2.14%
U.S. Agency	0.01%	2.08%
MBS (Mortgage-Backed Securities)	-0.03%	2.29%
CMBS (Commercial Mortgage-Backed Securities)	0.39%	3.39%
ABS (Asset-Backed Securities)	0.06%	1.63%
U.S. Corporate - Investment Grade	0.40%	5.61%
Corporate High Yield	0.42%	7.45%
Municipal Bond Index	0.24%	4.92%
TIPS (Treasury Inflation Protected Securities)	0.21%	1.94%

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.