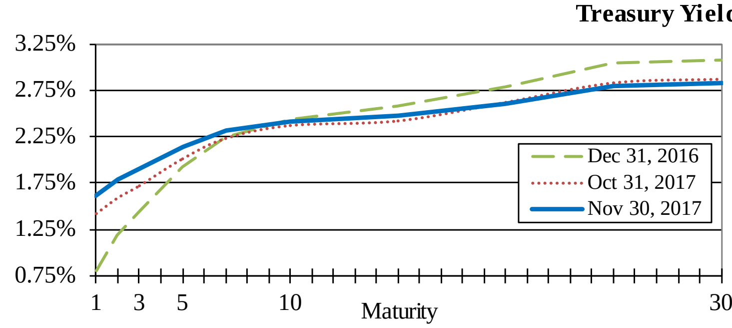
Baird Advisors
Fixed Income Market Comments
November 2017

Curve Flattening Accelerates, Low Inflation and Strong Demand Persist

The curve flattening trend accelerated last month as short-term yields rose rather sharply and long-term rates fell marginally. Expectations of another 25 bps increase in the fed funds rate target to 1.25%-1.50% in December and a continued path of gradual increases in 2018 helped push short-term rates higher. The *stickiness* of intermediate and long-term rates was due to several factors, including stubbornly low inflation (October Core PCE +1.4%) in the face of a tight labor market and strong demand from long duration investors, both domestic and abroad. At month end the curve slope between 2-year Treasuries and 10-year Treasuries was +62 bps, down 16 bps from the prior month and roughly one-half of the +125 bps slope at the start of the year. The likely new Fed Chair, Jerome (Jay) Powell, is expected to continue on the gradual path of monetary policy normalization that Janet Yellen has established. Another important development last month was the significant progress on tax reform. The House passed a bill in mid-November and the Senate passed their bill very early in December. The two bills now move to a House-Senate reconciliation process with hopes for passage of a final bill before year end. While the bills are very similar in many respects, legislators will have to reconcile the ultimate corporate tax rate - deciding whether it will become effective starting in 2019 or take effect immediately, and decide the limits on corporate bond interest payment deductions - which could reduce bond issuance in 2018.

Treasury Yields



Maturity	12/31/16	10/31/17	11/30/17	1Mo Chg	YTD Chg
1	0.81%	1.42%	1.61%	0.19%	0.80%
2	1.19%	1.59%	1.79%	0.20%	0.60%
3	1.45%	1.72%	1.90%	0.18%	0.45%
5	1.93%	2.01%	2.14%	0.13%	0.21%
7	2.25%	2.23%	2.31%	0.08%	0.06%
10	2.44%	2.37%	2.41%	0.04%	-0.03%
30	3.07%	2.87%	2.83%	-0.04%	-0.24%

Corporate Credit Spreads Slightly Wider, ABS Tightens

After tightening significantly for the last two months, corporate credit spreads widened 2 bps in November to 97 bps, primarily due to industrials widening 4 bps, giving back a small fraction of the YTD tightening. Securitized sectors such as agency CMBS and ABS, however, tightened a few basis points as investors were drawn to these high-quality sectors while new issue supply declined, heading into the seasonally-slow year end. After being as much as 41 bps wider midmonth, high yield corporates ended the month 6 bps wider at 344 bps.

Option-Adjusted Spreads (in bps)

	12/31/16	10/31/17	11/30/17	1Mo Chg	YTD Chg
U.S. Aggregate Index	43	35	37	2	-6
U.S. Agency (non-mortgage)	21	13	13	0	-8
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	15	21	24	3	9
U.S. Agency CMBS	47	39	38	-1	-9
U.S. Non-Agency CMBS	93	78	80	2	-13
Asset-Backed Securities	59	38	35	-3	-24
Corporate Sectors					
U.S. Investment Grade	123	95	97	2	-26
Industrial	125	99	103	4	-22
Utility	117	94	94	0	-23
Financial Institutions	120	87	87	0	-33
U.S. High Yield	409	338	344	6	-65

Source: Bloomberg Barclays Indices

Negative Month, Solid YTD Performance

The bear flattening of the yield curve contributed to negative returns across all sectors with the exception of TIPS (Treasury inflation protected securities), which had near-flat (+0.13%) performance. However, all sectors remain in positive territory for the year. Municipals (-0.54%) were the worst performing sector for the month due to an impending spike in issuance by year end. For a more detailed look at the tax bill's impact on the municipal market, see our November Municipal Fixed Income Market Comments.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	November	YTD
U.S. Aggregate Index	-0.13%	3.07%
U.S. Gov't/Credit Index	-0.12%	3.46%
U.S. Intermediate Gov't/Credit Index	-0.31%	2.02%
U.S. 1-3 Yr. Gov't/Credit Index	-0.22%	0.81%
U.S. Treasury	-0.14%	2.00%
U.S. Agency	-0.15%	1.93%
MBS (Mortgage-Backed Securities)	-0.14%	2.14%
CMBS (Commercial Mortgage-Backed Securities)	-0.33%	3.06%
ABS (Asset-Backed Securities)	-0.09%	1.53%
U.S. Corporate - Investment Grade	-0.15%	5.46%
Corporate High Yield	-0.26%	7.18%
Municipal Bond Index	-0.54%	4.36%
TIPS (Treasury Inflation Protected Securities)	0.13%	2.07%

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.