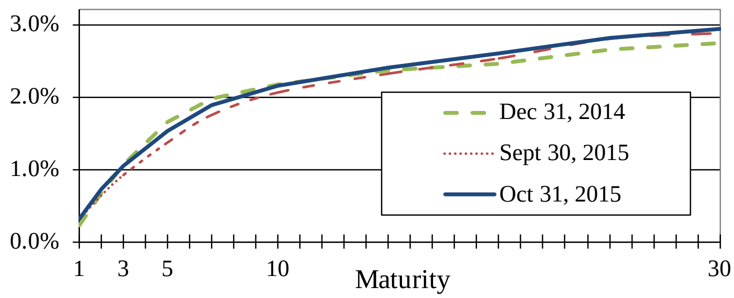
Baird Advisors
Fixed Income Market Comments
October 2015

Global Central Banks Ease Concerns, Fed Keeps December Hike on the Table

The yield on the 5-year Treasury rose 16 bps this month as global central banks (i.e. China, Europe) helped mitigate macro uncertainty with accommodative policy responses, while the Fed messaged that a December “lift-off” is very much still on the table. China’s central bank cut benchmark interest rates 25 bps and lowered bank reserve requirements to stimulate the economy amid concerns of slowing growth, while Draghi messaged that the European Central Bank would be ready to implement additional quantitative easing as needed. In a continued divergence of global central bank policies, the Fed’s Open Market Committee statement removed language citing concerns around “global economic and financial developments” and added comments on “whether it will be appropriate to raise [the Fed funds rate] at its next meeting.” After the release of the statement, interest rates rose and the market implied probability of a rate hike at the December meeting rose from less than 30% to 50%. While recent U.S. economic data only shows modest progress (September nonfarm payrolls +142K, core CPI +1.9% YoY, 3Q GDP +1.5%) it may still be sufficient for the Fed to move in December.

Treasury Yields



Maturity	12/31/14	9/30/15	10/31/15	1Mo Chg	YTD Chg
1	0.22%	0.31%	0.32%	0.01%	0.10%
2	0.67%	0.64%	0.73%	0.09%	0.06%
3	1.07%	0.92%	1.04%	0.12%	-0.03%
5	1.65%	1.37%	1.53%	0.16%	-0.12%
7	1.97%	1.75%	1.89%	0.14%	-0.08%
10	2.17%	2.06%	2.15%	0.09%	-0.02%
30	2.75%	2.88%	2.94%	0.06%	0.19%

Spreads Tighten on Reversal of Negative Tone

Spreads tightened this month as global central bank actions helped allay macro concerns. Investment grade credit tightened 10 bps this month to 159 bps, reversing some of this year’s spread widening (see table at right). High yield corporate spreads snapped 70 bps tighter in line with the October rally in risk assets (S&P 500 +8.3%), yet remain 77 bps wider for the year. Mortgage and asset-backed sectors lagged the spread tightening of the corporate sectors but continue to exhibit less spread volatility. CMBS tightened a mere 2 bps in October, but has held up much better for the year, only 8 bps wider, while agency debentures and pass-throughs have been the only sectors with any spread tightening year to date. Even with modest spread tightening YTD, agency pass-throughs have underperformed like duration Treasuries by 0.31% due to the cost of unfavorable “duration drift” (a.k.a. negative convexity) when interest rates are volatile.

Option-Adjusted Spreads (in bps)

	12/31/14	9/30/15	10/31/15	1Mo Chg	YTD Chg
U.S. Aggregate Index	48	59	55	-4	7
U.S. Agency (non-mortgage)	16	17	15	-2	-1
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	27	31	25	-6	-2
Asset-Backed Securities	58	69	70	1	12
CMBS	98	108	106	-2	8
Corporate Sectors					
U.S. Investment Grade	131	169	159	-10	28
Industrial	140	184	172	-12	32
Utility	119	152	147	-5	28
Financial Institutions	117	145	137	-8	20
U.S. High Yield	483	630	560	-70	77

Source: Barclays

Mixed Returns – Spread Sectors Rebound

Rising yields dampened returns and pushed many sectors into negative territory for the month. However investment grade corporates (+0.42%) and corporate high yield (+2.75%) posted sizable positive returns for the month as spread sectors outperformed given the tightening of spreads. After the rebound in corporate sectors, all sectors of the market are now posting positive year-to-date returns, with the exception of TIPS, which continue to trail in a low inflation environment (-0.55%).

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	October	YTD
U.S. Aggregate Index	0.02%	1.14%
U.S. Gov’t/Credit Index	0.00%	0.90%
U.S. Intermediate Gov’t/Credit Index	-0.10%	1.67%
U.S. 1-3 Yr. Gov’t/Credit Index	-0.03%	0.98%
U.S. Treasury	-0.37%	1.42%
U.S. Agency	-0.11%	1.55%
MBS (Mortgage-Backed Securities)	0.07%	1.68%
CMBS (Commercial Mortgage-Backed Securities)	-0.17%	2.07%
ABS (Asset-Backed Securities)	-0.22%	1.60%
U.S. Corporate - Investment Grade	0.42%	0.32%
Corporate High Yield	2.75%	0.23%
Municipal Bond Index	0.40%	2.17%
TIPS (Treasury Inflation Protected Securities)	0.25%	-0.55%

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 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 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 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 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 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 Barclays CMBS ERISA-Eligible Index is the ERISA-eligible component of the 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 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 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 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.