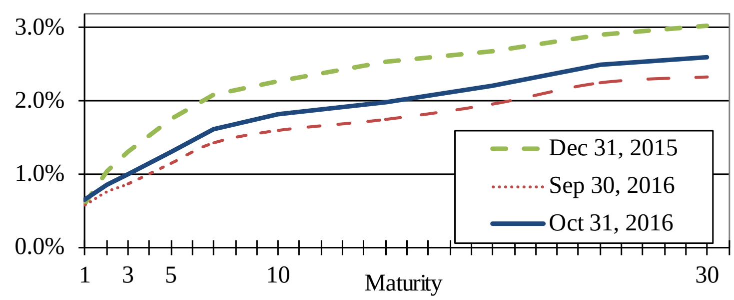
Baird Advisors
Fixed Income Market Comments
October 2016

Yields Rise Around the Globe, U.S. Treasury Curve Steepens

U.S. Treasury yields rose in tandem with other sovereign bond yields around the globe. The U.S. 10-year yield rose 23 bps to 1.83% and the yield curve steepened. U.S. economic data showed steady growth – the September nonfarm payrolls grew 156K, and the ISM non-manufacturing composite came in stronger than expected (57.1, with numbers over 50 showing an expansion). The release of the Fed's September meeting minutes pointed to a likely December federal funds rate hike barring a negative economic (or election) surprise in the interim. Meanwhile inflation has continued to move a bit higher (Sept CPI +1.5% YoY) and market-implied expectations for future inflation over the next decade rose from 1.61% to 1.72% per annum (as calculated by subtracting the yield on the inflation protected 10yr Treasury (TIPS) from the yield of a nominal 10yr Treasury). While the U.S. slowly unwinds post-crisis extraordinary monetary stimulus, foreign central banks in Japan and Europe continue negative interest rates and large scale bond purchase programs, including corporates. However, investors and central bankers continue to weigh the amount and effectiveness of additional quantitative easing and negative rate policies. Reports that ECB officials discussed potentially tapering the €80B monthly purchase program contributed to the selloff of European sovereign debt. The German 10-year yield emerged from negative territory - starting the month at -0.12% and rising 28 bps to end the month with a positive 0.16% yield.

Treasury Yields



Maturity	12/31/15	9/30/16	10/31/16	1Mo Chg	YTD Chg
1	0.60%	0.58%	0.65%	0.07%	0.05%
2	1.05%	0.76%	0.85%	0.09%	-0.20%
3	1.31%	0.87%	1.00%	0.13%	-0.31%
5	1.76%	1.15%	1.31%	0.16%	-0.45%
7	2.09%	1.43%	1.62%	0.19%	-0.47%
10	2.27%	1.60%	1.83%	0.23%	-0.44%
30	3.02%	2.33%	2.59%	0.26%	-0.43%

Spread Tightening Continues

Investment grade corporate spreads tightened modestly in October. Strong demand helped tighten corporate spreads 6 bps over the month to 132 bps. Spreads on financial institutions tightened the most as fundamentals remain solid and demand from both domestic and international investors remains strong. After a volatile widening and subsequent tightening earlier in the year, high yield corporate spreads only tightened a few basis points this month.

Option-Adjusted Spreads (in bps)

	12/31/15	6/30/16	8/31/16	9/30/16	10/31/16	1Mo Chg	YTD Chg
U.S. Aggregate Index	56	55	47	47	45	-2	-11
U.S. Agency (non-mortgage)	21	21	22	21	20	-1	-1
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	24	27	15	14	13	-1	-11
Asset-Backed Securities	72	61	59	55	53	-2	-19
CMBS	121	98	78	84	82	-2	-39
Corporate Sectors							
U.S. Investment Grade	165	156	135	138	132	-6	-33
Industrial	183	159	138	140	135	-5	-48
Utility	150	142	130	132	125	-7	-25
Financial Institutions	134	152	131	137	129	-8	-5
U.S. High Yield	660	594	490	480	477	-3	-183

Sources: Bloomberg Barclays Indices

Negative Returns Across Investment Grade Bonds

Giving back some of the strong year-to-date gains, returns across all investment grade sectors were negative for the month with Treasuries (-1.10%) delivering the weakest performance in the month. Non-treasury sectors with shorter average maturity profiles such as asset-backed securities (-0.03%) proved much more immune to rising rates and held their value. The high yield corporate sector (+0.39%) was the only segment of the bond market with positive returns in the month as relatively high coupon payments more than offset a dip in market prices.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	October	YTD
U.S. Aggregate Index	-0.76%	4.99%
U.S. Gov't/Credit Index	-0.97%	5.63%
U.S. Intermediate Gov't/Credit Index	-0.41%	3.81%
U.S. 1-3 Yr. Gov't/Credit Index	-0.04%	1.64%
U.S. Treasury	-1.10%	3.92%
U.S. Agency	-0.45%	2.96%
MBS (Mortgage-Backed Securities)	-0.26%	3.45%
CMBS (Commercial Mortgage-Backed Securities)	-0.79%	5.71%
ABS (Asset-Backed Securities)	-0.03%	2.71%
U.S. Corporate - Investment Grade	-0.81%	8.31%
Corporate High Yield	0.39%	15.56%
Municipal Bond Index	-1.05%	2.92%
TIPS (Treasury Inflation Protected Securities)	-0.40%	6.84%

<u>Disclosures</u>

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.