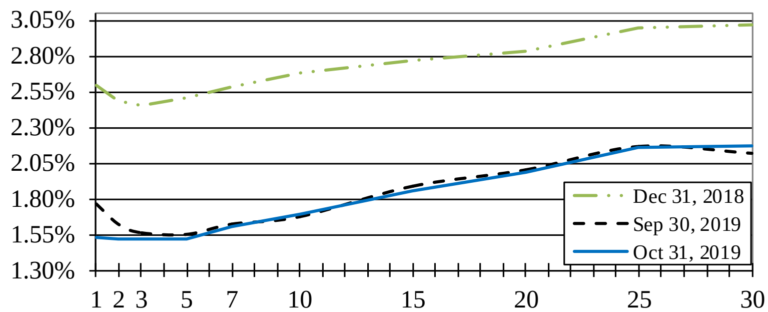
Baird Advisors
Fixed Income Market Commentary
October 2019

Fed Rate Cut and T-Bill Purchases Undo Front End Curve Inversion, China Trade Tensions Ease

Actions by the Federal Reserve last month led to a steepening of the Treasury curve, unwinding more than four months of inversion between short and intermediate rates, as 3 month Treasury Bill yields fell 29 bps while 10yr rates increased slightly from 1.68% to 1.69%. The Fed met market expectations and cut the federal funds target rate by one-quarter point for the third time in 2019 (to a range of 1.50%-1.75%); the Fed also announced an expansion of its balance sheet by purchasing $60B of Treasury bills each month through June 2020. The goal is not to lower long term rates as the Fed did with quantitative easing (QE), but is to provide much-needed liquidity to the overnight repo market where the depletion of excess reserves has caused rate spikes in the short-term funding markets, primarily repo. U.S. economic data confirmed a slowing of growth with 3Q GDP reported at 1.9%; above the 1.6% consensus estimate thanks to resilient consumer spending, but down from 2.0% in 2Q and 3.1% in 1Q. Political tensions continued as the U.S. House of Representatives approved a resolution that establishes rules for the impeachment process against President Trump. Outside the U.S., the October 31st Brexit deadline was extended until January 31, 2020, and a third UK general election in four years is set to take place on December 12th. Prime Minister Boris Johnson hopes to gain enough seats for his Brexit plan to be adopted, but risks losing ground should the opposition gain members. Finally, President Trump announced a truce in the trade war with China and is working to finalize a "phase one" agreement, although nothing has been signed yet.

Treasury Yields



Maturity	12/31/18	9/30/19	10/31/19	1Mo Chg	YTD
1	2.60%	1.77%	1.53%	-0.24%	-1.07%
2	2.49%	1.62%	1.52%	-0.10%	-0.97%
3	2.46%	1.56%	1.52%	-0.04%	-0.94%
5	2.51%	1.55%	1.52%	-0.03%	-0.99%
7	2.59%	1.62%	1.61%	-0.01%	-0.98%
10	2.68%	1.68%	1.69%	0.01%	-0.99%
30	3.02%	2.12%	2.18%	0.06%	-0.84%

Corporates Tighten while MBS & ABS Widen Modestly

Corporate spreads ended the month 5 bps tighter at 110 bps as corporate earnings came in better than expected and China trade concerns lessened. In contrast, Agency Pass-throughs widened 3 bps to 49 bps as prepayments on recent MBS vintages have come in faster (worse) than expected, putting further pressure on the sector. Asset-Backed Securities ended the month 4 bps wider at 41 bps as this sector underperformed Treasuries on the front end of the curve. High Yield Corporates gave back a portion of the strong YTD tightening in October as inflows moderated from a robust YTD pace.

All Sectors Positive in October, Treasuries Trail

All sectors posted positive returns in the month within a relatively small band. Emerging Market Debt (+0.68%) generated the greatest total return, followed closely by Investment Grade Corporates (+0.61%), which still leads the pack YTD (+13.89%). Hampered by rising 30yr rates, the Treasury sector (+0.07%) posted the lowest overall return in the month.

Option-Adjusted Spreads (in bps)

	12/31/18	9/30/19	10/31/19	1Mo Chg	YTD Chg
U.S. Aggregate Index	54	46	46	0	-8
U.S. Agency (non-mortgage)	16	11	12	1	-4
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	35	46	49	3	14
U.S. Agency CMBS	55	52	52	0	-3
U.S. Non-Agency CMBS	107	82	82	0	-25
Asset-Backed Securities	53	37	41	4	-12
Corporate Sectors					
U.S. Investment Grade	153	115	110	-5	-43
Industrial	157	121	117	-4	-40
Utility	144	113	108	-5	-36
Financial Institutions	147	103	98	-5	-49
Other Govt. Related	90	78	78	0	-12
U.S. High Yield Corporates	526	373	392	19	-134
Emerging Market Debt	560	612	617	5	57

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	October	YTD	Effective Duration (years)
U.S. Aggregate Index	0.30%	8.85%	5.81
U.S. Gov't/Credit Index	0.28%	10.03%	6.97
U.S. Intermediate Gov't/Credit Index	0.40%	6.83%	3.92
U.S. 1-3 Yr. Gov't/Credit Index	0.35%	3.78%	1.87
U.S. Treasury	0.07%	7.78%	6.56
U.S. Agency (Non-Mortgage)	0.19%	6.18%	4.05
U.S. Agency Pass-Throughs	0.35%	5.97%	2.86
CMBS (Commercial Mortgage Backed Securities)	0.33%	9.00%	5.26
ABS (Asset-Backed Securities)	0.27%	4.41%	2.21
U.S. Corporate Investment Grade	0.61%	13.89%	7.88
U.S. High Yield Corporates	0.28%	11.71%	3.11
Emerging Market Debt	0.68%	7.88%	4.63
Municipal Bond Index	0.18%	6.94%	5.28
TIPS (Treasury Inflation Protected Securities)	0.26%	7.85%	4.70

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.

Emerging Market: Bloomberg uses a fixed list of countries defined as emerging markets countries for index inclusion purposes that is based on World Bank Income group definitions (Low/Middle), IMF country classifications (Non-Advanced Economies), and other advanced economies that may be less accessible or investable for global debt investors.

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.