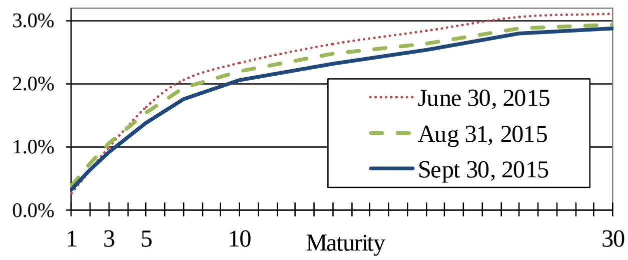
Baird Advisors
Fixed Income Market Comments
September 2015

Market Volatility Rises, Yields Fall, and the Fed Waits

Global markets were struck by a bout of volatility in the third quarter driven by Greece's narrowly avoided exit from the Euro, China-led global growth concerns and heightened uncertainty surrounding the Fed's timing of lift-off from their zero policy rate. Early in July Greece agreed to austere bailout terms, narrowly averting an exit from the Euro in last-minute negotiations. After a sharp decline in Chinese equities in July, linked to slower than expected growth in China, especially exports, the Central Bank of China unexpectedly devalued the Yuan in August by nearly 3% against the US Dollar. Yields ended a volatile quarter lower as the 10-year Treasury traded in a 56 bp range from 1.90% to 2.46% ending the quarter at 2.06%, while the S&P 500 fell 6.94% and WTI Crude Oil dropped nearly 25% to $45/bbl. The Fed decided not to raise the Fed Funds rate at its September meeting, noting that "recent global economic and financial developments may restrain economic activity." However, Chair Yellen said in a late September speech that the first increase will still likely be "later this year" (the Fed meets in October and December). In the midst of global uncertainty, U.S. economic data have been relatively steady (Aug. nonfarm payrolls +173K and +30K in prior month revisions; 1st half annualized GDP +2.2%); however, inflation remains below the Fed's 2% target (Aug headline CPI +0.2% YoY, CPI ex. food/energy +1.8% YoY). Markets are pricing a nearly 50% probability of a rate increase by year end.

Treasury Yields



Maturity	12/31/14	6/30/15	8/31/15	9/30/15	1Mo Chg	3Q Chg	YTD Chg
1	0.21%	0.26%	0.38%	0.31%	-0.07%	0.05%	0.10%
2	0.66%	0.63%	0.74%	0.64%	-0.10%	0.01%	-0.02%
3	1.07%	0.99%	1.05%	0.92%	-0.13%	-0.07%	-0.15%
5	1.65%	1.63%	1.54%	1.37%	-0.17%	-0.26%	-0.28%
7	1.97%	2.06%	1.93%	1.75%	-0.18%	-0.31%	-0.22%
10	2.17%	2.33%	2.20%	2.06%	-0.14%	-0.27%	-0.11%
30	2.75%	3.11%	2.93%	2.88%	-0.05%	-0.23%	0.13%

Macro Uncertainty, Commodity Weakness Pressure Spreads

Global macro concerns remained high in September, pushing yield spreads to some of the widest levels in three years. Investors sought the liquidity and safety of U.S. Government-guaranteed securities (note relatively stable spreads on Agency debentures and pass-throughs in table at right). Falling commodity prices continued to pressure investment-grade corporate spreads in commodity-related sectors (Industrials widened 31 bps for the quarter) while Corporate High Yield spreads widened 154 bps for the quarter to 630 bps, now 147 bps wider than year end.

Option-Adjusted Spreads (in bps)

	12/31/14	6/30/15	8/31/15	9/30/15	1Mo Chg	3Q Chg	YTD Chg
U.S. Aggregate Index	48	51	57	59	2	8	11
U.S. Agency (non-mortgage)	16	18	14	17	3	-1	1
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	27	26	27	31	4	5	4
Asset-Backed Securities	58	62	61	69	8	7	11
CMBS	98	101	112	108	-4	7	10
Corporate Sectors							
U.S. Investment Grade	131	145	163	169	6	24	38
Industrial	140	153	177	184	7	31	44
Utility	119	137	149	152	3	15	33
Financial Institutions	117	133	142	145	3	12	28
U.S. High Yield	483	476	544	630	86	154	147

Source: Barclays

Mixed Returns - High Yield and TIPS Lag

Falling yields kept nominal returns positive for the quarter with the exception of High Yield and TIPS. U.S. Treasuries led the pack (+1.76%) for the quarter, while spread sectors such as Corporates (+0.83%) had more modest absolute performance. Sectors with shorter average durations (ABS +0.74%) benefitted less from the drop in yields. Fundamental stress combined with High Yield fund outflows caused the High Yield sector to post the worst quarterly returns (-4.86%) by a wide margin, and falling inflation expectations pressed TIPS returns into negative territory (-1.15%).

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	September	3rd Quarter	YTD
U.S. Aggregate Index	0.68%	1.23%	1.13%
U.S. Gov't/Credit Index	0.70%	1.20%	0.90%
U.S. Intermediate Gov't/Credit Index	0.67%	0.95%	1.77%
U.S. 1-3 Yr. Gov't/Credit Index	0.30%	0.29%	1.02%
U.S. Treasury	0.88%	1.76%	1.80%
U.S. Agency	0.56%	1.06%	1.66%
MBS (Mortgage-Backed Securities)	0.58%	1.30%	1.61%
CMBS (Commercial Mortgage-Backed Securities)	1.22%	1.54%	2.24%
ABS (Asset-Backed Securities)	0.45%	0.74%	1.83%
U.S. Corporate - Investment Grade	0.75%	0.83%	-0.10%
Corporate High Yield	-2.60%	-4.86%	-2.45%
Municipal Bond Index	0.72%	1.65%	1.77%
TIPS (Treasury Inflation Protected Securities)	-0.59%	-1.15%	-0.80%

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.