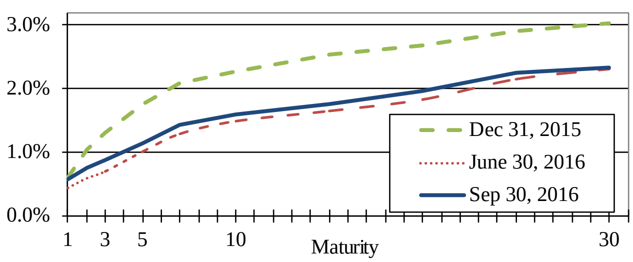
Baird Advisors
Fixed Income Market Comments
September 2016

Yields Rise Post-Brexit; Market Anticipates Fed Rate Hike

Treasury yields hit record lows early in July, only to rebound later in the quarter, with the 10-year ending the quarter 11 bps higher at 1.60%. The UK's June 23rd referendum decision to leave the European Union surprised markets, creating additional global growth concerns and contributing to record low interest rates. Concerns moderated later in the quarter and interest rate volatility subsided as U.S. economic data showed the modest expansion was still on solid ground (nonfarm payrolls averaged +232K for the last three months) and that the U.K. economy was not slowing as much as expected. In September the Fed left the Fed Funds rate unchanged "for the time being"; however, 3 of the 10 voting committee members dissented, expressing their desire to raise rates immediately. The Fed's statement left the chance of a rate move this year firmly on the table as they stated near term risks to their economic outlook were "roughly balanced". The committee also lowered its median projections for the path of rate increases in future years. Market-implied odds of a rate hike in 2016 have risen to nearly 60%, up from less than 10% at the start of the quarter. A rate hike would mark a further divergence in central bank policies as the U.S. continues to exit post-crisis extraordinary monetary stimulus. At the same time foreign central banks in Japan and Europe continue to increase stimulus through unconventional means such as negative rates and the large scale purchases of bonds including corporates. This month the Bank of Japan (BOJ) left its policy rate unchanged at -0.10% while introducing the concept of "yield curve control"- targeting a yield of 0.00% for Japan's 10yr and an inflation rate *above* its 2% target.

Treasury Yields



Maturity	12/31/15	6/30/16	8/31/16	9/30/16	1Mo Chg	3Mo Chg	YTD Chg
1	0.60%	0.44%	0.59%	0.58%	-0.01%	0.14%	-0.02%
2	1.05%	0.59%	0.79%	0.76%	-0.03%	0.17%	-0.29%
3	1.31%	0.70%	0.90%	0.87%	-0.03%	0.17%	-0.44%
5	1.76%	1.01%	1.18%	1.15%	-0.03%	0.14%	-0.61%
7	2.09%	1.29%	1.44%	1.43%	-0.01%	0.14%	-0.66%
10	2.27%	1.49%	1.57%	1.60%	0.03%	0.11%	-0.67%
30	3.02%	2.31%	2.23%	2.33%	0.10%	0.02%	-0.69%

In Spite of Heavy Supply, Spreads End Quarter Tighter

Investment grade corporate spreads widened modestly in September on more than $155B in new corporate bond issuance; however, strong demand (including foreign buying, which we previously highlighted) helped tighten spreads 18 bps over the quarter to 138 bps. In similar fashion, CMBS ended the quarter 14 bps tighter in spite of elevated supply in September. U.S corporate high yield ended the quarter 114 bps tighter as investors stretched for yield in lower quality issues.

Option-Adjusted Spreads (in bps)

	12/31/15	6/30/16	8/31/16	9/30/16	1Mo Chg	3Mo Chg	YTD Chg
U.S. Aggregate Index	56	55	47	47	0	-8	-9
U.S. Agency (non-mortgage)	21	21	22	21	-1	0	0
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	24	27	15	14	-1	-13	-10
Asset-Backed Securities	72	61	59	55	-4	-6	-17
CMBS	121	98	78	84	6	-14	-37
Corporate Sectors							
U.S. Investment Grade	165	156	135	138	3	-18	-27
Industrial	183	159	138	140	2	-19	-43
Utility	150	142	130	132	2	-10	-18
Financial Institutions	134	152	131	137	6	-15	3
U.S. High Yield	660	594	490	480	-10	-114	-180

Sources: Bloomberg Barclays

Mixed Monthly, Quarterly Returns, Strong YTD

Returns were mixed for the month, but most spread sectors ended the quarter in positive territory. Only Treasuries and Munis posted negative quarterly returns, as higher yields across the curve hurt performance. U.S. investment grade corporates delivered the highest returns of all investment grade sectors in the quarter (+1.41%). High yield corporates, however, generated the strongest returns overall for the quarter (+5.55%) as the sector followed the post-Brexit recovery in equities and other risk assets. Agency mortgage-backed securities had a strong quarter (+0.60%) as interest rate volatility continued to subside and modestly higher mortgage rates eased investor prepayment concerns.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	September	Q3	YTD
U.S. Aggregate Index	-0.06%	0.46%	5.80%
U.S. Gov't/Credit Index	-0.19%	0.40%	6.66%
U.S. Intermediate Gov't/Credit Index	0.13%	0.16%	4.24%
U.S. 1-3 Yr. Gov't/Credit Index	0.11%	0.02%	1.68%
U.S. Treasury	-0.13%	-0.28%	5.07%
U.S. Agency	0.09%	0.14%	3.42%
MBS (Mortgage-Backed Securities)	0.28%	0.60%	3.72%
CMBS (Commercial Mortgage-Backed Securities)	-0.21%	0.59%	6.55%
ABS (Asset-Backed Securities)	0.26%	0.20%	2.74%
U.S. Corporate - Investment Grade	-0.25%	1.41%	9.20%
Corporate High Yield	0.67%	5.55%	15.11%
Municipal Bond Index	-0.50%	-0.30%	4.01%
TIPS (Treasury Inflation Protected Securities)	0.55%	0.96%	7.27%

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.