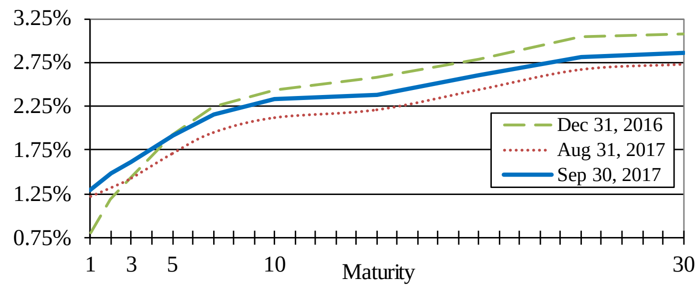
Baird Advisors
Fixed Income Market Comments
September 2017

Yields Rise in September but are Little Changed for the Quarter

Treasury yields rose across the curve in September on a more hawkish tone from Fed Chair Janet Yellen, signs of improvement in the U.S. and global economy, and early optimism regarding the recently released Trump/GOP tax reform framework. Yields in the intermediate segment of the curve (3 – 10 years) led the move higher in rates (up ~20 bps), while changes both shorter and longer were more muted. Rising rates in September reversed the entire decline earlier in the quarter, resulting in very modest yield increases and curve flattening for the quarter. The market had a lot to consider this quarter including an unprecedented cluster of three Category 4 hurricanes in less than 30 days; two hit the U.S. mainland and the third left Puerto Rico with massive damage. In addition, geopolitical tensions ran high following a series of missile launches by North Korea, leading to condemnation from global leaders. Yet, investors remained focused on the Fed's September meeting, in which the committee forecast one additional fed funds rate hike in 2017 and announced an October start of its previously-outlined plan to gradually reduce its balance sheet of Treasuries and Agency Mortgage-Backed Securities. Market-implied odds of a December rate hike rose to 70% after having fallen as low as 20% in early September. In contrast, the ECB chose in September to leave its QE program unchanged, making the ECB and BOJ as the two largest central banks that continue to increase their balance sheets. Despite all of the market challenges, demand for fixed income assets remained strong as YTD mutual fund inflows through September were $283B, nearly 50% above the $190B of inflows for all of 2016.

Treasury Yields



Maturity	12/31/16	6/30/17	8/31/17	9/30/17	1Mo Chg	3Mo Chg	YTD Chg
1	0.81%	1.22%	1.22%	1.29%	0.07%	0.07%	0.48%
2	1.19%	1.38%	1.32%	1.48%	0.16%	0.10%	0.29%
3	1.45%	1.54%	1.43%	1.61%	0.18%	0.07%	0.16%
5	1.93%	1.88%	1.71%	1.92%	0.21%	0.04%	-0.01%
7	2.25%	2.14%	1.95%	2.16%	0.21%	0.02%	-0.09%
10	2.44%	2.30%	2.12%	2.33%	0.21%	0.03%	-0.11%
30	3.07%	2.84%	2.73%	2.86%	0.13%	0.02%	-0.21%

Corporate Credit, Agency MBS Spreads Tighten in Quarter

Corporate credit spreads tightened in September on strong demand and solid credit fundamentals recouping more than the prior month's widening and ended the quarter 8 bps tighter at 101 bps. Strong demand and benign interest rate volatility allowed Agency Pass-through spreads to tighten 10bps in the third quarter. The sector is seemingly undeterred by the Fed's well-telegraphed plans to taper reinvestment purchases in the sector, commencing in October. The Fed's balance sheet normalization plans are set to reduce reinvestment in MBS by $12 B for the remainder of 2017 and ramp to a total of $168 B reduction in 2018.

Option-Adjusted Spreads (in bps)

	12/31/16	6/30/17	8/31/17	9/30/17	1Mo Chg	3Mo Chg	YTD Chg
U.S. Aggregate Index	43	43	42	38	-4	-5	-5
U.S. Agency (non-mortgage)	21	15	16	15	-1	0	-6
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	15	32	30	22	-8	-10	7
U.S. Agency CMBS	47	44	42	45	3	1	-2
U.S. Non-Agency CMBS	93	94	87	88	1	-6	-5
Asset-Backed Securities	59	46	41	44	3	-2	-15
Corporate Sectors							
U.S. Investment Grade	123	109	110	101	-9	-8	-22
Industrial	125	112	116	105	-11	-7	-20
Utility	117	110	105	100	-5	-10	-17
Financial Institutions	120	103	101	93	-8	-10	-27
U.S. High Yield	409	364	378	347	-31	-17	-62

Source: Bloomberg Barclays Indices

Quarterly Returns: Corporates Outperform, ABS Lags

In spite of a modest rise in interest rates, all sectors posted positive returns for the quarter. Investment Grade corporates (+1.34%) outperformed other higher quality sectors, while High Yield corporates (+1.98%) had the best performance overall, aided by rising equity markets.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	September	3 Mo	YTD
U.S. Aggregate Index	-0.48%	0.85%	3.14%
U.S. Gov't/Credit Index	-0.57%	0.81%	3.49%
U.S. Intermediate Gov't/Credit Index	-0.45%	0.60%	2.34%
U.S. 1-3 Yr. Gov't/Credit Index	-0.12%	0.34%	1.06%
U.S. Treasury	-0.86%	0.38%	2.26%
U.S. Agency	-0.48%	0.41%	2.07%
MBS (Mortgage-Backed Securities)	-0.22%	0.96%	2.32%
CMBS (Commercial Mortgage-Backed Securities)	-0.95%	0.79%	2.99%
ABS (Asset-Backed Securities)	-0.23%	0.42%	1.56%
U.S. Corporate - Investment Grade	-0.17%	1.34%	5.19%
Corporate High Yield	0.90%	1.98%	7.00%
Municipal Bond Index	-0.51%	1.06%	4.66%
TIPS (Treasury Inflation Protected Securities)	-0.64%	0.86%	1.72%

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.

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.