Baird Advisors
Fixed Income Market Commentary
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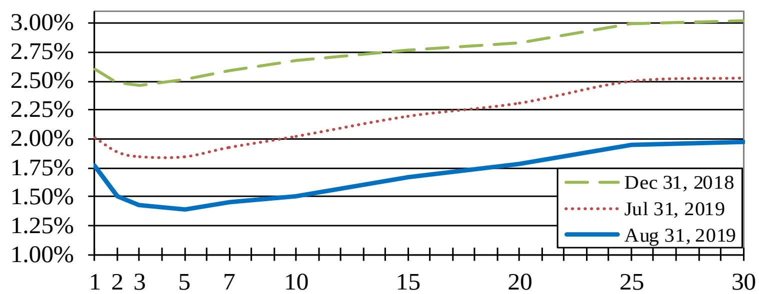
Rates Plunge on Sharp Escalation in U.S./China Trade War Amid Slowing Global Growth

The Treasury market produced its strongest monthly return in eight years as rates plunged in reaction to the sharp escalation in the U.S./China trade war, the expected negative impact on an already slowing global economy and the likely further easing by the Fed, ECB and other central banks. Long-term Treasury rates fell more than other maturity segments, leading to a flatter curve. The benchmark 10yr yield declined by 52 bps in August to close the month at 1.50%, just 14 bps above the record low of 1.36% set in 2016. Out longer, 30yr Treasury yields fell to new lows, closing at 1.97%, below the previous record close of 2.11%. While U.S. rates traded at or near record lows, they remained in positive territory, unlike nearly $17T of negatively yielding global debt, including over $1T of corporate debt. The unprecedented global yield environment illustrates both the abundance of global liquidity as well as heightened uncertainty and slower growth. On August 1, Trump surprised the market by announcing 10% tariffs on the remaining $300B of Chinese goods, effective September 1, prompting China to impose retaliatory tariffs of 5% and 10% on $75B of U.S. goods. President Trump responded with a 5% increase in tariffs on the entire $550B of Chinese imports – bringing total tariffs to 30% on $250B and 15% on the remaining $300B of Chinese goods. Furthermore he gave a nonbinding directive over Twitter that "American companies are hereby ordered to immediately start looking for an alternative to China." At the Jackson Hole, WY economic summit, Fed Chair Jay Powell admitted that "fitting trade policy uncertainty into this [monetary policy] framework is a new challenge" for the Fed. Other "hot spots" of focus for investors around the world include the approaching October 31 Brexit deadline, with odds of a no-deal exit rising, as well as continued protests in Hong Kong against mainland Chinese policies.

Treasury Yields



Maturity	12/31/18	7/31/19	8/31/19	1Mo Chg	YTD
1	2.60%	2.01%	1.77%	-0.24%	-0.83%
2	2.49%	1.89%	1.51%	-0.38%	-0.98%
3	2.46%	1.85%	1.43%	-0.42%	-1.03%
5	2.51%	1.84%	1.39%	-0.45%	-1.12%
7	2.59%	1.93%	1.46%	-0.47%	-1.13%
10	2.68%	2.02%	1.50%	-0.52%	-1.18%
30	3.02%	2.53%	1.97%	-0.55%	-1.05%

Corporate Spreads Widen on Growth, Trade Concerns

Corporate spreads widened 12 bps in August to 120 bps as global growth slowed and the U.S./China trade war escalated with both sides imposing additional tariffs. Agency Mortgage Pass-Throughs widened 9 bps to 47 bps, as investors reacted to heightened prepayments in a falling interest rate environment. Spreads on asset-backed securities (ABS) tightened 5 bps to 34 bps, as investors sought high-quality investments.

Treasuries Outperform, Emerging Market Debt Drops

Treasuries (+3.40%) led the pack this month as investors flocked to safe-haven assets. Despite spread widening, Corporates benefitted from a longer duration than other sectors, and posted very strong returns in August (+3.14%) over High Yield Corporates as the highest-returning sector YTD (+13.94% vs +11.00% respectively). In contrast, Emerging Market bonds dropped -4.35% as Argentina's crisis worsened and the Argentine Treasury delayed payment on $7B of bills coming due this year.

Option-Adjusted Spreads (in bps)

	12/31/18	7/31/19	8/31/19	1Mo Chg	YTD Chg
U.S. Aggregate Index	54	42	48	6	-6
U.S. Agency (non-mortgage)	16	13	10	-3	-6
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	35	38	47	9	12
U.S. Agency CMBS	55	44	51	7	-4
U.S. Non-Agency CMBS	107	76	82	6	-25
Asset-Backed Securities	53	39	34	-5	-19
Corporate Sectors					
U.S. Investment Grade	153	108	120	12	-33
Industrial	157	114	128	14	-29
Utility	144	104	116	12	-28
Financial Institutions	147	97	107	10	-40
Other Govt. Related	90	73	77	4	-13
U.S. High Yield Corporates	526	371	393	22	-133
Emerging Market Debt	560	488	640	152	80

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	August	YTD	Effective Duration (years)
U.S. Aggregate Index	2.59%	9.10%	5.75
U.S. Gov't/Credit Index	3.26%	10.56%	7.04
U.S. Intermediate Gov't/Credit Index	1.77%	6.79%	3.93
U.S. 1-3 Yr. Gov't/Credit Index	0.81%	3.47%	1.89
U.S. Treasury	3.40%	8.63%	6.69
U.S. Agency (Non-Mortgage)	2.20%	6.47%	4.01
U.S. Agency Pass-Throughs	0.89%	5.53%	2.40
CMBS (Commercial Mortgage Backed Securities)	2.38%	9.38%	5.31
ABS (Asset-Backed Securities)	1.09%	4.28%	2.14
U.S. Corporate Investment Grade	3.14%	13.94%	7.89
U.S. High Yield Corporates	0.40%	11.00%	3.07
Emerging Market Debt	-4.35%	5.91%	4.62
Municipal Bond Index	1.58%	7.61%	5.20
TIPS (Treasury Inflation Protected Securities)	2.38%	9.06%	4.77

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.