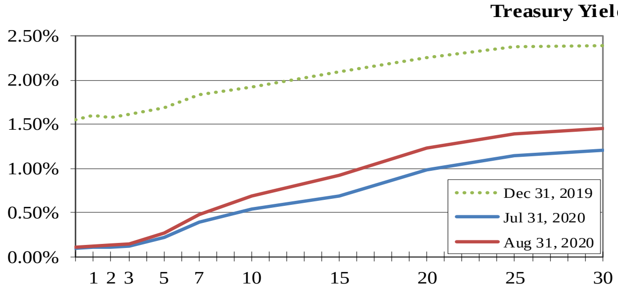
Baird Advisors
Fixed Income Market Commentary
August 2020

Curve Steepens as Fed Adjusts Monetary Policy to Target More Inflation, Housing Thrives on Low Mortgage Rates

The Treasury yield curve steepened in August with short maturities little changed, the 10yr Treasury rising 15 bps to finish the month at 0.69%, and the 30yr ending 25 bps higher at 1.45%. At its (virtual) Jackson Hole Economic Symposium, Fed Chair Powell released what he called a "robust updating" of monetary policy which included a "Statement on Longer-Run Goals and Monetary Policy Strategy." As expected, the Fed will move to an inflation target that *averages* 2% over time, which after an extended period of sub-2% inflation, means the Fed would tolerate inflation overshooting 2% going forward for some time. The change was due to the Fed's evolving understanding of four key economic developments: a decline of the potential longer-run growth rate, a decrease in the general level of interest rates closer to the zero lower bound, labor market gains shared widely across society when labor markets are tight, and tight labor markets did not cause a concerning rise in inflation. In response, inflation expectations for the next decade embedded in the TIPs market rose 25 bps from 1.55% to 1.80% in August. Higher nominal yields in August were also driven by improving economic data and positive developments in the fight to contain Covid-19, as equity markets posted the best August returns in 34 years. Housing has been boosted by record low interest rates which pushed both new and existing home sales well above consensus estimates in July, even though initial unemployment claims continue to hover over one million per week. Congress has ceased active negotiations on a Phase Four fiscal relief package, though the market still expects that a deal around $1.5 trillion will be done by the end of September. The Republican and Democratic parties held their mostly-virtual conventions, with few surprises, as President Trump and Joe Biden were officially selected as their party's nominee for President.

Treasury Yields



Maturity	12/31/19	7/31/20	8/31/20	1Mo Chg	YTD
3 Mo	1.55%	0.09%	0.10%	0.01%	-1.45%
1	1.60%	0.11%	0.12%	0.01%	-1.48%
2	1.57%	0.11%	0.13%	0.02%	-1.44%
3	1.61%	0.12%	0.15%	0.03%	-1.46%
5	1.69%	0.22%	0.26%	0.04%	-1.43%
7	1.83%	0.39%	0.48%	0.09%	-1.35%
10	1.92%	0.54%	0.69%	0.15%	-1.23%
30	2.39%	1.20%	1.45%	0.25%	-0.94%

Spreads Grind Tighter, Record Corporate Issuance, Reduced ABS Issuance

Corporate spreads tightened a modest 4 bps to +129 despite another month of very heavy supply. Corporate issuers continued to take advantage of record low yields as issuance was the highest ever for the month of August, exceeding $160B. Asset-Backed Securities tightened the most of any investment grade sector in August, with spreads compressing 14 bps to end the month at 46 bps in this short duration sector. Demand for high quality bonds such as ABS (the ABS index yields 0.59%) was very strong, as yield from short Treasuries has withered, with the 1-3yr Treasury index yield declining to a meager 0.14%. Meanwhile, ABS issuance has declined sharply YTD as consumer credit issuance has slowed due to the pandemic. Non-Agency CMBS tightened 12 bps to 148 bps, partly catching up but remaining one of the widest high-quality sectors as the virus caused a high degree of uncertainty in sub-sectors such as hotels and retail. Emerging Market Debt tightened 58 bps to 647 bps buoyed by a weaker U.S. dollar, a recovering global economy led by China, and demand from yield-starved investors in one of the highest-yielding below investment grade sectors.

Option-Adjusted Spreads (in bps)

	12/31/19	7/31/20	8/31/20	1Mo Chg	YTD Chg
U.S. Aggregate Index	39	60	57	-3	18
U.S. Agency (non-mortgage)	10	22	17	-5	7
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	39	58	56	-2	17
U.S. Agency CMBS	53	65	59	-6	6
U.S. Non-Agency CMBS	85	160	148	-12	63
Asset-Backed Securities	44	60	46	-14	2
Corporate Sectors					
U.S. Investment Grade	93	133	129	-4	36
Industrial	99	138	135	-3	36
Utility	97	130	134	4	37
Financial Institutions	80	122	117	-5	37
Other Govt. Related	72	87	82	-5	10
U.S. High Yield Corporates	336	488	477	-11	141
Emerging Market Debt	573	705	647	-58	74

Source: Bloomberg Barclays Indices

Returns Mixed in the Month, Firmly Positive YTD – Except for EM

The Fed's official policy shift on inflation contributed to the underperformance of longer-duration segments of the market as the yield curve steepened in August, while many shorter-duration sectors still generated positive returns. Emerging Market Debt was the top performing sector in the month, returning +2.02%, but it remains the only sector in negative territory YTD at -0.61%.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	August	YTD	Effective Duration (years)
U.S. Aggregate Index	-0.81%	6.85%	6.09
U.S. Gov't/Credit Index	-1.16%	8.09%	7.68
U.S. Intermediate Gov't/Credit Index	-0.12%	5.94%	4.11
U.S. 1-3 Yr. Gov't/Credit Index	0.04%	3.11%	1.92
U.S. Treasury	-1.10%	8.75%	7.22
U.S. Agency (Non-Mortgage)	-0.27%	5.23%	3.73
U.S. Agency Pass-Throughs	0.04%	3.73%	1.99
CMBS (Commercial Mortgage Backed Securities)	0.14%	6.62%	5.32
ABS (Asset-Backed Securities)	0.25%	4.01%	2.13
U.S. Corporate Investment Grade	-1.38%	6.94%	8.67
U.S. High Yield Corporates	0.95%	1.67%	3.60
Emerging Market Debt	2.02%	-0.61%	4.90
Municipal Bond Index	-0.47%	3.31%	5.35
TIPS (Treasury Inflation Protected Securities)	1.09%	9.63%	5.50

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.