Baird Advisors
Fixed Income Market Comments
December 2009

Bonds Bounce Back (in a BIG way)

After nearly *dying on the table* in 2008, the bond market staged a remarkable recovery in 2009 as unprecedented Government intervention and ultra-aggressive Fed policy successfully turned investors' paralyzing fear of risk back toward an eye for opportunity. In response to the dramatic turnaround in investor sentiment, sectors that plunged in 2008 skyrocketed in 2009. High yield (-26.16%/2008 vs. +58.21%/2009), CMBS (–20.52% vs. +28.45%), asset-backeds (-12.72% vs. +24.72%) and investment grade corporates (-4.94% vs. +18.68%) made the most dramatic comebacks from abysmal performances in 2008 while municipals (-2.47% vs. +12.91%) and TIPS (-2.35% vs. +11.41%) also made impressive leaps from more modest declines the prior year. In contrast, Treasuries, which had an impressive +13.74% return in 2008 on an historic flight to quality, fell in 2009 (-3.57%) as Treasury issuance surged and investors opted for more *yieldy* sectors. Direct secondary market purchases by the US Government (several hundred $billion worth) of Government Agency debentures and Agency guaranteed mortgage pass-throughs (MBS Sector) enabled these two sectors to again post positive returns of +1.95% and +5.89% respectively in 2009 after impressive 2008 returns of +9.08% and +8.34%. While sector returns varied sharply, broader index returns in 2009 were surprisingly close to their returns in 2008. For example, the Aggregate Index returned +5.93% this year after +5.24% last year.

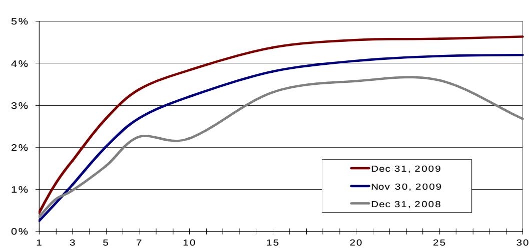
Total Returns of Selected Barclays Capital Sectors and Indices

Sector/Index	December	4th Quarter	2009	2008
US Treasury Sector	-2.61%	-1.30%	-3.57%	13.74%
Gov't Agency Sector	-1.28%	-0.03%	1.95%	9.08%
Corporate Sector	-0.78%	1.35%	18.68%	-4.94%
MBS Sector	-1.41%	0.57%	5.89%	8.34%
CMBS Sector	0.34%	3.27%	28.45%	-20.52%
ABS Sector	-0.09%	1.34%	24.72%	-12.72%
Municipal Sector	0.34%	-0.96%	12.91%	-2.47%
TIPS	-2.19%	1.76%	11.41%	-2.35%
High Yield Sector	3.28%	6.19%	58.21%	-26.16%
BC Aggregate Index	-1.56%	0.20%	5.93%	5.24%
BC Gov't/Credit Index	-1.77%	-0.21%	4.52%	5.70%
BC Int. Gov't/Credit Index	-1.46%	0.31%	5.24%	5.08%
BC 1-3 yr. Gov't/Credit Index	-0.58%	0.38%	3.83%	4.97%

Yield Curve Steepens

While short-term yields remained low (pegged to the Fed's zero Fed Funds target), the yield curve steepened sharply in 2009 as stimulus-driven inflation concerns and heavy new Treasury supply pushed long-term Treasury yields higher by nearly 200 bps. The spread between 2 year and 30 year Treasuries briefly hit an all-time high of 375 bps on December 10 but ended the year at 350 bps. Rates remained volatile in 2009 with Treasury yields rising over 60 bps in December alone (see chart and table below).

Treasury Yields (Source: Bloomberg)

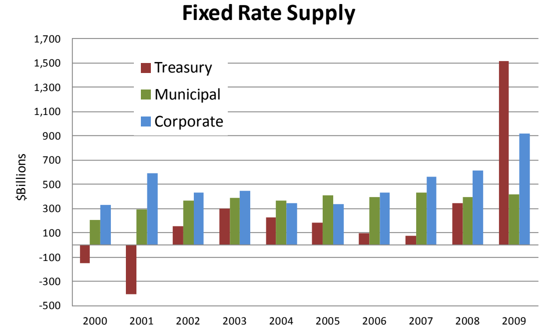


Maturity	Dec 31, 2008	Nov 30, 2009	Dec 31, 2009	1 mo. change	1 yr. change
1	0.34%	0.24%	0.44%	0.20	0.10
2	0.76%	0.66%	1.14%	0.48	0.38
3	0.97%	1.10%	1.68%	0.58	0.71
5	1.55%	2.00%	2.68%	0.68	1.13
10	2.21%	3.20%	3.84%	0.64	1.63
30	2.68%	4.19%	4.64%	0.45	1.96

Heavy New Supply

Unprecedented Government stimulus resulted in record Treasury issuance. Net new supply of Treasury notes and bonds spiked to an all-time high of $1.5 trillion in 2009 from $340 billion in 2008 (see chart at right). Investment grade corporate issuance also surged to a record $918 billion (up from a prior record of $608 billion last year) as companies flocked to take advantage of strong investor demand and rebuilt liquidity into their balance sheets. Municipal issuance was steady at $410 billion with Build America Bonds (BABs) comprising approximately 16% ($65 billion). BABs, which are taxable, are effectively reducing true tax-exempt supply and could grow to as much as 30% of municipal issuance next year.

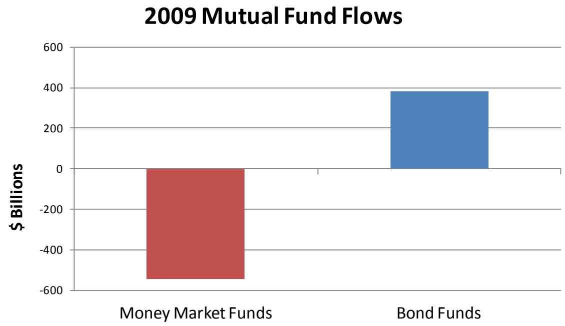
Fixed Rate Supply



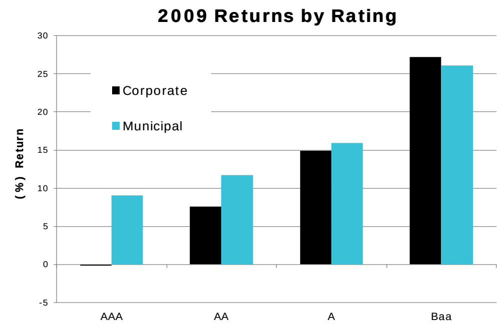
Source: US Treasury, Bond Buyer, Barclays Capital

Strong Demand Absorbs Supply

Heavy supply in 2009 was easily absorbed by strong investor demand. Disenchanted with near-zero money market yields, investors pulled over $545 billion out of money market funds during the year in search of higher yielding alternatives. The bond market was the chief beneficiary and fixed income mutual funds had inflows of over $380 billion (see below left). This incoming flood of liquidity *floated all boats higher* in the bond market, but lower quality bonds dramatically outperformed higher quality issues in 2009. In both the taxable and tax-exempt markets, investors went searching for yield and BBBs outperformed AAAs by a very wide margin (see below right).



Source: ICI



Source: Barclays Capital

Yield Spreads Collapse

The remarkable recovery of the bond market in 2009 is best reflected in the collapse of yield spreads on non-Treasury sectors and the resulting huge excess returns (see table at right). Many sectors went from being grossly undervalued early in the year to fairly valued and even *rich* in some cases by the end of 2009. Yield spreads on most sectors more than recovered from last year's meltdown, tightening below 12/31/07 levels and even below their 10-year average spread. For example, in the asset-backed sector, the TALF program restored liquidity and helped tighten option-adjusted spreads from 955 bps to just 100 bps by year end, resulting in an excess return of 24.96%. ABS spreads are now tighter than where they finished 2007 (242 bps) and also below the 10-year average of 160 bps. Direct government purchases in 2009 of Agency debentures and Agency pass-through MBS tightened spreads in these sectors to just 30 and 19 bps respectively on 12/31/09 (highlighted in yellow). With an end in sight to further Government purchases and spreads well below 12/31/07 levels and their 10-year averages, we see very limited value in these sectors as we head into 2010. We are also cautious on high yield and many industrial credits given uncertain credit fundamentals and relatively tight yield spreads. Two sectors where we still see good relative value (albeit on a selective basis) are Finance and CMBS. Government support and the deleveraging of financial institutions' balance sheets, although painful to equity holders, have strengthened the position of bondholders of financial companies and while significant challenges lie ahead for the commercial real estate market, we believe bondholders can also find adequate protection in certain senior CMBS structures where very strong structural credit enhancement provides a significant margin of safety. We believe these two sectors offer bondholders unique protection and, while spreads have come in significantly, they are still wider than long-term averages and 12/31/07 levels.

Option-Adjusted Spreads and Excess Returns

Source: Barclays Capital

	Option-Adjusted Spreads (bps)				Excess Returns v.s. U.S. Treasuries (bps)	
	12/31/2007	12/31/2008	12/31/2009	10 yr Avg OAS	2008	2009
U.S. Aggregate Index	91	213	61	75	-710	746
U.S. Agency (non-mortgage) Sector	43	93	30	43	-110	238
Mortgage and ABS Sectors						
U.S. Agency Pass-Throughs	87	145	18	51	-232	495
Asset-Backed Securities	242	955	100	160	-2223	2496
CMBS	170	1010	473	201	-3274	2960
Corporate Sectors						
U.S. Investment Grade	198	555	172	175	-1988	2276
Industrial	181	500	138	173	-1756	2312
Utility	189	537	161	179	-2039	2780
Financial Institutions	220	629	226	177	-2209	2141
U.S. High Yield	569	1669	617	616	-3832	5955

Outlook

While the "super sale" opportunities of early 2009 are clearly gone, we do still see value in the bond market in 2010. However, in contrast to 2009 where a dramatic recovery from a state of disarray produced eye-popping returns for virtually all spread sector issues, we believe the bond market will be much more discriminating in 2010, focusing more closely once again on risk and the credit fundamentals of individual issues. As the market settles into the "new normal", *crisis-level* volatility in yield spreads should subside. We expect solid, positive market returns, but it is [virtually] mathematically impossible for many spread sectors to once again produce returns of last years' magnitude. Heavy Treasury supply will put upward pressure on interest rates and weigh on relative returns of this sector, but we do not anticipate significantly higher market yields overall. We believe the economy is fragile and while mammoth Government stimulus will likely contribute to inflation in the long run, weak employment dynamics will keep inflation in check for the short run. We agree with market consensus that the Fed will begin tightening later this year, but believe that surprises from the Fed will likely be from less action rather than more. As a result, we believe the yield curve will remain steep (particularly in the intermediate sector) providing strong roll-down potential to issues with very limited cash flow uncertainty (i.e. positive convexity). More limited Government buying of Agency debentures and mortgage pass-throughs will limit the relative return potential of these *tight-spread* sectors in 2010. Furthermore, we believe relative return prospects for Agency mortgage pass-throughs will dim as investors, who have been preoccupied with the virtue of Government guarantees in this sector, will once again become more sensitive to the risk of higher negative convexity. Expectations of higher marginal income tax rates and increased BABs issuance should provide technical support for [tax-exempt] municipals, but we are concerned about declining credit fundamentals in this sector and caution that prevalent downgrades could result in selective price declines in this sector.

Indices and subsectors are unmanaged and an investment cannot be made directly in an index or a sector.