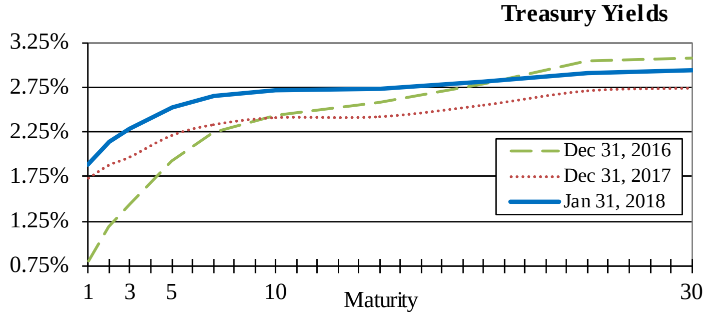
Baird Advisors
Fixed Income Market Commentary
January 2018

Yields Rise on Higher Growth and Inflation Expectations

Treasury yields rose across the curve last month as investors reassessed their outlook for both growth and inflation. The curve flattened modestly overall, though steepened in the 2yr to 10yr segment as the 10-year Treasury yield rose 31 bps to 2.72% - the highest level in 4 years. While 4Q U.S. GDP grew slightly below expectations at +2.6%, the outlook for growth over the next several quarters rose due to the corporate and personal tax cuts. The IMF raised the global growth outlook for 2018 to 3.9% up from 3.7% in 2017 as the synchronous global expansion continues. This improvement in growth outside of the U.S coupled with the uncertainty of whether the Trump administration is committed to a strong dollar policy going forward and rising “twin” U.S. deficits (budget and trade) kept downward pressure on the U.S. dollar, which fell another 3% in January and is off nearly 12% since early 2017. Inflation expectations rose last month as 10-year breakeven rates (the difference between nominal Treasury yields and TIPS) rose 13 bps to 2.11%. While the fed funds rate target remained unchanged at 1.25%-1.50% at Chair Yellen’s last meeting, the December meeting minutes showed some discussion of “alternative frameworks for monetary policy,” due to the “persistent shortfall of inflation from the Committee’s 2% objective.” That discussion hints that the committee might allow inflation to rise over the 2% target for a period of time to make up for past shortfalls. This uncertainty around the Fed’s inflation target is likely also contributing to the weaker U.S. dollar. The new Fed Chair, Jerome “Jay” Powell, will preside over the March meeting where the market anticipates a 25 bps fed funds rate hike. As of month end, the market is pricing a 65% probability of 3 rate hikes in 2018, which would bring the fed funds rate target to 2.00%-2.25% by year end.

Treasury Yields



Maturity	12/31/16	12/31/17	1/31/18	1Mo Chg
1	0.81%	1.73%	1.89%	0.16%
2	1.19%	1.88%	2.14%	0.26%
3	1.45%	1.97%	2.29%	0.32%
5	1.93%	2.21%	2.52%	0.31%
7	2.25%	2.33%	2.66%	0.33%
10	2.44%	2.41%	2.72%	0.31%
30	3.07%	2.74%	2.94%	0.20%

Spreads Tighten on Strong Fundamentals

Markets continued to price in the fundamental boost of tax cuts to corporations, helping Investment Grade Corporate spreads tighten 7 bps in the month to 86 bps. Non-Agency CMBS tightened 9bps to 70bps as relatively light January issuance was met with strong demand. High Yield tightened 24bps in the month, maintaining a high correlation to the strong performance in equity markets. Option-Adjusted Spreads on Agency Pass-throughs were unchanged, as prepayment/extension risks were heightened by rising interest rate volatility.

Negative Returns to Start 2018

In the wake of rising Treasury yields, all investment grade sectors posted negative returns to start the year. U.S. Treasuries posted the worst overall returns (-1.36%). Short-duration spread sectors such as ABS (-0.29%) weathered rising rates much better, while High Yield Corporates (+0.60%) were the exception, generating positive total returns.

Option-Adjusted Spreads (in bps)

	12/31/16	12/31/17	1/31/18	1Mo Chg
U.S. Aggregate Index	43	36	34	-2
U.S. Agency (non-mortgage)	21	14	12	-2
Mortgage and ABS Sectors				
U.S. Agency Pass-throughs	15	25	25	0
U.S. Agency CMBS	47	35	34	-1
U.S. Non-Agency CMBS	93	79	70	-9
Asset-Backed Securities	59	36	33	-3
Corporate Sectors				
U.S. Investment Grade	123	93	86	-7
Industrial	125	98	89	-9
Utility	117	92	85	-7
Financial Institutions	120	85	80	-5
U.S. High Yield	409	343	319	-24

Source: Bloomberg Barclays Indices

Total Returns of Selected Barclays Indices and Subsectors

Barclays Index/Sector	January 2018	*2017*
U.S. Aggregate Index	-1.15%	*3.54%*
U.S. Gov’t/Credit Index	-1.15%	*4.00%*
U.S. Intermediate Gov’t/Credit Index	-0.88%	*2.14%*
U.S. 1-3 Yr. Gov’t/Credit Index	-0.27%	*0.84%*
U.S. Treasury	-1.36%	*2.31%*
U.S. Agency	-0.73%	*2.06%*
MBS (Mortgage Backed Securities)	-1.17%	*2.47%*
CMBS (Commercial Mortgage Backed Securities)	-1.09%	*3.35%*
ABS (Asset Backed Securities)	-0.29%	*1.55%*
U.S. Corporate - Investment Grade	-0.96%	*6.42%*
Corporate High Yield	0.60%	*7.50%*
Municipal Bond Index	-1.18%	*5.45%*
TIPS (Treasury Inflation Protected Securities)	-0.86%	*3.01%*

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.