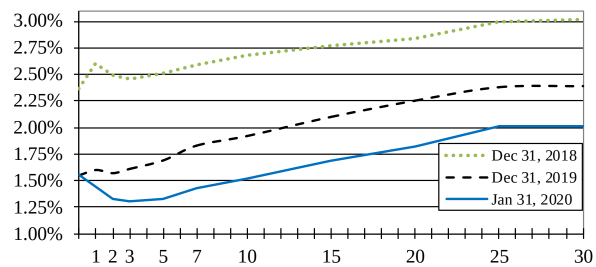
Baird Advisors
Fixed Income Market Commentary
January 2020

Yields Decline, Curve Flattens/Inverts as Fed Leave Rates Unchanged, Coronavirus Concerns Grow

The benchmark 10yr Treasury ended the month at 1.52%, down 0.40% from the end of 2019 as the curve flattened and inverted again as the 3mo Treasury bill (1.55%) yielded more than the 10yr on 1/31. The Fed unanimously voted to keep rates unchanged at 1.50%-1.75% in January, as Fed Chair Jerome Powell made it clear that the FOMC would need to see a material change in the economy before instituting a change in their policy rate. In addition, the Fed extended repo operations at least until April 2020 to avoid another spike in repo rates like mid-September of last year. Powell did cite several causes for concern including the China coronavirus, sluggish growth abroad, and rocky trade negotiations. The coronavirus continued to spread, with the World Health Organization reporting more confirmed cases than the SARS outbreak of 2002-2003. Fears of the disease becoming a pandemic and substantially detracting from global growth contributed to market volatility at the end of the month. Although unemployment remains historically low, the Fed changed its categorization of household spending growth from "strong" to "moderate." Low inflation remains a concern, as Core PCE came in at +1.6% YoY and Powell commented that the Fed is "..not satisfied with inflation running below 2%." The impeachment trial of President Trump continued in the U.S. Senate as the market anticipates a vote acquitting the President of charges as early as the first week of February. The U.S. Presidential primary season begins in earnest in early February for the Democratic party, with caucuses in Iowa and primary voting in New Hampshire. Overseas, the UK officially left the EU – a union it had been part of since 1973 – at the end of the January, fulfilling the will of the voters from the June 2016 referendum. A bi-lateral trade agreement between the UK and the EU is next with an ambitious year-end deadline that may need to be extended.

Treasury Yields



Maturity	12/31/18	9/30/19	12/31/19	1/31/20	1Mo Chg
3 Mo	2.37%	1.82%	1.55%	1.55%	0.00%
1	2.60%	1.77%	1.60%	1.44%	-0.16%
2	2.49%	1.62%	1.57%	1.33%	-0.24%
3	2.46%	1.56%	1.61%	1.31%	-0.30%
5	2.51%	1.55%	1.69%	1.33%	-0.36%
7	2.59%	1.62%	1.83%	1.43%	-0.40%
10	2.68%	1.68%	1.92%	1.52%	-0.40%
30	3.02%	2.12%	2.39%	2.01%	-0.38%

Corporates & Agency MBS Widen, CMBS & ABS Tighten

Investment Grade Corporates widened 9 bps in January to 102 bps in response to coronavirus pandemic fears. Agency Pass-throughs also widened 9 bps to end the month at 48 bps as the sharp drop in interest rates led to heightened mortgage refinancing activity - a negative for investors in MBS that trade at premium dollar prices. In light of the yield curve inversion, demand surged for high-quality, short-duration assets as Asset-Backed Securities tightened 13 bps to 31 bps.

CMBS, Longer Maturities Outperform to Start the Year

CMBS (+2.49%) posted the highest total return to start the year, as demand for high-quality assets was particularly strong and issuance was easily absorbed. Corporates (+2.34%) posted the second-highest total returns as long maturities outperformed shorter sectors. High Yield Corporates barely posted positive returns (+0.03%) as the sector bore the brunt of virus-related global growth concerns.

Option-Adjusted Spreads (in bps)

	12/31/18	9/30/19	12/31/19	1/31/20	1Mo Chg
U.S. Aggregate Index	54	46	39	44	5
U.S. Agency (non-mortgage)	16	11	10	10	0
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	35	46	39	48	9
U.S. Agency CMBS	55	52	53	50	-3
U.S. Non-Agency CMBS	107	82	85	79	-6
Asset-Backed Securities	53	37	44	31	-13
Corporate Sectors					
U.S. Investment Grade	153	115	93	102	9
Industrial	157	121	99	110	11
Utility	144	113	97	102	5
Financial Institutions	147	103	80	87	7
Other Govt. Related	90	78	72	75	3
U.S. High Yield Corporates	526	373	336	390	54
Emerging Market Debt	560	612	573	609	36

Source: Bloomberg Barclays Indices

Total Returns of Selected Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	2019	January	Effective Duration (yrs)
U.S. Aggregate Index	8.72%	1.92%	5.85
U.S. Gov't/Credit Index	9.71%	2.38%	7.10
U.S. Intermediate Gov't/Credit Index	6.80%	1.42%	3.93
U.S. 1-3 Yr. Gov't/Credit Index	4.03%	0.55%	1.87
U.S. Treasury	6.86%	2.44%	6.67
U.S. Agency (Non-Mortgage)	5.89%	1.54%	3.98
U.S. Agency Pass-Throughs	6.35%	0.70%	2.62
CMBS (Commercial Mortgage Backed Securities)	8.29%	2.49%	5.32
ABS (Asset-Backed Securities)	4.53%	0.99%	2.15
U.S. Corporate Investment Grade	14.54%	2.34%	8.05
U.S. High Yield Corporates	14.32%	0.03%	3.07
Emerging Market Debt	10.90%	0.82%	4.77
Municipal Bond Index	7.54%	1.80%	5.16
TIPS (Treasury Inflation Protected Securities)	8.43%	2.10%	5.24

Disclosures

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.

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.