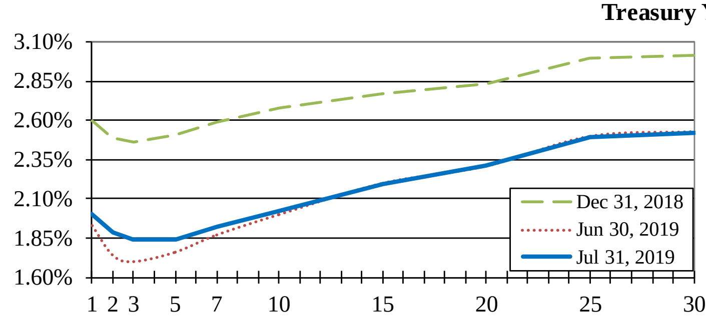
Baird Advisors
Fixed Income Market Commentary
July 2019

Fed Cuts Rates by 25 bps on "Weak Global Growth and Trade Tensions," in Step with Other Global Central Banks

The 2yr Treasury rate rose 15 bps in July to 1.89%, while the 10yr rose a mere 2 bps to 2.02% as the Fed cut rates despite a solid +224K June nonfarm payroll report and better-than-expected GDP growth (+2.1% actual vs. +1.8% consensus estimate). On July 31 the Fed cut the federal funds rate by 25 bps to a 2.00%-2.25% range, the first cut since December 2008. However the 25 bps cut disappointed some market participants, who had assigned a higher probability to a 50 bps cut. The Fed also announced an immediate end to its balance sheet runoff, two months earlier than planned. Fed Chair Powell described the cut as a "midcycle adjustment," which he suggested was "to ensure against downside risks from weak global growth and trade tensions." Powell noted that "trade policy tensions nearly boiled over in May and June, but now appear to have returned to a simmer." *(On August 1, only one day after Powell's comments, Trump threatened 10% tariffs on an additional $300B of Chinese imports.)* The Fed move followed similar cuts by several other global central banks (e.g. Australia, New Zealand, India, Korea, et al) and the ECB signaled a likely cut in September. Christine Lagarde, nominated to succeed ECB President Mario Draghi in October, is expected to continue to support (if not further) the bank's negative interest rate policy. Elsewhere in Europe, Boris Johnson succeeded Theresa May as UK Prime Minister, increasing the possibility of a no-deal Brexit on October 31, weighing on the slowing European growth outlook. Finally, President Trump and Congress reached a budget agreement which boosts federal spending over the next two years and pushed the federal debt limit beyond the 2020 elections, reducing the odds of a government shutdown.

Treasury Yields



Maturity	12/31/18	3/31/19	6/30/19	7/31/19	1Mo Chg	YTD
1	2.60%	2.39%	1.93%	2.01%	0.08%	-0.59%
2	2.49%	2.27%	1.74%	1.89%	0.15%	-0.60%
3	2.46%	2.22%	1.70%	1.85%	0.15%	-0.61%
5	2.51%	2.24%	1.76%	1.84%	0.08%	-0.67%
7	2.59%	2.32%	1.87%	1.93%	0.06%	-0.66%
10	2.68%	2.41%	2.00%	2.02%	0.02%	-0.66%
30	3.02%	2.82%	2.53%	2.53%	0.00%	-0.49%

Corporate Spreads Tighten as Fed Eases, Flows Remain Strong

Corporate spreads tightened 7 bps in July to 108 bps as the Fed eased and fixed income fund industry inflows continued at record pace. Year-to-date flows into fixed income mutual funds and ETFs now exceed $250B according to ICI data, on pace to break the previous high set in 2017. Meanwhile corporate gross supply for July was manageable at just over $100B. Thus far, companies reporting second quarter earnings have posted flat to slightly positive earnings growth, exceeding conservative estimates for a small decline. Spreads in high quality mortgage and asset-backed sectors also tightened in the month. As interest rate volatility was relatively benign, Agency Pass-throughs tightened 8 bps, reversing some of the widening earlier this year.

Option-Adjusted Spreads (in bps)

	12/31/18	3/31/19	6/30/19	7/31/19	1Mo Chg	YTD Chg
U.S. Aggregate Index	54	44	46	42	-4	-12
U.S. Agency (non-mortgage)	16	13	14	13	-1	-3
Mortgage and ABS Sectors						
U.S. Agency Pass-throughs	35	35	46	38	-8	3
U.S. Agency CMBS	55	45	47	44	-3	-11
U.S. Non-Agency CMBS	107	85	83	76	-7	-31
Asset-Backed Securities	53	39	41	39	-2	-14
Corporate Sectors						
U.S. Investment Grade	153	119	115	108	-7	-45
Industrial	157	125	120	114	-6	-43
Utility	144	116	115	104	-11	-40
Financial Institutions	147	109	103	97	-6	-50
Other Govt. Related	90	76	78	73	-5	-17
U.S. High Yield Corporates	526	391	377	371	-6	-155
Emerging Market Debt	560	493	504	488	-16	-72

Source: Bloomberg Barclays Indices

Emerging Market, Municipal Bonds Outperform in July

Strong demand helped Emerging Market bonds (+1.15%) post the best overall returns in the month as non-government sectors outperformed. Municipal bonds (+0.81%) also delivered some of the highest returns as light new issue supply has been met by very strong demand. In contrast, shorter-duration sectors such as ABS (-0.02%) posted slightly negative returns as the Fed delivered a smaller interest rate cut than some expected, causing short-term market yields to rise.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	July	YTD	Effective Duration (years)
U.S. Aggregate Index	0.22%	6.35%	5.71
U.S. Gov't/Credit Index	0.15%	7.06%	6.77
U.S. Intermediate Gov't/Credit Index	-0.03%	4.93%	3.90
U.S. 1-3 Yr. Gov't/Credit Index	-0.06%	2.65%	1.88
U.S. Treasury	-0.12%	5.06%	6.37
U.S. Agency (Non-Mortgage)	0.01%	4.18%	4.07
U.S. Agency Pass-Throughs	0.40%	4.59%	3.07
CMBS (Commercial Mortgage Backed Securities)	0.21%	6.84%	5.28
ABS (Asset-Backed Securities)	-0.02%	3.16%	2.12
U.S. Corporate Investment Grade	0.56%	10.47%	7.68
U.S. High Yield Corporates	0.56%	10.56%	3.19
Emerging Market Debt	1.15%	10.73%	4.72
Municipal Bond Index	0.81%	5.94%	5.53
TIPS (Treasury Inflation Protected Securities)	0.36%	6.53%	5.24

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.