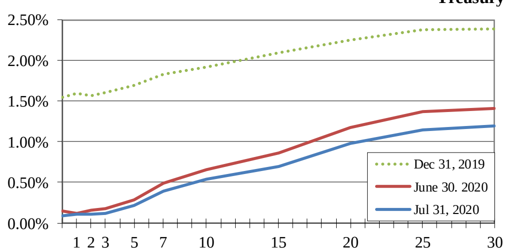
Baird Advisors
Fixed Income Market Commentary
July 2020

Treasury Yields Move Lower on Surging Covid-19 Cases, Slowing Economic Recovery and Escalating China Tensions

The 10yr Treasury yield declined 11 bps to end the month at 0.54% as the yield curve modestly flattened, with rates at all maturities falling. States had been reopening their economies, but spikes in new Covid-19 cases – especially in the South – have required targeted rollbacks to reopening plans, including bar reclosings, reduced restaurant capacities and mandatory mask orders. These reopening rollbacks are slowing the momentum of the economic recovery that began in May as evidenced by first time weekly unemployment claims starting to move higher in the back half of July after steady declines since the late March peak. The Fed met in July and reiterated its support for the economy by extending the unprecedented lending programs and leaving rates near zero with Fed Chair Jerome Powell stating that the Fed's "not even thinking about thinking about thinking about raising rates." Buoyed by the Fed's supportive policy, according to the Freddie Mac Primary Mortgage Market Survey, 30yr mortgage rates reached a historic low of 2.98%; the first time below 3%, contributing to a surge in refinancing activity, elevated new purchase mortgage applications and an increase in homebuilder confidence. This unprecedented government policy support, particularly by the Fed, along with continued positive news on the development of a vaccine – two leading vaccine candidates began Phase 3 trials – are the two main pillars supporting financial markets. On the fiscal side, Democrats and Republicans in Congress are trying to pass another relief package, but the two sides remain far apart on certain key points, including the amount of supplemental federal unemployment aid, relief for state and local governments and liability protection for businesses. Tensions between the U.S. and China continue to increase, with a wide range of potential outcomes. After the passage of Hong Kong's security law last month, China appears to be targeting Taiwan, including unsuccessfully trying to force senior Taiwanese officials to sign a "one China" pledge that recognizes Beijing's sovereignty over Taiwan. History-making U.S. real GDP for Q2 was reported in July at an annualized rate of -32.9% – in line with market expectations – as the magnitude of the negative economic impact of the mandated shutdown from the first wave of Covid-19 is now known. This unprecedented drop marks the sharpest decline since records began in 1947 and much worse than the 8.4% annualized decline in Q4 2008. The GDP figure coincided with the U.S economy generating $17.2 trillion of real annualized GDP, which is back to output levels from the beginning of 2015, and roughly $2 trillion below the recent $19.2 trillion cycle peak as of December 31, 2019.

Treasury Yields



Maturity	12/31/19	3/31/20	6/30/20	7/31/20	1Mo Chg	YTD
3 Mo	1.55%	0.12%	0.15%	0.09%	-0.06%	-1.46%
1	1.60%	0.16%	0.16%	0.11%	-0.05%	-1.49%
2	1.57%	0.23%	0.15%	0.11%	-0.04%	-1.46%
3	1.61%	0.29%	0.18%	0.12%	-0.06%	-1.49%
5	1.69%	0.38%	0.29%	0.22%	-0.07%	-1.47%
7	1.83%	0.57%	0.49%	0.39%	-0.10%	-1.44%
10	1.92%	0.70%	0.65%	0.54%	-0.11%	-1.38%
30	2.39%	1.36%	1.41%	1.20%	-0.21%	-1.19%

Corporate Spreads Tighten on Strong Flows, Fed Support

Corporate spreads tightened 17 bps in July to 133 bps as fixed income fund industry inflows continued a strong rebound since March. YTD Fund flows reached approximately $90B of inflows (rebounding from nearly $200B of outflows in Q1) according to ICI data. In addition, credit supply in July was $94B, down 9% YoY from July 2019, and well below the extremely elevated $277B per month average supply issued in March-June. Non-Agency CMBS spreads tightened 18 bps on the month, moving in line with corporate spreads, but also benefitting from limited supply and early discussions of a potential relief package targeted for commercial real estate borrowers. High Yield Corporates tightened a remarkable 138 bps to 488 bps, also lifted by strong institutional demand, and a slowdown in defaults and downgrades.

High Yield and IG Corporates Outperform, Pass-Throughs Lag

High Yield Corporates (+4.69%) offered the highest total returns followed by Investment Grade Corporates (+3.25%). EM had a strong month (+2.64%), though it remains the only category in negative territory YTD (-2.58%). In contrast, Pass-throughs lagged in July (+0.18%) as greater-than-expected prepayments (at par) detracted from performance on the bonds which have an average price over $107 in the index.

Option-Adjusted Spreads (in bps)

	12/31/19	3/31/20	6/30/20	7/31/20	1Mo Chg	YTD Chg
U.S. Aggregate Index	39	95	68	60	-8	21
U.S. Agency (non-mortgage)	10	49	21	22	1	12
Mortgage and ABS Sectors						
U.S. Agency Pass-throughs	39	60	70	58	-12	19
U.S. Agency CMBS	53	116	69	65	-4	12
U.S. Non-Agency CMBS	85	238	178	160	-18	75
Asset-Backed Securities	44	213	68	60	-8	16
Corporate Sectors						
U.S. Investment Grade	93	272	150	133	-17	40
Industrial	99	276	156	138	-18	39
Utility	97	254	146	130	-16	33
Financial Institutions	80	268	139	122	-17	42
Other Govt. Related	72	164	97	87	-10	15
U.S. High Yield Corporates	336	880	626	488	-138	152
Emerging Market Debt	573	1254	744	705	-39	132

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	July	YTD	Effective Duration (years)
U.S. Aggregate Index	1.49%	7.72%	6.09
U.S. Gov't/Credit Index	2.01%	9.36%	7.77
U.S. Intermediate Gov't/Credit Index	0.75%	6.06%	4.10
U.S. 1-3 Yr. Gov't/Credit Index	0.19%	3.07%	1.91
U.S. Treasury	1.14%	9.96%	7.28
U.S. Agency (Non-Mortgage)	0.44%	5.52%	3.72
U.S. Agency Pass-Throughs	0.18%	3.69%	1.68
CMBS (Commercial Mortgage Backed Securities)	1.22%	6.47%	5.34
ABS (Asset-Backed Securities)	0.42%	3.75%	2.14
U.S. Corporate Investment Grade	3.25%	8.44%	8.79
U.S. High Yield Corporates	4.69%	0.71%	3.53
Emerging Market Debt	2.64%	-2.58%	4.85
Municipal Bond Index	1.68%	3.80%	5.18
TIPS (Treasury Inflation Protected Securities)	2.30%	8.44%	5.31

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.