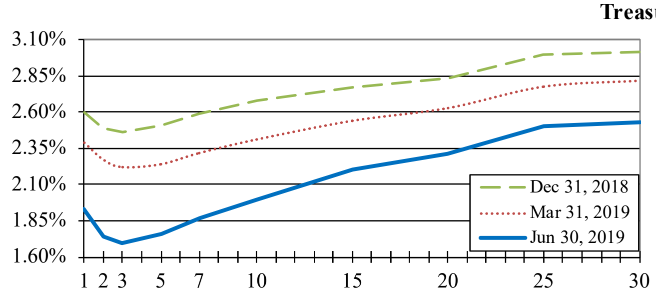
**Baird Advisors**
**Fixed Income Market Commentary**
**June 2019**

## Treasury Yields Fall on Signs of Slowing Growth, Anticipation of Fed Rate Cuts and Global Central Bank Easing

Rates fell and the curve steepened in June, extending the trend for the quarter and year, as signs of slowing global growth drove markets to anticipate fed rate cuts in the coming quarter and further easing from foreign central banks. The Treasury curve steepened this quarter as 2yr yields fell 53 bps, more than the drop in 10yr (41 bps) or 30yr (29 bps) yields. Economic data showed signs of slower growth: May nonfarm payrolls grew by a modest 75K jobs and even those gains were offset by an equal -75K downward revision in prior two months' data. Heightened global trade and geopolitical concerns weighed on economic activity as surveys showed a slowing in U.S. manufacturing activity. Market sentiment shifted in the quarter, anticipating more accommodative monetary policy. Fed Chair Powell opened the door to rate cuts: in the FOMC press release, the reference to a "patient" approach to policy was dropped and in his post-meeting press conference he omitted any references to the recent modest inflation data as "transitory." Last month the Core PCE inflation level held steady at 1.6% YoY, down from just 2% in July 2018, which suggests the current fed funds target range of 2.25% - 2.50% may be more restrictive than intended. At quarter end, market-implied odds of a rate cut were 100% for the July 31st FOMC meeting with a roughly 25% probability that the Fed would cut rates by 50 bps at that meeting. The Fed's dovish pivot has been mirrored globally: European Central Bank President Draghi stated in June that "additional stimulus will be required" if inflation data doesn't improve. The ECB left its policy rate unchanged at *negative* 0.40% and the German 10yr yield hit a new record low of *negative* 0.30% in the quarter. In spite of a temporary truce between President Trump and President Xi at the G-20 meeting (no additional tariffs; lifting some restrictions on Huawei), uncertainty remains high around the U.S.-China trade dispute. Meanwhile, in Britain, potential successors to Theresa May as Prime Minister continue to discuss alternate Brexit strategies, trying to avoid a no-deal Brexit by the October 31st deadline.

**Treasury Yields**




| Maturity | 12/31/18 | 3/31/19 | 5/31/19 | 6/30/19 | 1Mo Chg | Q2 Chg | YTD |
|---|---|---|---|---|---|---|---|
| 1 | 2.60% | 2.39% | 2.22% | 1.93% | -0.29% | -0.46% | -0.67% |
| 2 | 2.49% | 2.27% | 1.94% | 1.74% | -0.20% | -0.53% | -0.75% |
| 3 | 2.46% | 2.22% | 1.90% | 1.70% | -0.20% | -0.52% | -0.76% |
| 5 | 2.51% | 2.24% | 1.93% | 1.76% | -0.17% | -0.48% | -0.75% |
| 7 | 2.59% | 2.32% | 2.03% | 1.87% | -0.16% | -0.45% | -0.72% |
| 10 | 2.68% | 2.41% | 2.14% | 2.00% | -0.14% | -0.41% | -0.68% |
| 30 | 3.02% | 2.82% | 2.58% | 2.53% | -0.05% | -0.29% | -0.49% |

## Corporate Spreads Tighten on Fed Expectations, Strong Flows

Corporate spreads tightened 13 bps in June, ending the quarter modestly tighter at 115 bps as markets started to expect a rate cut from the Fed and fixed income fund industry inflows ran at record pace. YTD Fund flows exceeded $190B according to ICI data as flows into fixed income mutual funds and ETFs exceeded the record-setting pace seen in 2017. Furthermore, corporate gross and net supply has been very manageable, declining 5% vs last year's pace. Concerns around heightened prepayment risks in Agency Pass-throughs contributed to an 11 bps widening over the quarter, ending at 46 bps. High Yield Corporates tightened 56 bps in June, recovering from a sharp widening the prior month driven by trade worries, ending the quarter 14 bps tighter at 377 bps.

**Option-Adjusted Spreads (in bps)**

| | 12/31/18 | 3/31/19 | 5/31/19 | 6/30/19 | 1Mo Chg | Q2 Chg | YTD Chg |
|---|---|---|---|---|---|---|---|
| U.S. Aggregate Index | 54 | 44 | 49 | 46 | -3 | 2 | -8 |
| U.S. Agency (non-mortgage) | 16 | 13 | 12 | 14 | 2 | 1 | -2 |
| Mortgage and ABS Sectors | | | | | | | |
| U.S. Agency Pass-throughs | 35 | 35 | 44 | 46 | 2 | 11 | 11 |
| U.S. Agency CMBS | 55 | 45 | 46 | 47 | 1 | 2 | -8 |
| U.S. Non-Agency CMBS | 107 | 85 | 80 | 83 | 3 | -2 | -24 |
| Asset-Backed Securities | 53 | 39 | 32 | 41 | 9 | 2 | -12 |
| Corporate Sectors | | | | | | | |
| U.S. Investment Grade | 153 | 119 | 128 | 115 | -13 | -4 | -38 |
| Industrial | 157 | 125 | 136 | 120 | -16 | -5 | -37 |
| Utility | 144 | 116 | 122 | 115 | -7 | -1 | -29 |
| Financial Institutions | 147 | 109 | 116 | 103 | -13 | -6 | -44 |
| Other Govt. Related | 90 | 76 | 78 | 78 | 0 | 2 | -12 |
| U.S. High Yield Corporates | 526 | 391 | 433 | 377 | -56 | -14 | -149 |
| Emerging Market Debt | 560 | 493 | 549 | 504 | -45 | 11 | -56 |

*Source: Bloomberg Barclays Indices*

## Corporates Outperform, Agency Pass-Throughs Lag in Q2

Investment Grade Corporates (+4.48%) posted the best overall returns in the quarter as non-government and longer-duration sectors outperformed. In contrast, Agency Pass-Throughs (+1.96%) posted the lowest sector returns, as heightened prepayments on premium-priced bonds detracted from returns.

**Total Returns of Selected Bloomberg Barclays Indices and Subsectors**

| | June | Q2 | YTD | Effective Duration (years) |
|---|---|---|---|---|
| U.S. Aggregate Index | 1.26% | 3.08% | 6.11% | 5.73 |
| U.S. Gov't/Credit Index | 1.48% | 3.53% | 6.90% | 6.76 |
| U.S. Intermediate Gov't/Credit Index | 1.07% | 2.59% | 4.97% | 3.92 |
| U.S. 1-3 Yr. Gov't/Credit Index | 0.56% | 1.48% | 2.71% | 1.89 |
| U.S. Treasury | 0.92% | 3.01% | 5.18% | 6.38 |
| U.S. Agency (Non-Mortgage) | 0.70% | 2.32% | 4.17% | 4.01 |
| U.S. Agency Pass-Throughs | 0.72% | 1.96% | 4.17% | 3.15 |
| CMBS (Commercial Mortgage Backed Securities) | 1.00% | 3.28% | 6.62% | 5.27 |
| ABS (Asset-Backed Securities) | 0.42% | 1.67% | 3.17% | 2.15 |
| U.S. Corporate Investment Grade | 2.45% | 4.48% | 9.85% | 7.64 |
| U.S. High Yield Corporates | 2.28% | 2.50% | 9.94% | 3.23 |
| Emerging Market Debt | 3.59% | 3.38% | 9.47% | 4.70 |
| Municipal Bond Index | 0.37% | 2.14% | 5.09% | 5.50 |
| TIPS (Treasury Inflation Protected Securities) | 0.86% | 2.86% | 6.15% | 1.13 |

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.