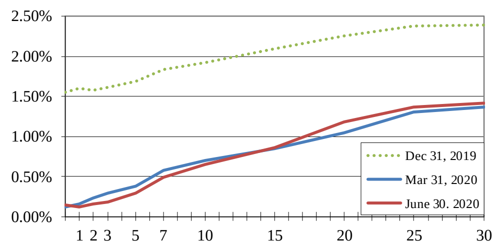
Baird Advisors
Fixed Income Market Commentary
June 2020

Yields Nearly Unchanged in June, Curve Modestly Steeper in Q2, Sharp Recovery in Risk Assets, Continued Fed Backstop

The 10yr Treasury yield ended June at 0.65%, rising a mere 1 bp in the month, but down 5 bps for the quarter and 127 bps for the year. The yield curve steepened modestly in the second quarter, as the 30yr rose 5 bps to 1.41%, while yields on 1yr to 10yr maturities declined by a similar amount. The Fed's balance sheet increased from $4 trillion at the start of the year to over $7 trillion as the Fed continues its extremely accommodative bond buying program. Since resuming large scale purchases in March, the Fed has purchased $1.7T of Treasuries, nearly $800B of Agency Pass-throughs, over $9B of Agency CMBS, and almost $9B of Credit ETFs and individual corporate bonds. In response to the historic policy actions by the Fed coordinated with equally historic fiscal policy by Congress and the Treasury to go along with a better than expected reopening of the economy, equities made the largest and most rapid post-bear market rally since the Great Depression as the S&P 500 index returned +20.5% for the quarter. The Fed's meeting minutes still showed pessimism, stating "The recovery in consumer spending was not expected to be particularly rapid beyond this year, with voluntary social distancing, precautionary saving, and lower levels of employment and income restraining the pace of expansion over the medium term" and "the economy is likely to need support from highly accommodative monetary policy for some time." The initial economic rebound has clearly been better than expected. Nonfarm payrolls grew by 2.5M jobs in May in arguably the largest economic data surprise ever as the consensus forecast called for a 7.5M **decline**. A rebound in retail sales (+17.7% May, -14.7% April) confirmed this initial bounce. However, it remains to be seen if this can continue as the pace of U.S. daily positive cases of Covid-19 reached new highs, exceeding 50,000/day with Dr. Fauci warning that the pace of new cases could exceed 100,000/day without significant changes to behavior. States such as Arizona, Florida, and Texas have had to pause or partially reverse their reopening plans, as cases have skyrocketed, especially among a younger demographic. On June 30, Beijing enacted a national security law that further limited Hong Kong's autonomy, and may lead to additional trade tensions and tariffs between the U.S. and China, further escalating the overall risk environment.

Treasury Yields



Maturity	12/31/19	3/31/20	5/31/20	6/30/20	1Mo Chg	Q2 Chg	YTD
3 Mo	1.55%	0.12%	0.14%	0.15%	0.01%	0.03%	-1.40%
1	1.60%	0.16%	0.17%	0.16%	-0.01%	0.00%	-1.44%
2	1.57%	0.23%	0.16%	0.15%	-0.01%	-0.08%	-1.42%
3	1.61%	0.29%	0.19%	0.18%	-0.01%	-0.11%	-1.43%
5	1.69%	0.38%	0.30%	0.29%	-0.01%	-0.09%	-1.40%
7	1.83%	0.57%	0.49%	0.49%	0.00%	-0.08%	-1.34%
10	1.92%	0.70%	0.64%	0.65%	0.01%	-0.05%	-1.27%
30	2.39%	1.36%	1.40%	1.41%	0.01%	0.05%	-0.98%

Corporate Spreads Tighten on Strong Demand, Stimulus

Massive spread tightening in the quarter was made possible by the unprecedented amount of monetary and fiscal stimulus and the better-than-expected initial resurgence in hiring and economic activity as states began to reopen. In the quarter, a record-setting $834B of fixed rate, Investment Grade Credit issuance was met with strong demand from investors as fund flows turned massively positive, and the Fed purchased nearly $9B of Corporate Credit ETFs and individual bonds. Credit spreads tightened 122 bps to end the quarter at 150 bps, while Asset-Backed Securities tightened 145 bps to 68 bps on solid demand and greatly reduced supply. U.S. Agency Pass-throughs were the only sector with wider spreads, ending the quarter 10 bps wider at 70 bps. This widening was driven by index-provider Bloomberg's prepayment model update. Without the update, spreads would have been roughly 20 bps tighter for the quarter. The update incorporates pandemic-related hurdles to refinancing activity. However, last month's faster-than-projected prepayment speeds indicate that originators are quickly moving online and overcoming obstacles related to social distancing.

Option-Adjusted Spreads (in bps)

	12/31/19	3/31/20	5/31/20	6/30/20	1Mo Chg	Q2 Chg	YTD Chg
U.S. Aggregate Index	39	95	76	68	-8	-27	29
U.S. Agency (non-mortgage)	10	49	23	21	-2	-28	11
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	39	60	73	70	-3	10	31
U.S. Agency CMBS	53	116	81	69	-12	-47	16
U.S. Non-Agency CMBS	85	238	213	178	-35	-60	93
Asset-Backed Securities	44	213	111	68	-43	-145	24
Corporate Sectors							
U.S. Investment Grade	93	272	174	150	-24	-122	57
Industrial	99	276	176	156	-20	-120	57
Utility	97	254	161	146	-15	-108	49
Financial Institutions	80	268	174	139	-35	-129	59
Other Govt. Related	72	164	106	97	-9	-67	25
U.S. High Yield Corporates	336	880	637	626	-11	-254	290
Emerging Market Debt	573	1254	822	744	-78	-510	171

Source: Bloomberg Barclays Indices

EM Debt Outperforms, Treasuries Lag for the Quarter

The Emerging Market Debt sector posted the highest total return in Q2 (+13.77%), despite poor performers such as Venezuela bonds which plummeted in price and were removed from the index in the quarter. Investment Grade Corporates posted strong returns for the quarter (+8.98%), while Treasuries had weakest quarterly returns (+0.48%). In spite of this, Treasuries remain the top performing asset YTD (+8.71%).

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	June	Q2	YTD	Effective Duration (yrs)
U.S. Aggregate Index	0.63%	2.90%	6.14%	6.04
U.S. Gov't/Credit Index	0.87%	3.71%	7.21%	7.59
U.S. Intermediate Gov't/Credit Index	0.62%	2.81%	5.28%	4.09
U.S. 1-3 Yr. Gov't/Credit Index	0.20%	1.17%	2.88%	1.91
U.S. Treasury	0.09%	0.48%	8.71%	7.15
U.S. Agency (Non-Mortgage)	0.19%	0.88%	5.06%	3.73
U.S. Agency Pass-Throughs	-0.09%	0.67%	3.50%	2.07
CMBS (Commercial Mortgage Backed Securities)	1.62%	3.95%	5.19%	5.33
ABS (Asset-Backed Securities)	1.07%	3.54%	3.32%	2.11
U.S. Corporate Investment Grade	1.96%	8.98%	5.02%	8.54
U.S. High Yield Corporates	0.98%	10.18%	-3.80%	3.90
Emerging Market Debt	3.94%	13.77%	-5.09%	4.77
Municipal Bond Index	0.82%	2.72%	2.08%	5.42
TIPS (Treasury Inflation Protected Securities)	1.12%	4.24%	6.01%	4.35

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.