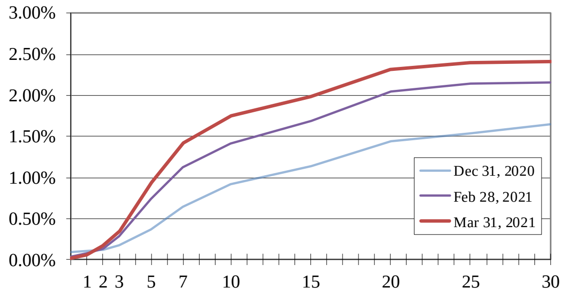
Baird Advisors
Fixed Income Market Commentary
March 2021

Rates Rise Quickly as Fiscal Stimulus, Vaccine Rollout Lead to Higher Growth & Inflation Expectations

The 10yr Treasury yield rose 82 bps this quarter to end March at 1.74%, and the yield curve steepened (particularly in the 2 – 10yr segment) as 2-year rates were anchored by the Fed's expectations that short rates will need to remain near zero through 2023 to achieve their dual mandate of full employment and price stability as defined by a 2% average inflation rate. In addition to continued accommodative monetary policy, large fiscal stimulus was passed in the quarter and the vaccine rollout accelerated faster than expected, which caused already-lofty 2021 GDP expectations to be revised to a higher 6 – 8% range, which would be the fastest pace since 1984. Fueling the investor optimism on growth was the accelerating pace of vaccinations and business/school openings across the country. Nearly three million vaccine doses were being administered daily by quarter-end and new Covid cases declined to 57,000/day (from 250,000 at year-end). President Biden signed the $1.9T American Relief Plan Act (ARPA) which provides the equivalent of 9% of annual GDP in fiscal stimulus with much of it expected to be spent this year. Even more, the President outlined a $2.25 trillion infrastructure plan (The American Jobs Plan) with spending spread over an 8-year period, the cost of which would be partially offset by higher corporate taxes. Higher YoY inflation data is expected in coming months, as outright monthly price declines (deflation) from March and April of last year fall out of the YoY inflation rate calculation. However, investors are also concerned that supply chain bottlenecks may sustain inflation at higher levels for an extended period. Fed Chair Jay Powell disagrees, saying he did not expect the economic activity to "produce substantially higher prices or that the effects will be persistent."

Treasury Yields



Maturity	12/31/19	12/31/20	2/28/21	3/31/21	1Mo Chg	Q1 Chg
3 Mo	1.55%	0.09%	0.04%	0.02%	-0.02%	-0.07%
1	1.60%	0.11%	0.07%	0.06%	-0.01%	-0.05%
2	1.57%	0.12%	0.13%	0.16%	0.03%	0.04%
3	1.61%	0.17%	0.28%	0.35%	0.07%	0.18%
5	1.69%	0.36%	0.73%	0.94%	0.21%	0.58%
7	1.83%	0.65%	1.13%	1.42%	0.29%	0.77%
10	1.92%	0.92%	1.41%	1.74%	0.33%	0.82%
30	2.39%	1.65%	2.16%	2.42%	0.26%	0.77%

Spreads Tighter Across Most Market Segments YTD

Spreads tightened during the quarter across most market segments, with High Yield Corporates tightening the most (-50 bps) and ending the quarter at just 310 bps. Investment Grade Corporate spreads were a modest 5 bps tighter despite much higher than anticipated supply in the quarter ($524B gross and $217B net). The impact of supply was muted by continued very strong inflows into fixed income mutual funds and ETFs. Agency Pass-throughs tightened -27 bps, ending the quarter at 12 bps, as the Fed continued its rapid pace of Quantitative Easing purchases. However, roughly 10 bps of the tightening was due to an update of Bloomberg's prepayment model rather than from market demand. Emerging Market Debt (+20 bps) widened, ending the quarter at 523 bps.

Option-Adjusted Spreads (in bps)

	12/31/20	2/28/21	3/31/21	1Mo Chg	Q1 Chg
U.S. Aggregate Index	42	34	31	-3	-11
U.S. Agency (non-mortgage)	10	4	4	0	-6
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	39	20	12	-8	-27
U.S. Agency CMBS	44	38	34	-4	-10
U.S. Non-Agency CMBS	109	94	99	5	-10
Asset-Backed Securities	33	29	35	6	2
Corporate Sectors					
U.S. Investment Grade	96	90	91	1	-5
Industrial	101	95	93	-2	-8
Utility	106	97	99	2	-7
Financial Institutions	83	77	84	7	1
Other Govt. Related	66	62	58	-4	-8
U.S. High Yield Corporates	360	326	310	-16	-50
Emerging Market Debt	503	498	523	25	20

Source: Bloomberg Barclays Indices

Sector Returns Negative, Except High Yield Corporates

The Aggregate Index (-3.37%) had its worst quarterly return since 1981 as Treasury rates rose sharply in anticipation of higher growth and inflation. Except for High Yield Corporates (+0.85%), all major sectors posted negative returns for the quarter. Investment Grade Corporates (-4.65%) had the worst performance of the quarter as longer-duration sectors underperformed shorter-duration sectors such as ABS (-0.16%). Although TIPS returns were still negative in Q1 (-1.47%), they outperformed nominal Treasuries (-4.25%) as inflation expectations rose.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	March	Q1	Effective Duration (years)
U.S. Aggregate Index	-1.25%	-3.37%	6.40
U.S. Gov't/Credit Index	-1.54%	-4.28%	7.37
U.S. Intermediate Gov't/Credit Index	-0.78%	-1.86%	4.16
U.S. 1-3 Yr. Gov't/Credit Index	-0.05%	-0.04%	1.94
U.S. Treasury	-1.54%	-4.25%	6.79
U.S. Agency (Non-Mortgage)	-0.68%	-1.59%	3.91
U.S. Agency Pass-Throughs	-0.51%	-1.10%	4.09
CMBS (Commercial Mortgage Backed Securities)	-1.12%	-2.32%	5.22
ABS (Asset-Backed Securities)	-0.16%	-0.16%	2.08
U.S. Corporate Investment Grade	-1.72%	-4.65%	8.48
U.S. High Yield Corporates	0.15%	0.85%	3.87
Emerging Market Debt	-1.60%	-3.06%	5.21
Municipal Bond Index	0.62%	-0.35%	5.27
TIPS (Treasury Inflation Protected Securities)	-0.19%	-1.47%	7.67

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.

JG2020-1203*

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