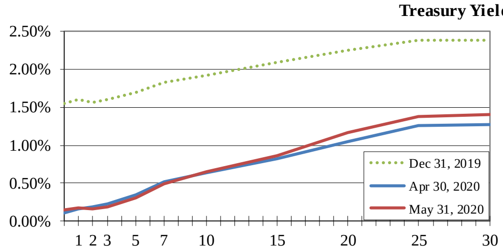
Baird Advisors
Fixed Income Market Commentary
May 2020

Yield Curve Steepens Modestly, Spreads Tighten on Reopening Optimism, Continued Fed backstop and Positive News on Vaccines

The 10yr Treasury yield rose a mere 1 bp, ending May at 0.64% as a phased reopening of the economy began. The curve steepened as the 30yr Treasury yield rose 13 bps to 1.40%. Economic data remains weak, but there are signs that the worst of the decline may be over, and the Fed remains extremely accommodative. In an interview on "60 Minutes" Chairman Powell assured markets of the Fed's ongoing commitment, telling viewers "we're not out of ammunition by a long shot." Over 40 million Americans have filed initial claims for unemployment, pushing April's official unemployment rate to nearly 15% with a 20% rate expected for May. Yet, markets continued to recover on expectations of an economic rebound and an accelerated medical development timeline for both therapies and vaccines for Covid-19. Oil recovered in May, ending the month near $35/barrel, while the S&P 500 rose by 4.8%. Meanwhile U.S./China trade tensions re-escalated over China's limited transparency during the early stages of the pandemic and China's encroachment on Hong Kong. Beijing recently proposed a national security law which would further limit Hong Kong's autonomy, and secretary of state Pompeo reported to Congress that Hong Kong was no longer autonomous from China. This state department determination could trigger tariffs on Hong Kong's exports to the U.S. - which thus far have been exempted from Trump's tariffs given Hong Kong's special trade status. Additionally, a bipartisan bill passed the Senate that would de-list many Chinese companies from U.S. stock exchanges by requiring an attestation that they are not under the control of a foreign government. Late in the month, social unrest flared up across the country in response to the wrongful death of George Floyd in Minneapolis police custody. The protests add a new element of economic and political uncertainty, in addition to the continuing risk of virus-related setbacks as states gradually reopen.

Treasury Yields



Maturity	12/31/19	4/30/20	5/31/20	1Mo Chg	YTD
3 Mo	1.55%	0.10%	0.14%	0.04%	-1.41%
1	1.60%	0.16%	0.17%	0.01%	-1.43%
2	1.57%	0.19%	0.16%	-0.03%	-1.41%
3	1.61%	0.23%	0.19%	-0.04%	-1.42%
5	1.69%	0.35%	0.30%	-0.05%	-1.39%
7	1.83%	0.52%	0.49%	-0.03%	-1.34%
10	1.92%	0.63%	0.64%	0.01%	-1.28%
30	2.39%	1.27%	1.40%	0.13%	-0.99%

Corporate Spreads Tighten on Strong Demand

Corporate spreads tightened further in the month as a near-record $286B in investment grade issuance was met with strong demand from investors, including the Fed, which purchased nearly $3B of Corporate Credit ETFs. Despite another month of heavy issuance, Investment Grade Corporate Credit spreads tightened 28 bps to end the month at 174 bps, retracing roughly three quarters of the coronavirus spread widening seen in March. Asset-Backed Securities tightened 48 bps to 111 bps on solid demand and greatly reduced supply. U.S. Agency Pass-throughs ended the month wider at 73 bps. However, the 34 bps of widening was not performance driven, but rather the effect of index-provider Bloomberg's prepayment model update. The new model assumes a much weaker economic outlook and incorporates additional pandemic-related hurdles to refinancing activity extending the duration of the MBS sector by 0.7 years. Separately, the index provider removed deeply distressed, illiquid Venezuelan debt from the Emerging Market Debt Index. The month-end index rebalance (which removed Venezuela) explains 336 bps of the EM sector's 395 bps spread compression.

Option-Adjusted Spreads (in bps)

	12/31/19	4/30/20	5/31/20	1Mo Chg	YTD Chg
U.S. Aggregate Index	39	74	76	2	37
U.S. Agency (non-mortgage)	10	32	23	-9	13
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	39	39	73	34	34
U.S. Agency CMBS	53	89	81	-8	28
U.S. Non-Agency CMBS	85	231	213	-18	128
Asset-Backed Securities	44	159	111	-48	67
Corporate Sectors					
U.S. Investment Grade	93	202	174	-28	81
Industrial	99	207	176	-31	77
Utility	97	168	161	-7	64
Financial Institutions	80	203	174	-29	94
Other Govt. Related	72	126	106	-20	34
U.S. High Yield Corporates	336	744	637	-107	301
Emerging Market Debt	573	1217	822	-395	249

Source: Bloomberg Barclays Indices

EM Debt Outperforms, Treasuries Lag

Despite negative returns in Venezuelan debt, the whole Emerging Market Debt sector posted the highest total return in May (+6.13%), but still has the worst YTD returns (-8.69%). In contrast, Investment Grade Corporate returns for the month (+1.56%) and YTD (+3.00%) are solidly positive. Treasuries had a weaker month (-0.25%) as heightened issuance put pressure on the long end, but still has been the top performing safe haven asset YTD (+8.61%).

Total Returns of Selected Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	May	YTD	Effective Duration (yrs)
U.S. Aggregate Index	0.47%	5.47%	6.01
U.S. Gov't/Credit Index	0.58%	6.28%	7.54
U.S. Intermediate Gov't/Credit Index	0.76%	4.63%	4.07
U.S. 1-3 Yr. Gov't/Credit Index	0.33%	2.67%	1.92
U.S. Treasury	-0.25%	8.61%	7.15
U.S. Agency (Non-Mortgage)	0.18%	4.86%	3.75
U.S. Agency Pass-Throughs	0.12%	3.60%	2.15
CMBS (Commercial Mortgage Backed Securities)	1.06%	3.51%	5.33
ABS (Asset-Backed Securities)	1.09%	2.23%	2.12
U.S. Corporate Investment Grade	1.56%	3.00%	8.43
U.S. High Yield Corporates	4.41%	-4.73%	3.76
Emerging Market Debt	6.13%	-8.69%	4.67
Municipal Bond Index	3.18%	1.24%	5.67
TIPS (Treasury Inflation Protected Securities)	0.30%	4.84%	2.98

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.