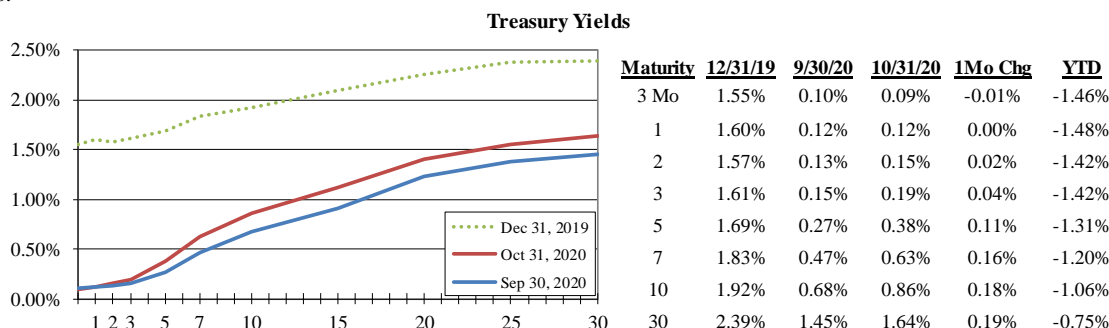


Baird Advisors
Fixed Income Market Commentary
October 2020

Curve Steepens in Anticipation of Post-Election Stimulus; Virus Surge Leads to New U.S. Restrictions, Lockdowns Overseas

The curve steepened in October, with yields on the shortest maturities holding steady while the benchmark 10yr Treasury rose 18 bps to end October at 0.86%. Although policy makers were unable to reach a deal on additional fiscal stimulus, the increase in rates was driven, in part, by expectations that a post-election agreement will be reached, regardless of the political make-up in Washington. If there is a “blue wave,” in which Democrats control the White House and both chambers of Congress, the fiscal package will likely be larger than if Republicans retain control of the Senate. The strong rebound in economic growth in the early stage of the recovery was confirmed last month as Q3 GDP rose at an annualized rate of 33.1% to an annualized production of \$21.16T. This follows the -31.4% decline in Q2, leaving the U.S. economy down about 3% from Q4 2019 annualized production of \$21.75T. Areas of economic strength were found in solid personal income and spending data even as first-time jobless claims remained elevated relative to pre-Covid levels. Housing also continued to be a bright spot with record-low mortgage rates. New U.S. Covid-19 cases hit an all-time high of nearly 100,000 in daily cases at month-end as a third surge of the virus focused primarily in the Upper Midwest forced several states to implement targeted curfews as well as bar and restaurant shut-downs. Simultaneously, cases in the U.K. and Europe surged with both France and Germany announcing new lockdowns.



Spreads Tighten Across Most Market Segments in October

U.S. Investment Grade Corporate spreads tightened 11 bps in the month, now only 32 bps wider YTD, to end the month at 125 bps. Gross credit issuance returned to a more moderate pace of \$108B in October, down from a greater-than-expected \$205B in September, and corporate earnings have come in better than expected. Agency Mortgage Pass-throughs tightened 9 bps to end the month at 52 bps, as the Fed continued its bond buying program of \$40B/net per month. In addition, rising Treasury rates offered little reprieve from continued extremely elevated refinancing activity as record-low mortgage rates generated the fastest Agency Pass-through prepayment speeds since April 2004, which negatively offset much of the benefit this premium-priced sector received from the move tighter in spreads. In contrast, Non-Agency CMBS demand showed a little fatigue, as spreads widened 1 bp to 140 bps, giving back some relative outperformance after being a standout sector in September.

Option-Adjusted Spreads (in bps)

	12/31/19	9/30/20	10/31/20	1Mo Chg	YTD Chg
U.S. Aggregate Index	39	60	54	-6	15
U.S. Agency (non-mortgage)	10	16	13	-3	3
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	39	61	52	-9	13
U.S. Agency CMBS	53	62	56	-6	3
U.S. Non-Agency CMBS	85	139	140	1	55
Asset-Backed Securities	44	41	39	-2	-5
Corporate Sectors					
U.S. Investment Grade	93	136	125	-11	32
Industrial	99	140	131	-9	32
Utility	97	141	131	-10	34
Financial Institutions	80	126	112	-14	32
Other Govt. Related	72	84	79	-5	7
U.S. High Yield Corporates	336	517	509	-8	173
Emerging Market Debt	573	638	638	0	65

Source: Bloomberg Barclays Indices

Negative October Returns Except for Short Duration, High Yield

Most sectors delivered negative returns this month as Treasury yields moved higher and prices declined. Treasuries (-0.94%), Emerging Market Debt (-0.50%), CMBS (-0.46%), Corporates (-0.18%), and Agency Pass-throughs (-0.04%) all failed to hold their value. However, High Yield (+0.51%) and ABS (+0.01%) benefitted from positions shorter on the curve coupled with relatively stable demand.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	October	YTD	Effective Duration (yrs)
U.S. Aggregate Index	-0.45%	6.32%	6.12
U.S. Gov't/Credit Index	-0.60%	7.39%	7.61
U.S. Intermediate Gov't/Credit Index	-0.22%	5.69%	4.10
U.S. 1-3 Yr. Gov't/Credit Index	0.02%	3.14%	1.91
U.S. Treasury	-0.94%	7.88%	7.14
U.S. Agency (Non-Mortgage)	-0.30%	5.12%	3.71
U.S. Agency Pass-Throughs	-0.04%	3.58%	2.34
CMBS (Commercial Mortgage Backed Securities)	-0.46%	6.49%	5.29
ABS (Asset-Backed Securities)	0.01%	4.15%	2.13
U.S. Corporate Investment Grade	-0.18%	6.44%	8.64
U.S. High Yield Corporates	0.51%	1.13%	3.80
Emerging Market Debt	-0.50%	-3.61%	5.14
Municipal Bond Index	-0.30%	3.02%	5.60
TIPS (Treasury Inflation Protected Securities)	-0.65%	8.52%	3.85

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.