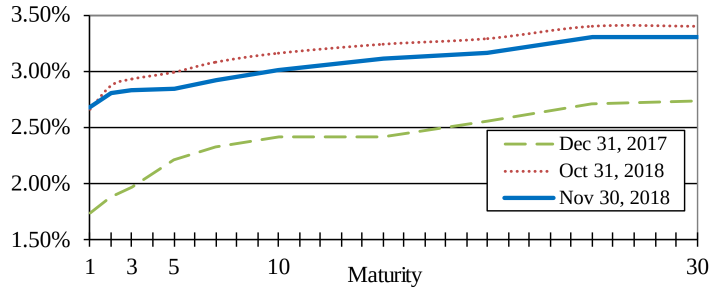
Baird Advisors
Fixed Income Market Commentary
November 2018

Yields Decline on Dovish Fed Tone, Softer Inflation, and Flight to Safety

The 10-year Treasury yield rose to 3.23% on Nov. 8 before declining to 3.01% at month-end as the Fed adopted a more dovish tone, key inflation measures came in lower than expected, and investors sought the safety of U.S. Treasuries. The result was a flatter Treasury curve as 2's–10's narrowed to +20 bps from +29 bps with yields falling on all but the shortest maturities. Market volatility remained elevated as the S&P 500 tested October lows, continuing the risk-averse market trend following Fed Chair Jay Powell's October 3rd surprisingly hawkish remarks that the fed funds rate was still a "long way from neutral." In his Nov. 28 speech, Powell adopted a more dovish tone and clarified that the policy rate is now "just below" neutral. The market expects a rate hike in December, but the market-implied odds now point to just one rate hike in 2019, down from two at the start of the month. Inflation data supported the case for lower rates as core PCE fell to 1.8% YoY last month from a recent peak of 2.0% in July, and WTI Crude fell from over $70/bbl in October to $50.93/bbl at month-end. The 10-year inflation breakeven rate - the difference between nominal Treasury and TIPs yields - fell from a 2.17% high in October to below 1.97% at the end of November. Trade tensions remained elevated as President Trump and President Xi Jinping of China were poised to meet at the G-20 summit to discuss tariffs on December 1. Election results largely met market expectations as the GOP retained control of the Senate and Democrats won back a majority of seats in the House. A split Congress lowers the probability of significant legislative changes in the next two years with the possible exception of a federal infrastructure plan that has bi-partisan support.

Treasury Yields



Maturity	12/31/17	10/31/18	11/30/18	1Mo Chg	YTD Chg
1	1.73%	2.66%	2.68%	0.02%	0.95%
2	1.88%	2.87%	2.81%	-0.06%	0.93%
3	1.97%	2.93%	2.83%	-0.10%	0.86%
5	2.21%	2.99%	2.84%	-0.15%	0.63%
7	2.33%	3.08%	2.92%	-0.16%	0.59%
10	2.41%	3.16%	3.01%	-0.15%	0.60%
30	2.74%	3.40%	3.31%	-0.09%	0.57%

Spreads Widen on Volatile Markets, Challenging Fixed Income Flows

In spite of Powell's more dovish comments later in the month, Investment Grade Corporate spreads ended the month 19 bps wider at 137 bps. Heightened equity volatility and softer corporate earnings guidance continued to pressure the sector. Furthermore, industry-level fund flow data showed outflows that began in October continued in November. Higher-quality spreads held in better than lower-quality as MBS/ABS sectors widened less than Corporates and A-rated corporates held in better than BBBs.

Mixed Returns – Munis, Treasuries Outperform

Returns were mixed in November as falling Treasury rates boosted returns, but wider spreads pushed Corporates and Emerging Market debt into negative territory. Municipal bonds (+1.11%), a domestic-focused sector, posted the highest overall returns, while Treasuries (+0.89%) came in a close second. High Yield Corporates (-0.86%) came in last this month, while EM Debt fell further (-0.48%) and remains the worst performing sector YTD (-5.27%).

Option-Adjusted Spreads (in bps)

	12/31/17	10/31/18	11/30/18	1Mo Chg	YTD Chg
U.S. Aggregate Index	36	44	50	6	14
U.S. Agency (non-mortgage)	14	13	15	2	1
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	25	34	35	1	10
U.S. Agency CMBS	35	46	51	5	16
U.S. Non-Agency CMBS	79	85	93	8	14
Asset-Backed Securities	36	43	47	4	11
Corporate Sectors					
U.S. Investment Grade	93	118	137	19	44
Industrial	98	122	141	19	43
Utility	92	112	132	20	40
Financial Institutions	85	112	132	20	47
Other Govt. Related	68	79	84	5	16
U.S. High Yield Corporates	343	371	418	47	75
Emerging Market Debt	352	495	533	38	181

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

Bloomberg Barclays Index/Sector	November	YTD 2018	Effective Duration (yrs)
U.S. Aggregate Index	0.60%	-1.79%	5.97
U.S. Gov't/Credit Index	0.47%	-2.24%	6.29
U.S. Intermediate Gov't/Credit Index	0.45%	-0.45%	3.88
U.S. 1-3 Yr. Gov't/Credit Index	0.29%	0.81%	1.92
U.S. Treasury	0.89%	-1.27%	5.97
U.S. Agency (non-mortgage)	0.62%	-0.08%	4.01
U.S. Agency Pass-throughs	0.90%	-0.81%	5.30
CMBS (Commercial Mortgage Backed Securities)	0.66%	-0.82%	5.27
ABS (Asset-Backed Securities)	0.38%	0.98%	2.20
U.S. Corporate Investment Grade	-0.17%	-3.92%	7.05
U.S. High Yield Corporates	-0.86%	0.06%	3.90
Emerging Market Debt	-0.48%	-5.27%	4.46
Municipal Bond Index	1.11%	0.08%	6.34
TIPS (Treasury Inflation Protected Securities)	0.48%	-1.80%	5.08

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.