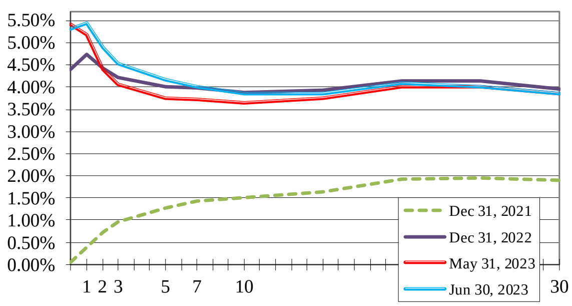
Baird Advisors
Fixed Income Market Commentary
June 2023

Treasury Yields Rise and Curve Inversion Deepens as Fed Skips June Hike but Maintains Hawkish Stance

The Fed opted to "skip" a rate hike at its June meeting, leaving the Fed Funds rate at 5.25%, the first time after ten consecutive moves in as many meetings. Treasury yields rose, with the 10yr yield climbing 19 bps for the month and 37 bps for the quarter to end at 3.84%, roughly where it began 2023. The 2yr spiked 49 bps in June and 87 bps in Q2. The 2yr ended June at 4.90%, just 17 bps shy of its 5.07% cycle peak. The 2yr10yr curve inversion moved to -106 bps at the end of the quarter, just shy of the -108 bps maximum it reached in March, just prior to the SVB/Signature Bank failures. Fed Chair Powell clarified that this pause in hikes did not mean the tightening was complete or that easing was imminent, but reiterated the potential for future hikes as the Fed monitors economic conditions. The Fed's hawkish bias was evident in its Summary of Economic Projections (SEP) forecasting two additional hikes before year-end. Powell quipped that it's akin to driving somewhere, first on the interstate and then local roads in that "as you get closer to your destination…you slow down…" Strong economic data seemingly validated the Fed's position that restrictive policy remains appropriate, including: the strong labor market (+339k jobs in May), solid growth (GDP +2% Q1, revised higher), impressive housing market resilience (New Home Sales +763k vs +676k est.) and sticky inflation (+4% CPI, +5.3% Core Ex Food/Energy). After President Biden signed the debt ceiling legislation in June, the Treasury began what is expected to be a heavy round of issuance to rebuild cash balances. The market expects at least $1.25T of short-term issuance over the next several months, the majority of which will be in T-bills maturing in 3 months or less, targeting money market funds which can finance the purchases by reducing overnight repo balances held at the Fed.



Treasury Yields

Maturity	12/31/21	12/31/22	3/31/23	5/31/23	6/30/23	1 Mo Chg	Q2 Chg	YTD Chg
3 Mo	0.06%	4.41%	4.80%	5.42%	5.31%	-0.11%	0.51%	0.90%
1	0.39%	4.73%	4.65%	5.18%	5.44%	0.26%	0.79%	0.71%
2	0.74%	4.43%	4.03%	4.41%	4.90%	0.49%	0.87%	0.47%
3	0.96%	4.23%	3.79%	4.05%	4.53%	0.48%	0.74%	0.30%
5	1.27%	4.01%	3.58%	3.76%	4.16%	0.40%	0.58%	0.15%
7	1.44%	3.97%	3.54%	3.71%	4.01%	0.30%	0.47%	0.04%
10	1.51%	3.88%	3.47%	3.65%	3.84%	0.19%	0.37%	-0.04%
20	1.94%	4.15%	3.80%	4.02%	4.08%	0.06%	0.28%	-0.07%
30	1.91%	3.97%	3.65%	3.86%	3.86%	0.00%	0.21%	-0.11%

Spreads Tighter in June & Q2; Financials Lead in IG

IG Corporate spreads tightened in June (-15 bps) and Q2 (-15 bps). Financials, the widest major corporate sector to begin June, tightened most for the month (-18 bps) and quarter (-25 bps); this tightening was particularly notable in money-center banks. ABS ended the month (-11 bps) and quarter (-17 bps) tighter. Non-Agency CMBS tightened -4 bps for the quarter but has widened most among Mortgage/ABS sectors YTD. Lower quality tightened notably in June: US HY (-69 bps) and EM debt (-66 bps).

Agg Index Returns Modestly Negative for June and Q2

The US Agg Index returned -0.36% in June and -0.84% in Q2. Excess returns were positive among major sectors for the month and quarter. Agency RMBS excess returns were strong in June (+0.45%) and Q2 (+0.76%) following successful FDIC sales from failed banks. IG corporate excess returns were robust for the month (+1.22%) and quarter (+1.31%) as mutual funds/ETFs had inflows and regional bank fears subsided. TIPs nominal returns (-1.42%) were lowest among major sectors for the quarter.

Option-Adjusted Spreads (in bps)

	12/31/21	12/31/22	3/31/23	5/31/23	6/30/23	1Mo Chg	Q2 Chg	YTD Chg
U.S. Aggregate Index	36	51	57	55	49	-6	-8	-2
U.S. Agency (non-mortgage)	8	26	28	23	19	-4	-9	-7
Mortgage and ABS Sectors								
U.S. Agency RMBS (Pass-throughs)	31	51	63	56	52	-4	-11	1
U.S. Agency CMBS	34	52	62	55	51	-4	-11	-1
U.S. Non-Agency CMBS	95	179	215	212	211	-1	-4	32
Asset-Backed Securities	38	76	85	79	68	-11	-17	-8
Corporate Sectors								
U.S. Investment Grade	92	130	138	138	123	-15	-15	-7
Industrial	95	125	124	127	113	-14	-11	-12
Utility	107	129	136	140	132	-8	-4	3
Financial Institutions	83	140	164	157	139	-18	-25	-1
Non-Corporate Credit	55	66	68	63	58	-5	-10	-8
U.S. High Yield Corporates	283	469	455	459	390	-69	-65	-79
Emerging Market Debt	581	687	731	747	681	-66	-50	-6

Source: Bloomberg Indices

Total Returns of Selected Bloomberg Indices and Subsectors

	MTD Total Return	MTD Excess Return	Q2 Total Return	Q2 Excess Return	YTD Total Return	YTD Excess Return	Effective Duration (years)
U.S. Aggregate Index	-0.36%	0.45%	-0.84%	0.59%	2.09%	0.52%	6.31
U.S. Gov't/Credit Index	-0.32%	0.45%	-0.93%	0.52%	2.21%	0.61%	6.46
U.S. Intermediate Gov't/Credit Index	-0.68%	0.26%	-0.81%	0.36%	1.50%	0.41%	3.81
U.S. 1-3 Yr. Gov't/Credit Index	-0.41%	0.08%	-0.37%	0.18%	1.13%	0.10%	1.86
U.S. Treasury	-0.75%	0.00%	-1.38%	0.00%	1.59%	0.00%	6.20
U.S. Agency (Non-Mortgage)	-0.48%	0.10%	-0.44%	0.31%	1.64%	0.31%	3.20
U.S. Agency RMBS (Pass-Throughs)	-0.43%	0.45%	-0.64%	0.76%	1.87%	0.29%	6.07
CMBS (Commercial Mortgage Backed Securities)	-0.85%	0.24%	-0.60%	0.81%	1.20%	0.10%	4.45
ABS (Asset-Backed Securities)	-0.27%	0.25%	-0.12%	0.58%	1.74%	0.54%	2.76
U.S. Corporate Investment Grade	0.41%	1.22%	-0.29%	1.31%	3.21%	1.56%	7.14
U.S. High Yield Corporates	1.67%	2.54%	1.75%	2.79%	5.38%	4.11%	3.50
Emerging Market Debt	3.74%	4.69%	2.26%	3.57%	3.72%	2.39%	4.99
Municipal Bond Index	1.00%	N/A	-0.10%	N/A	2.67%	N/A	6.06
TIPS (Treasury Inflation Protected Securities)	-0.34%	0.00%	-1.42%	0.00%	1.87%	0.00%	6.64

*Excess return represents the return of a spread sector versus a like-duration U.S. Treasury.

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 U.S. 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 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 Intermediate U.S. Government/Credit Bond 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 1-3 Year U.S. Government/Credit Bond 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 zero and three years.

The Bloomberg 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 CMBS ERISA-Eligible Index is the ERISA-eligible component of the Bloomberg 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 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 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 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.

RB2021-0805

Robert W. Baird & Co. Incorporated