Baird Advisors
Fixed Income Market Commentary
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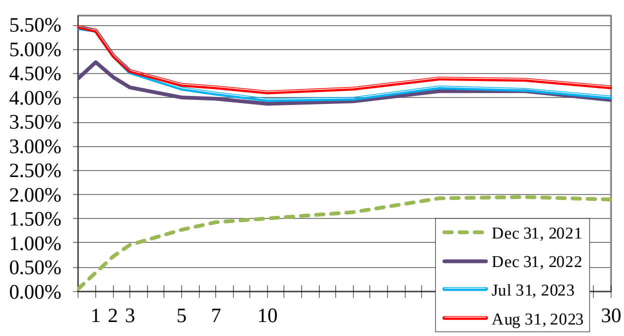
Fitch Downgrades US Treasury Debt to AA+, 10yr Reaches Highest Yield Since 2007 on Resilient Economic Data

Fitch downgraded the US Treasury to AA+ from AAA on the first of the month, joining S&P which did the same in August of 2011, 12 years prior. Fitch cited expected fiscal deterioration (FY24 deficit of 6.6%), a growing debt burden (Treasury debt outstanding of 113% of GDP, forecast to grow to 118% by FY25) and governance concerns relative to AAA rated peers. Repeated debt limit standoffs, last minute resolutions and limited progress on rising social security and Medicare costs provided additional justification. The Treasury curve steepened in August with the 10yr yield rising 14 bps while the 2yr fell 1 bps, leaving the 2s10s slope deeply inverted at -76 bps, but up from -91 bps from the prior month end. Labor market resilience was evident in both continued payroll growth (+187k July) and the UPS Teamsters labor union ratification of a 5-year contract that increased wages and benefits for 340k workers. US Q3 GDP appears poised to grow at 3%, pushing off prospects of a US recession. At the annual Jackson Hole Economic Symposium, Fed Chair Powell reiterated that the tight labor market, strong consumer spending and resilient housing market have kept inflation "too high." He specifically noted that Core PCE, the Fed's preferred inflation measure, remained above target at 4.2% YoY, down just 1.2% from the high. In contrast, the CPI has fallen from 9.1% to 3.2%. Market rates remain restrictive as 30-year mortgage rates ended August at 7.2%, the highest level since 2001. Signs of slowing are emerging as the number of job openings fell by 338k MoM, back to the lowest level since 2021, and 2Q GDP was revised down to 2.1% from 2.4%. Chair Powell concluded his conference remarks underscoring that the Fed is "navigating by the stars under cloudy skies."

Treasury Yields



Maturity	12/31/21	12/31/22	6/30/23	7/31/23	8/31/23	1 Mo Chg	YTD Chg
3 Mo	0.06%	4.41%	5.31%	5.43%	5.47%	0.04%	1.06%
1	0.39%	4.73%	5.44%	5.40%	5.40%	0.00%	0.67%
2	0.74%	4.43%	4.90%	4.88%	4.87%	-0.01%	0.44%
3	0.96%	4.23%	4.53%	4.53%	4.56%	0.03%	0.33%
5	1.27%	4.01%	4.16%	4.18%	4.26%	0.08%	0.25%
7	1.44%	3.97%	4.01%	4.09%	4.21%	0.12%	0.24%
10	1.51%	3.88%	3.84%	3.97%	4.11%	0.14%	0.23%
20	1.94%	4.15%	4.08%	4.21%	4.41%	0.20%	0.26%
30	1.91%	3.97%	3.86%	4.01%	4.22%	0.21%	0.25%

Spreads Wider in August on Light Trading

IG Corporate spreads widened +6 bps in August but remain -12 tighter YTD. Spreads reached 124 bps mid-month but rallied the final two weeks to end at 118. Agency RMBS widened +5 bps and now stands +2 bps wider YTD. Spreads were unchanged for ABS following four consecutive months of tightening. Non-Agy CMBS spreads were also unchanged but spreads remain outsized at 202 bps.

Agg Returns Negative for 4th Consecutive Month

The US Agg Index declined -0.64% in August. Monthly returns were negative for all IG subsectors except US Agencies and ABS. Agency RMBS returns declined (-0.82%) and were weakest when adjusted for duration (excess return -0.33%) among IG sectors. Municipals had the weakest monthly returns (-1.44%), a delayed response to persistent increases in Treasury yields in recent months.

Option-Adjusted Spreads (in bps)

	12/31/21	12/31/22	6/30/23	7/31/23	8/31/23	1Mo Chg	YTD Chg
U.S. Aggregate Index	36	51	49	46	48	2	-3
U.S. Agency (non-mortgage)	8	26	19	20	19	-1	-7
Mortgage and ABS Sectors							
U.S. Agency RMBS (Pass-throughs)	31	51	52	48	53	5	2
U.S. Agency CMBS	34	52	51	56	58	2	6
U.S. Non-Agency CMBS	95	179	211	202	202	0	23
Asset-Backed Securities	38	76	68	63	63	0	-13
Corporate Sectors							
U.S. Investment Grade	92	130	123	112	118	6	-12
Industrial	95	125	113	104	108	4	-17
Utility	107	129	132	120	124	4	-5
Financial Institutions	83	140	139	125	132	7	-8
Non-Corporate Credit	55	66	58	55	54	-1	-12
U.S. High Yield Corporates	283	469	390	367	372	5	-97
Emerging Market Debt	581	687	681	632	649	17	-38

Source: Bloomberg Indices

Total Returns of Selected Bloomberg Indices and Subsectors

	MTD Total Return	MTD Excess Return	3 Mo Total Return	3 Mo Excess Return	YTD Total Return	YTD Excess Return	Effective Duration (years)
U.S. Aggregate Index	-0.64%	-0.10%	-1.06%	0.66%	1.37%	0.73%	6.25
U.S. Gov't/Credit Index	-0.59%	-0.02%	-0.98%	0.76%	1.53%	0.92%	6.32
U.S. Intermediate Gov't/Credit Index	-0.01%	-0.05%	-0.43%	0.38%	1.75%	0.53%	3.79
U.S. 1-3 Yr. Gov't/Credit Index	0.35%	-0.04%	0.37%	0.12%	1.92%	0.14%	1.85
U.S. Treasury	-0.52%	0.00%	-1.61%	0.00%	0.70%	0.00%	6.08
U.S. Agency (Non-Mortgage)	0.21%	0.08%	-0.10%	0.22%	2.03%	0.43%	3.12
U.S. Agency RMBS (Pass-Throughs)	-0.82%	-0.33%	-1.32%	0.40%	0.95%	0.24%	6.25
CMBS (Commercial Mortgage Backed Securities)	-0.05%	0.02%	-0.68%	0.47%	1.37%	0.33%	4.41
ABS (Asset-Backed Securities)	0.26%	0.05%	0.41%	0.53%	2.44%	0.83%	2.65
U.S. Corporate Investment Grade	-0.78%	-0.08%	-0.02%	2.02%	2.76%	2.37%	6.97
U.S. High Yield Corporates	0.28%	0.17%	3.36%	3.98%	7.13%	5.60%	3.45
Emerging Market Debt	-1.29%	-1.01%	5.06%	6.42%	5.04%	4.13%	4.99
Municipal Bond Index	-1.44%	N/A	-0.06%	N/A	1.59%	N/A	6.19
Taxable Municipal Bond: Agg Eligible	-0.66%	0.61%	-1.22%	1.88%	3.66%	3.92%	9.50
TIPS (Treasury Inflation Protected Securities)	-0.89%	0.00%	-1.10%	0.00%	1.09%	0.00%	6.69

*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.

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