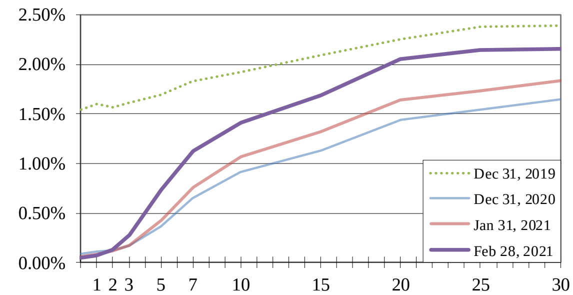
Baird Advisors
Fixed Income Market Commentary
February 2021

Longer Yields Rise as Curve Steepens, Covid-19 Cases Plateau, House Passes Pandemic Relief Package

The 10yr Treasury yield rose 34 bps (+49 bps YTD) to end the month at 1.41% while short rates under 2 years fell modestly. Interest rate volatility spiked as rates rose quickly and the curve steepened. Markets increasingly expect a strong acceleration of U.S. economic growth and inflation due to a combination of Covid-19 cases declining with vaccine distribution ramping up, and the Senate likely to pass a version of the $1.9T pandemic relief package that has already been passed by the US. House of Representatives. After a more orderly rise in rates in January, the end of February saw heavy turbulence leaving the markets to contemplate what actions the Fed may take to try to contain some of the bear steepening. Fed Chair Powell testified before Congress that, "The economic recovery remains uneven and far from complete, and the path ahead is highly uncertain." Additionally, Powell downplayed inflation concerns, stating "the economy is a long way from our employment and inflation goals, and it is likely to take some time for substantial further progress to be achieved." However, markets increasingly expect core inflation to rise to the Fed's new *average* inflation target of 2%, and perhaps higher, due to pent-up demand that could be released in a strong post-Covid economy.

Treasury Yields



Maturity	12/31/19	12/31/20	1/31/21	2/28/21	1Mo Chg	YTD Chg
3 Mo	1.55%	0.09%	0.06%	0.04%	-0.02%	-0.05%
1	1.60%	0.11%	0.08%	0.07%	-0.01%	-0.04%
2	1.57%	0.12%	0.11%	0.13%	0.02%	0.01%
3	1.61%	0.17%	0.17%	0.28%	0.11%	0.11%
5	1.69%	0.36%	0.42%	0.73%	0.31%	0.37%
7	1.83%	0.65%	0.76%	1.13%	0.37%	0.48%
10	1.92%	0.92%	1.07%	1.41%	0.34%	0.49%
30	2.39%	1.65%	1.83%	2.16%	0.33%	0.51%

Spreads Tighter Across All Market Segments YTD

Spreads were tighter YTD across all market segments, and mostly tighter in February as Investment Grade Corporate spreads were 7bps tighter in the month to end at +90 OAS. While supply in investment grade credit was robust ($139B gross supply, +43% YoY), demand also remained high as inflows continued into investment grade bond funds and ETFs. Agency Pass-throughs and ABS were exceptions to the tightening trend, widening 2 bps and 3 bps, respectively, for the month. Interest rate volatility rose, weakening the demand for Agency Pass-throughs, as the rise in interest rates caused durations to extend quickly in anticipation of potentially lower refinancing activity at higher rates. U.S. High Yield Corporates tightened the most at 36 bps to end the month at 326 bps, while Emerging Debt tightened 12 bps to end the month at 498 bps.

Option-Adjusted Spreads (in bps)

	12/31/19	12/31/20	1/31/21	2/28/21	1Mo Chg	YTD Chg
U.S. Aggregate Index	39	42	36	34	-2	-8
U.S. Agency (non-mortgage)	10	10	7	4	-3	-6
Mortgage and ABS Sectors						
U.S. Agency Pass-throughs	39	39	18	20	2	-19
U.S. Agency CMBS	53	44	40	38	-2	-6
U.S. Non-Agency CMBS	85	109	96	94	-2	-15
Asset-Backed Securities	44	33	26	29	3	-4
Corporate Sectors						
U.S. Investment Grade	93	96	97	90	-7	-6
Industrial	99	101	102	95	-7	-6
Utility	97	106	103	97	-6	-9
Financial Institutions	80	83	84	77	-7	-6
Other Govt. Related	72	66	63	62	-1	-4
U.S. High Yield Corporates	336	360	362	326	-36	-34
Emerging Market Debt	573	503	510	498	-12	-5

Source: Bloomberg Barclays Indices

Sector Returns Negative Except High Yield Corporates

As rates rose on 2yr and longer maturities, the returns in major sectors were generally negative, particularly those with longer durations, such as U.S. Treasuries (-1.81%), U.S. Corporate Investment Grade (-1.72%), and CMBS (-1.19%). U.S. High Yield Corporates (+0.37%) was the only sector positive for the month. February's returns pushed nearly all segments flat or negative on a year-to-date basis, with the exception of U.S. High Yield Corporates (+0.70%).

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	February	YTD	Effective Duration (years)
U.S. Aggregate Index	-1.44%	-2.15%	6.31
U.S. Gov't/Credit Index	-1.76%	-2.78%	7.50
U.S. Intermediate Gov't/Credit Index	-0.82%	-1.09%	4.16
U.S. 1-3 Yr. Gov't/Credit Index	-0.03%	0.00%	1.94
U.S. Treasury	-1.81%	-2.75%	6.97
U.S. Agency (Non-Mortgage)	-0.75%	-0.91%	3.85
U.S. Agency Pass-Throughs	-0.67%	-0.59%	3.38
CMBS (Commercial Mortgage-Backed Securities)	-1.19%	-1.22%	5.23
ABS (Asset-Backed Securities)	-0.14%	0.00%	2.08
U.S. Corporate Investment Grade	-1.72%	-2.98%	8.57
U.S. High Yield Corporates	0.37%	0.70%	3.79
Emerging Market Debt	-0.54%	-1.49%	5.25
Municipal Bond Index	-1.59%	-0.96%	5.33
TIPS (Treasury Inflation Protected Securities)	-1.61%	-1.29%	7.66

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.

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