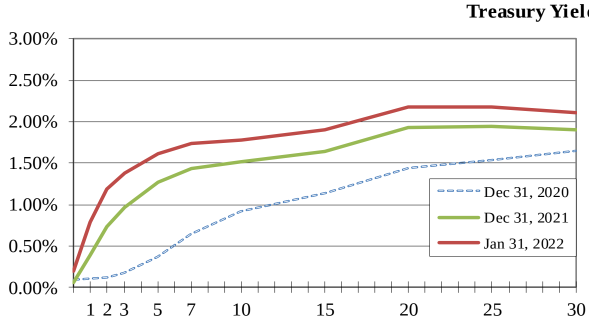
Baird Advisors
Fixed Income Market Commentary
January 2022

Fed Articulates Faster Path of Policy Tightening to Fight Inflation; Yields Climb Sharply

The 10yr Treasury began the month at 1.51% and rose as high as 1.87% before ending January at 1.78%, up 27 bps. Yields climbed for all Treasury maturities, but the increases were greatest among short maturities. The differential between 2- and 10-year Treasury yields ended January at 60 bps – 98 bps flatter from March 31, 2021 – the beginning of this flattening cycle. Higher yields and a flatter curve stemmed from the Fed's more assertive stance on policy tightening outlined in the December FOMC minutes released in early January. The December jobs report of 199k vs expectations of 450k appeared to reflect reduced labor supply, not demand, as unemployment fell to 3.9%. Job openings have remained above 10mm for 7 months, roughly double the 20 year average. Average hourly earnings are +4.7% YoY, but real incomes are pressured by the notable +7% YoY reading for CPI, the highest since 1982. Inflation has pushed the Fed to signal a faster pace of tightening with forecasts growing to as many as five hikes in 2022, up from three at year end. When the Fed began tightening in 2015 it waited over two years to adjust its balance sheet. Now, Chairman Powell noted that reductions to the Fed's nearly $9T balance sheet may begin earlier in this tightening process, potentially in the second half of 2022, given the stronger labor market and higher inflation and growth compared to the prior cycle. Heightened volatility led to $7B of net outflows from U.S. High Yield funds YTD, roughly 1.42% of the category AUM. The larger investment grade fund universe exhibited greater resilience, losing $1.5B of assets, just 0.04% of AUM.

Treasury Yields



Maturity	12/31/20	9/30/21	12/31/21	1/31/22	1Mo Chg
3 Mo	0.09%	0.04%	0.06%	0.19%	0.13%
1	0.11%	0.08%	0.39%	0.79%	0.40%
2	0.12%	0.28%	0.74%	1.18%	0.44%
3	0.17%	0.51%	0.96%	1.38%	0.42%
5	0.36%	0.97%	1.27%	1.61%	0.34%
7	0.65%	1.29%	1.44%	1.74%	0.30%
10	0.92%	1.49%	1.51%	1.78%	0.27%
30	1.65%	2.05%	1.91%	2.11%	0.20%

Credit Spreads Widen; Agency RMBS Model Changes

Corporate spreads widened 14 bps in January as investors required a greater risk premium as the Fed signals a faster removal of policy accommodation. Elevated new issue supply of $154B also contributed to wider spreads. Despite heavy debt issuance from Banks, Financials outperformed the Industrial and Utility sectors in the Corporate Index. Agency RMBS appear tighter (-13bps) but the sector underperformed Treasuries by 12 bps. The spread change is largely the result of a Bloomberg index prepayment model update. The model contributed to index duration declining 0.19 years despite RMBS duration normally rising with Treasury yields. High Yield Corporates widened the most (59 bps) given their correlation to stocks, which also declined in January.

January Returns Negative Across the Board

The Aggregate Index return was negative in January (-2.15%), its lowest monthly return since November 2016 and 15th worst all-time. U.S. Corporate investment grade debt produced the lowest returns (-3.37%), partially due to the sector's somewhat longer duration. Municipals, which performed strongly in 2021, were the second lowest return in January (-2.74%). U.S. Corporate High Yield, a top performing asset class of 2021, declined -2.73% for the first month of 2022. ABS offered the highest return (-0.56%) in large part due to their shorter duration.

Option-Adjusted Spreads (in bps)

	12/31/20	9/30/21	12/31/21	1/31/22	1Mo Chg
U.S. Aggregate Index	42	33	36	36	0
U.S. Agency (non-mortgage)	10	3	8	9	1
Mortgage and ABS Sectors					
U.S. Agency RMBS (Pass-throughs)	39	27	31	18	-13
U.S. Agency CMBS	44	29	34	34	0
U.S. Non-Agency CMBS	109	85	95	96	1
Asset-Backed Securities	33	29	38	30	-8
Corporate Sectors					
U.S. Investment Grade	96	84	92	106	14
Industrial	101	88	95	109	14
Utility	106	96	107	117	10
Financial Institutions	83	75	83	97	14
Non-Corporate Credit	66	52	55	59	4
U.S. High Yield Corporates	360	289	283	342	59
Emerging Market Debt	503	581	581	596	15

Source: Bloomberg Indices

Total Returns of Selected Bloomberg Indices and Subsectors

	2021	January	Effective Duration (years)
U.S. Aggregate Index	-1.54%	-2.15%	6.57
U.S. Gov't/Credit Index	-1.75%	-2.44%	7.42
U.S. Intermediate Gov't/Credit Index	-1.44%	-1.47%	4.10
U.S. 1-3 Yr. Gov't/Credit Index	-0.47%	-0.72%	1.91
U.S. Treasury	-2.32%	-1.89%	6.99
U.S. Agency (Non-Mortgage)	-1.32%	-1.24%	3.86
U.S. Agency RMBS (Pass-Throughs)	-1.04%	-1.48%	4.57
CMBS (Commercial Mortgage-Backed Securities)	-1.16%	-1.59%	5.04
ABS (Asset-Backed Securities)	-0.34%	-0.56%	2.28
U.S. Corporate Investment Grade	-1.04%	-3.37%	8.42
U.S. High Yield Corporates	5.28%	-2.73%	4.05
Emerging Market Debt	-3.07%	-1.95%	5.47
Municipal Bond Index	1.52%	-2.74%	5.14
TIPS (Treasury Inflation Protected Securities)	5.96%	-2.02%	7.69

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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