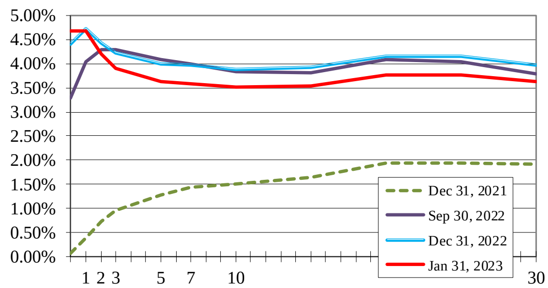
Baird Advisors
Fixed Income Market Commentary
January 2023

Solid Start to 2023 as Pace of Fed Rate Hikes Slow and Flows Turn Positive

Yields declined across the Treasury curve in January and fell the most in the 5–7-year segment (-39 bps) for the month. The 10yr yield closed the month at 3.51%, 37 bps lower than the start of the year and nearly 75 bps below the Oct ’22 high. The favorable market tone was fueled by improving inflation data and continued slowing of growth resulting in expectations that the Fed would only increase rates by 25 bps at the February FOMC meeting, its smallest hike since last March. December CPI fell 0.1% and eased on a YoY basis to 6.5% from 7.1% the prior month. However, Fed Chair Jay Powell and others continued to emphasize that the fight against inflation may be a “harder slog,” to quote Chris Waller, a member of the Federal Reserve Board of Governors, requiring rates to stay higher for longer than current market consensus. Solid economic growth in Q4 (GDP 2.9% vs 2.6% expected) and a continuation of strong nonfarm payrolls (+223k actual vs +205k est.) with a cycle-low unemployment rate at 3.5% all support the Fed’s view that rate cuts will not occur in 2023. Yet, restrictive monetary policy is slowing interest rate sensitive sectors such as housing. In December, existing home sales fell for the eleventh month in a row to a twelve year low, falling 34% YoY. The ISM Manufacturing Index fell to 48.4 (from 49.0), the second month below the contractionary threshold of 50. More corporate layoffs were also announced, particularly in the tech sector (IBM (3,900), Alphabet (12,000) and Microsoft (10,000)), potentially weakening the labor market in months ahead.

Treasury Yields



Maturity	12/31/21	9/30/22	12/31/22	1/31/23	1 Mo Chg
3 Mo	0.06%	3.29%	4.41%	4.69%	0.28%
1	0.39%	4.05%	4.73%	4.69%	-0.04%
2	0.74%	4.28%	4.43%	4.21%	-0.22%
3	0.96%	4.29%	4.23%	3.90%	-0.33%
5	1.27%	4.09%	4.01%	3.62%	-0.39%
7	1.44%	3.99%	3.97%	3.58%	-0.39%
10	1.51%	3.84%	3.88%	3.51%	-0.37%
20	1.94%	4.09%	4.15%	3.77%	-0.38%
30	1.91%	3.78%	3.97%	3.64%	-0.33%

Tightening Trend Continued for IG Corporate Spreads

IG Corporate spread tightening continued in January (-13), maintaining the 4-month trend (-42). Financials, which widened more than other corporate sectors in ’22, also tightened the most (-18) for the month. Agency RMBS (-10), ABS (-11) and non-Agency CMBS (-18) were all firmer. January spread tightening was greatest in higher risk market segments, such as High Yield (-49) and EMD (-40), as monetary policy movements slow.

Inflows Foster Robust January Bond Market Returns

US Aggregate index return of 3.08% was indicative of a broad-based bond market rally. $18B of YTD industry net inflows to IG bond funds/ETFs lifted prices. Among US IG sectors, the corporate sector led both nominal (+4.01%) and excess returns (+1.20%). Bloomberg made its annual mortgage prepayment model update. While valuation impacts were limited, it resulted in a 0.25-year RMBS index duration extension on slower forward prepayment assumptions. January returns were strongly positive (+3.29%). The largest monthly excess returns were found among risker market segments of High Yield (+2.18%) and EM Debt (+2.12%). TIPs, despite a higher duration, returned only 1.83%.

Option-Adjusted Spreads (in bps)

	12/31/21	9/30/22	12/31/22	1/31/23	1Mo Chg
U.S. Aggregate Index	36	62	51	45	-6
U.S. Agency (non-mortgage)	8	15	26	25	-1
Mortgage and ABS Sectors					
U.S. Agency RMBS (Pass-throughs)	31	69	51	41	-10
U.S. Agency CMBS	34	48	52	45	-7
U.S. Non-Agency CMBS	95	154	179	161	-18
Asset-Backed Securities	38	53	76	65	-11
Corporate Sectors					
U.S. Investment Grade	92	159	130	117	-13
Industrial	95	155	125	114	-11
Utility	107	158	129	120	-9
Financial Institutions	83	166	140	122	-18
Non-Corporate Credit	55	73	66	65	-1
U.S. High Yield Corporates	283	552	469	420	-49
Emerging Market Debt	581	824	687	647	-40

Source: Bloomberg Indices

Total Returns of Selected Bloomberg Indices and Subsectors

	2022 Total Return	Jan Total Return	Jan Excess Return	Effective Duration (years)
U.S. Aggregate Index	-13.01%	3.08%	0.57%	6.33
U.S. Gov’t/Credit Index	-13.58%	3.01%	0.43%	6.55
U.S. Intermediate Gov’t/Credit Index	-8.23%	1.87%	0.25%	3.84
U.S. 1-3 Yr. Gov’t/Credit Index	-3.69%	0.80%	0.07%	1.86
U.S. Treasury	-12.46%	2.51%	0.00%	6.26
U.S. Agency (Non-Mortgage)	-7.87%	1.51%	0.14%	3.33
U.S. Agency RMBS (Pass-Throughs)	-11.81%	3.29%	0.93%	5.91
CMBS (Commercial Mortgage-Backed Sec.)	-10.91%	2.63%	0.71%	4.61
ABS (Asset-Backed Securities)	-4.30%	1.42%	0.29%	2.88
U.S. Corporate Investment Grade	-15.76%	4.01%	1.20%	7.30
U.S. High Yield Corporates	-11.19%	3.81%	2.18%	3.79
Emerging Market Debt	-11.99%	4.22%	2.12%	5.11
Municipal Bond Index	-8.53%	2.87%	N/A	6.09
TIPS (Treasury Inflation Protected Sec.)	-11.85%	1.83%	0.00%	6.89

*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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