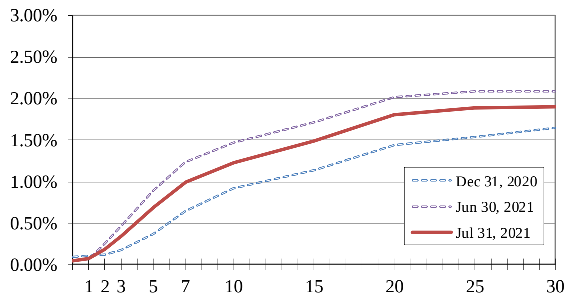
Baird Advisors
Fixed Income Market Commentary
July 2021

Yields Continue to Fall and Curve Flattens as Fed Signals Status Quo; Delta Variant Increases Covid-19 Cases

The bond market rallied in July as the benchmark 10yr Treasury fell 24 bps to 1.23% and the 2yr-10yr yield curve flattened 18 bps to end the month at 104 bps. The drop in yields came despite evidence of continued recovery in the economy as Q2 GDP came in at +6.5% annualized (vs. +8.4% expected) and June CPI increased +5.4% YoY, the highest annual increase since 1990. The inflation spike was driven by categories generally connected with reopening (e.g. used cars, car rentals, apparel, airfares), supporting the Fed's view of "transitory inflation." While the drop in yields has been partially attributed to technical factors, the market is looking beyond the recent economic data to the risks associated with an increase in Covid-19 cases amid the emergence of the Delta variant. While this could be a concern, Fed Chair Powell indicated at his semi-annual testimony to Congress that substantial further progress toward employment goals is "still a ways off." At the July meeting, the Fed acknowledged the "economy has made progress towards goals laid out to taper" but that the Fed "will continue to assess progress in coming meetings" as they left rates unchanged at the zero bound and maintained the pace of monthly net asset purchases ($80B Treasuries, $40B MBS). On the fiscal policy front, an agreement was reached in the Senate on the Bipartisan Infrastructure Investment and Jobs Act. This plan would provide $548B of new spending over five years on physical infrastructure needs, including roads, bridges, the electric grid, rail and broadband, among others. If this bill passes in the Senate, as is likely, it will move to the House, where Speaker Pelosi may try to pair it with the $3.5T American Families Plan (AFP) bill, though the final price tag may be lower. The AFP bill is currently only supported by Democrats who would need to use the budget reconciliation process requiring just a simple majority to pass the Senate, versus the 60 votes typically needed to avoid filibuster.

Treasury Yields



Maturity	12/31/20	3/31/21	6/30/21	7/31/21	1Mo Chg	YTD Chg
3 Mo	0.09%	0.02%	0.05%	0.05%	0.00%	-0.04%
1	0.11%	0.06%	0.07%	0.07%	0.00%	-0.04%
2	0.12%	0.16%	0.25%	0.19%	-0.06%	0.07%
3	0.17%	0.35%	0.46%	0.34%	-0.12%	0.17%
5	0.36%	0.94%	0.89%	0.69%	-0.20%	0.33%
7	0.65%	1.42%	1.24%	1.00%	-0.24%	0.35%
10	0.92%	1.74%	1.47%	1.23%	-0.24%	0.31%
30	1.65%	2.42%	2.09%	1.90%	-0.19%	0.25%

Spreads Widen in July; Still Tighter YTD

Spreads across investment grade sectors widened modestly in July, while spreads in below investment grade sectors such as EM (48 bps wider) and HY Corporates (26 bps wider) saw larger moves. The widening was due in large part to uncertainty of the economy reopening as the Delta variant spreads, sparking concerns over whether additional measures will be needed to mitigate the spread of the virus and what the financial impact might be. The continued drop in yields, particularly on the long end, also may have led to lower demand for long IG credit. Despite the widening in July, all sectors with the exception of EM (46 bps wider) are tighter YTD.

Sector Returns Generally Positive in July; Mixed YTD

Returns were generally positive in July, with longer-duration sectors outperforming shorter-duration sectors as rates fell. Emerging Markets were the sole sector with negative returns (-0.60%). TIPS were the best-performing investment grade sector for the month (+2.67%) and YTD (+4.44%) as investors' inflation expectations remain elevated. The Aggregate Index continued its rebound, returning +1.12% in July, though it remains in negative territory for the year (-0.50%).

Option-Adjusted Spreads (in bps)

	12/31/20	5/31/21	6/30/21	7/31/21	1Mo Chg	YTD Chg
U.S. Aggregate Index	42	30	32	35	3	-7
U.S. Agency (non-mortgage)	10	2	3	3	0	-6
Mortgage and ABS Sectors						
U.S. Agency Pass-throughs	39	16	27	31	4	-8
U.S. Agency CMBS	44	22	25	31	6	-13
U.S. Non-Agency CMBS	109	87	84	86	2	-23
Asset-Backed Securities	33	25	22	26	4	-7
Corporate Sectors						
U.S. Investment Grade	96	84	80	86	6	-10
Industrial	101	87	83	89	6	-12
Utility	106	95	93	97	4	-10
Financial Institutions	83	73	71	76	5	-7
Non-Corporate Credit	66	56	56	53	-3	-13
U.S. High Yield Corporates	360	296	268	294	26	-66
Emerging Market Debt	503	483	501	549	48	46

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	July	YTD	Effective Duration (years)
U.S. Aggregate Index	1.12%	-0.50%	6.57
U.S. Gov't/Credit Index	1.32%	-0.67%	7.67
U.S. Intermediate Gov't/Credit Index	0.77%	-0.14%	4.17
U.S. 1-3 Yr. Gov't/Credit Index	0.17%	0.17%	1.92
U.S. Treasury	1.36%	-1.25%	7.13
U.S. Agency (Non-Mortgage)	0.70%	-0.10%	3.74
U.S. Agency Pass-Throughs	0.63%	-0.15%	3.86
CMBS (Commercial Mortgage Backed Securities)	0.93%	0.43%	5.19
ABS (Asset-Backed Securities)	0.20%	0.39%	2.11
U.S. Corporate Investment Grade	1.37%	0.08%	8.80
U.S. High Yield Corporates	0.38%	4.01%	3.86
Emerging Market Debt	-0.60%	0.13%	5.55
Municipal Bond Index	0.83%	1.90%	5.03
TIPS (Treasury Inflation Protected Securities)	2.67%	4.44%	7.97

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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