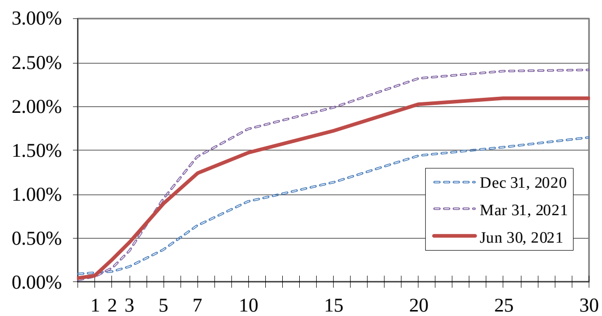
Baird Advisors
Fixed Income Market Commentary
June 2021

Yield Curve Flattens as Fed Signals Tapering and Liftoff May Begin Earlier Than Previously Anticipated

The yield curve flattened in Q2, with the 2yr-10yr Treasury spread decreasing 36 bps to 122 bps. The Fed left rates unchanged at its June meeting, but the 2yr rose as the updated statement of economic projections (i.e., dot plots) for the first time signaled two potential interest rate hikes as early as 2023, a year earlier than the March projection. Long Treasury yields declined despite the Fed's forecast for higher 2021 GDP (6.5%→7%) and core PCE inflation (2.2%→3%). Fed Chair Powell later clarified that the Fed's updated economic projections need to be taken with a "big grain of salt" and confirmed the Fed was "talking about talking about" tapering its monthly bond purchases (net $80B Treasuries, $40B of MBS) as the Fed's balance sheet has grown from $7.4T to $8T YTD. He noted the timing will hinge on "substantial further progress" in the labor market and Fed will provide "advance notice." Markets currently anticipate tapering will begin Q1 2022. The economy added +559K new jobs in May (vs expectations for +675K) and the unemployment rate declined to 5.8%, while many employers cited trouble filling vacant positions with job openings at a record high of over 9 million. However, many may return to the workforce in the coming months as enhanced unemployment benefits expire, vaccination efforts progress, and the resumption of in-person school in the fall alleviates childcare difficulties. On the fiscal policy front, although Congress has reached a bipartisan infrastructure deal totaling $579B – down from an initial $2.3T proposal from President Biden – questions remain around the timing and final version of this initiative.

Treasury Yields



Maturity	12/31/20	3/31/21	5/31/21	6/30/21	1Mo Chg	Q2 Chg	YTD Chg
3 Mo	0.09%	0.02%	0.02%	0.05%	0.03%	0.03%	-0.04%
1	0.11%	0.06%	0.05%	0.07%	0.02%	0.01%	-0.04%
2	0.12%	0.16%	0.15%	0.25%	0.10%	0.09%	0.13%
3	0.17%	0.35%	0.30%	0.46%	0.16%	0.11%	0.29%
5	0.36%	0.94%	0.80%	0.89%	0.09%	-0.05%	0.53%
7	0.65%	1.42%	1.26%	1.24%	-0.02%	-0.18%	0.59%
10	0.92%	1.74%	1.60%	1.47%	-0.13%	-0.27%	0.55%
30	1.65%	2.42%	2.29%	2.09%	-0.20%	-0.33%	0.44%

Pass-Through Spreads Widen in Q2; Other Sectors Tighten

Through mid-June, ICI reported YTD flows into taxable investment grade mutual funds and ETFs of $374B. This record-setting pace of buying from the private sector, along with the Fed's QE and continued improvement in fundamentals driven by the economic recovery, contributed to spreads tightening modestly across nearly all market segments in Q2. The only exception was Agency Mortgage Pass-throughs (15 bps wider) as investors worried that the Fed may begin tapering MBS purchases earlier than previously anticipated. Investor demand for lower-rated sectors remained strong as High Yield corporates tightened 42 bps, ending the quarter at +268, the tightest spread since 2007.

Option-Adjusted Spreads (in bps)

	12/31/20	3/31/21	5/31/21	6/30/21	1Mo Chg	Q2 Chg	YTD Chg
U.S. Aggregate Index	42	31	30	32	2	1	-10
U.S. Agency (non-mortgage)	10	4	2	3	1	-1	-7
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	39	12	16	27	11	15	-12
U.S. Agency CMBS	44	34	22	25	3	-9	-19
U.S. Non-Agency CMBS	109	99	87	84	-3	-15	-25
Asset-Backed Securities	33	35	25	22	-3	-13	-11
Corporate Sectors							
U.S. Investment Grade	96	91	84	80	-4	-11	-16
Industrial	101	93	87	83	-4	-10	-18
Utility	106	99	95	93	-2	-6	-13
Financial Institutions	83	84	73	71	-2	-13	-12
Other Govt. Related	66	58	56	56	0	-2	-10
U.S. High Yield Corporates	360	310	296	268	-28	-42	-92
Emerging Market Debt	503	523	483	501	18	-22	-2

Source: Bloomberg Barclays Indices

Sector Returns Positive During Q2; Mixed YTD

All major sectors posted positive returns in Q2; however, YTD returns remain mixed. U.S. Corporates were the best-performing investment grade sector for the quarter (+3.55%) as longer-duration outperformed shorter-duration sectors and spread sectors outperformed governments. The Aggregate Index returned +1.83% in Q2, rebounding after its worst quarterly return since 1981 (-3.37% in Q1), yet remains in negative territory for the year (-1.60%). TIPS (+3.25%) outperformed nominal Treasuries (+1.75%) in the quarter as inflation expectations remain elevated.

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	June	Q2	YTD	Effective Duration (years)
U.S. Aggregate Index	0.70%	1.83%	-1.60%	6.58
U.S. Gov't/Credit Index	1.01%	2.42%	-1.96%	7.59
U.S. Intermediate Gov't/Credit Index	0.08%	0.98%	-0.90%	4.18
U.S. 1-3 Yr. Gov't/Credit Index	-0.15%	0.04%	0.00%	1.94
U.S. Treasury	0.64%	1.75%	-2.58%	7.01
U.S. Agency (Non-Mortgage)	0.12%	0.81%	-0.80%	3.87
U.S. Agency Pass-Throughs	-0.04%	0.33%	-0.77%	4.16
CMBS (Commercial Mortgage Backed Securities)	0.20%	1.87%	-0.50%	5.19
ABS (Asset-Backed Securities)	-0.02%	0.34%	0.18%	2.04
U.S. Corporate Investment Grade	1.63%	3.55%	-1.27%	8.72
U.S. High Yield Corporates	1.34%	2.74%	3.62%	3.84
Emerging Market Debt	0.06%	3.92%	0.73%	5.35
Municipal Bond Index	0.27%	1.42%	1.06%	5.05
TIPS (Treasury Inflation Protected Securities)	0.61%	3.25%	1.73%	7.72

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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