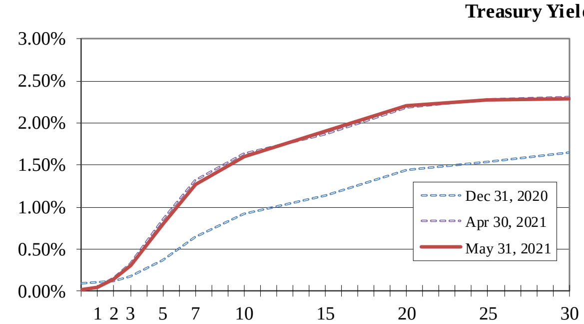
Baird Advisors
Fixed Income Market Commentary
May 2021

Rates Decline Modestly Despite Inflation Concerns; Demand Outpaces Supply as Economy Reopening Continues

The 5yr Treasury yield declined 5 bps in May to 0.80% as the partial reversal of the bear steepener seen in Q1 continued. The spread between 2yr and 5yr Treasury yields began the year at 24 bps, steepened to 78 bps on 3/31, and partially retraced to end May at 65 bps. Employment data raised questions about how quickly the labor market will recover the jobs lost due to the pandemic as the headline April nonfarm payrolls number disappointed (+266K vs +1000K market consensus) and employers struggled to fill a record-high 8.1 million job openings. Average hourly earnings increased 0.7% in May and the workweek increased to 35 hours, suggesting that employers are responding to the labor shortage by increasing wages and asking current employees to work more hours. Growth expectations for 2021 remain very elevated in the +6-8% range, with large fiscal stimulus and a big bounce in consumer spending driving growth as pandemic-related restrictions ease. Inflation came in stronger than expected (April CPI +4.2% YoY vs +3.6% CPI market consensus; +0.8% MoM), with sharp increases in the prices of transportation, airfare, and lodging as Americans resume social activities and travel; a 10% surge in used vehicle prices accounted for over a third of the monthly CPI increase as the chip shortage limits new car production. YoY numbers are distorted due to the pandemic-depressed April 2020 numbers, known as the base effect. However, the Fed still views the current ramp in inflation as transitory that will recede as supply chain disruptions ease over the next couple of quarters. The Fed minutes from the April meeting stated, “a number of participants suggested that if the economy continued to make rapid progress toward the Committee’s goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases” signaling that the Fed may be *thinking about thinking about* tapering.

Treasury Yields



Maturity	12/31/20	4/30/21	5/31/21	1Mo Chg	YTD Chg
3 Mo	0.09%	0.02%	0.02%	0.01%	-0.07%
1	0.11%	0.05%	0.05%	0.00%	-0.06%
2	0.12%	0.16%	0.15%	-0.01%	0.03%
3	0.17%	0.33%	0.30%	-0.03%	0.13%
5	0.36%	0.85%	0.80%	-0.05%	0.44%
7	0.65%	1.31%	1.26%	-0.05%	0.61%
10	0.92%	1.63%	1.60%	-0.03%	0.68%
30	1.65%	2.30%	2.29%	-0.01%	0.64%

Spreads Tighter Across Most Market Segments in May

Continued inflows into the investment grade bond market along with the Fed’s sustained accommodative policy and momentum from reopening the economy contributed to spreads tightening across most market segments in May. Exceptions to the tightening were Agency Pass-throughs (+9 bps wider) as demand away from Fed buying waned given unattractive, tight spreads, and High Yield Corporates (+5 bps wider).

Sector Returns Mostly Positive for May; Mixed YTD

With the exception of Agency Pass-throughs, all sectors posted positive returns in May, resulting in mixed YTD returns. Emerging Market Debt was again the top performer for the month (+1.32%) driven by strong demand for yield. The Aggregate Index continued its Q2 rebound (May +0.33%; April +0.79%) after its worst quarterly return since 1981 (-3.37%), yet remains in negative territory for the year (-2.29%). TIPS (+1.21%) outperformed nominal Treasuries (+0.34%) again this month as inflation expectations inched higher. U.S. Investment Grade Corporates (+0.77%) and CMBS (+0.71%) also performed well in May.

Option-Adjusted Spreads (in bps)

	12/31/20	4/30/21	5/31/21	1Mo Chg	YTD Chg
U.S. Aggregate Index	42	29	30	1	-12
U.S. Agency (non-mortgage)	10	4	2	-2	-8
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	39	7	16	9	-23
U.S. Agency CMBS	44	30	22	-8	-22
U.S. Non-Agency CMBS	109	93	87	-6	-22
Asset-Backed Securities	33	31	25	-6	-8
Corporate Sectors					
U.S. Investment Grade	96	88	84	-4	-12
Industrial	101	91	87	-4	-14
Utility	106	96	95	-1	-11
Financial Institutions	83	79	73	-6	-10
Other Govt. Related	66	58	56	-2	-10
U.S. High Yield Corporates	360	291	296	5	-64
Emerging Market Debt	503	496	483	-13	-20

Source: Bloomberg Barclays Indices

Total Returns of Selected Bloomberg Barclays Indices and Subsectors

	May	YTD	Effective Duration (years)
U.S. Aggregate Index	0.33%	-2.29%	6.49
U.S. Gov’t/Credit Index	0.51%	-2.95%	7.47
U.S. Intermediate Gov’t/Credit Index	0.40%	-0.98%	4.18
U.S. 1-3 Yr. Gov’t/Credit Index	0.12%	0.16%	1.94
U.S. Treasury	0.34%	-3.20%	6.92
U.S. Agency (Non-Mortgage)	0.27%	-0.91%	3.72
U.S. Agency Pass-Throughs	-0.18%	-0.73%	4.15
CMBS (Commercial Mortgage Backed Securities)	0.71%	-0.70%	5.21
ABS (Asset-Backed Securities)	0.22%	0.20%	1.99
U.S. Corporate Investment Grade	0.77%	-2.85%	8.59
U.S. High Yield Corporates	0.30%	2.25%	3.89
Emerging Market Debt	1.32%	0.67%	5.31
Municipal Bond Index	0.30%	0.78%	5.06
TIPS (Treasury Inflation Protected Securities)	1.21%	1.12%	7.77

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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