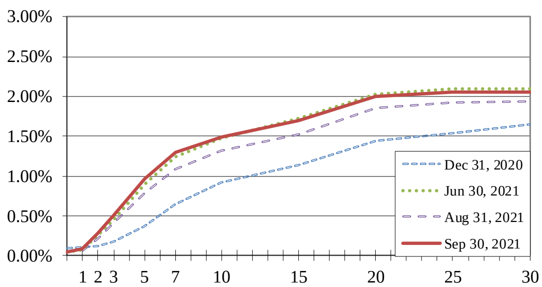
Baird Advisors
Fixed Income Market Commentary
September 2021

Yield Curve Flattens as Yields Rise, Potential Turmoil at the Fed, Increased Volatility Impacts Economic Recovery

The benchmark 10yr Treasury ended September at 1.49%, increasing 18 bps for the month but a mere 2 bps for the quarter. Despite late-quarter rate volatility, the curve flattened slightly QoQ as the 30yr Treasury declined 4 bps and yields at most other tenors marginally increased. Fed Chair Powell noted tapering may begin as early as November and be completed by mid-2022 while reemphasizing that taper is not a direct signal of interest rate increases, "which we have articulated a different and substantially more stringent test." The Fed is currently buying $120B of bonds ($40B Agency MBS and $80B Treasuries) for its balance sheet every month. The heads of two regional Federal Reserve Banks, Kaplan (Dallas) and Rosengren (Boston) each resigned their post after coming under scrutiny for personal securities trading. The openings give President Biden an opportunity to influence these replacements along with directly appointing four new members to the Fed's Board of Governors if he chooses not to reappoint Chair Powell, Vice Chairs Clarida and Quarles, and one additional open seat. What had seemed an almost certain reappointment of Powell is now less so, as Senator Warren called him a "dangerous man to head up the Fed," acknowledging that she wouldn't support him if renominated. Treasury Secretary Yellen joined Powell in warning Congress that the failure to raise the debt ceiling prior to October 18 would be "catastrophic," risking the potential default of U.S. Treasury debt for the first time. On the last day of the quarter, the House and Senate passed a bill to keep the government funded through early December, narrowly avoiding (at least temporarily) a government shutdown. After passing in a bipartisan vote in the Senate, House Speaker Pelosi delayed the vote on the $1B infrastructure bill because progressive Democrats withdrew their support until they receive assurance that moderates will support the $3.5T Build Back Better Act which would fund various social spending and be paid for by increased taxes on corporations and wealthy individuals. The large Chinese real estate developer Evergrande missed interest payments on some of its $300B in debt, leading to broader global credit concerns of contagion. Supply chain bottlenecks continue to act as a headwind to what is still a large rebound in economic growth (Q2 GDP +6.7% annualized QoQ) while placing upward pressure on inflation measures (CPI +5.3% YoY through August). The stock market reflected the uncertainty of the economy with the S&P falling 4.8% in September, the worst month since March 2020.

Treasury Yields



Maturity	12/31/20	6/30/21	8/31/21	9/30/21	1Mo Chg	Q3 Chg	YTD Chg
3 Mo	0.09%	0.05%	0.05%	0.04%	-0.01%	-0.01%	-0.05%
1	0.11%	0.07%	0.07%	0.08%	0.01%	0.01%	-0.03%
2	0.12%	0.25%	0.21%	0.28%	0.07%	0.03%	0.16%
3	0.17%	0.46%	0.41%	0.51%	0.10%	0.05%	0.34%
5	0.36%	0.89%	0.78%	0.97%	0.19%	0.08%	0.61%
7	0.65%	1.24%	1.09%	1.29%	0.20%	0.05%	0.64%
10	0.92%	1.47%	1.31%	1.49%	0.18%	0.02%	0.57%
30	1.65%	2.09%	1.94%	2.05%	0.11%	-0.04%	0.40%

Spreads Mostly Widen During Q3; Tighter YTD

Spreads were mixed during the month, though wider during the quarter with the exception of Non-Corporate Credit (4 bps tighter), and remain tighter YTD, with the exception of EM Debt (78 bps wider). While most moves during the quarter were relatively small, High Yield Corporates (21 bps wider) and EM Debt (80 bps wider) saw larger moves. Investment Grade sectors were modestly wider on the quarter as strong demand offset lingering concerns around inflation, persistent supply chain delays, Evergrande, and risk of government shutdown.

Market Returns Negative in Sept; Mixed QTD and YTD

Returns in all market sectors were negative in September as rates rose, though still mixed for the quarter and generally negative for the year. The best-performing sectors for the quarter were TIPS (+1.75%) and HY Corporates (0.89%) while the worst-performing sector was EM Debt (-1.57%).

Option-Adjusted Spreads (in bps)

	12/31/20	6/30/21	8/31/21	9/30/21	1Mo Chg	Q3 Chg	YTD Chg
U.S. Aggregate Index	42	32	35	33	-2	1	-9
U.S. Agency (non-mortgage)	10	3	2	3	1	0	-7
Mortgage and ABS Sectors							
U.S. Agency Pass-throughs	39	27	33	27	-6	0	-12
U.S. Agency CMBS	44	25	30	29	-1	4	-15
U.S. Non-Agency CMBS	109	84	85	85	0	1	-24
Asset-Backed Securities	33	22	27	29	2	7	-4
Corporate Sectors							
U.S. Investment Grade	96	80	87	84	-3	4	-12
Industrial	101	83	90	88	-2	5	-13
Utility	106	93	100	96	-4	3	-10
Financial Institutions	83	71	76	75	-1	4	-8
Non-Corporate Credit	66	56	50	52	2	-4	-14
U.S. High Yield Corporates	360	268	288	289	1	21	-71
Emerging Market Debt	503	501	526	581	55	80	78

Source: Bloomberg Indices

Total Returns of Selected Bloomberg Indices and Subsectors

	September	Q3	YTD	Effective Duration (years)
U.S. Aggregate Index	-0.87%	0.05%	-1.55%	6.71
U.S. Gov't/Credit Index	-1.07%	0.04%	-1.93%	7.59
U.S. Intermediate Gov't/Credit Index	-0.57%	0.02%	-0.87%	4.17
U.S. 1-3 Yr. Gov't/Credit Index	-0.08%	0.09%	0.09%	1.93
U.S. Treasury	-1.08%	0.09%	-2.50%	7.06
U.S. Agency (Non-Mortgage)	-0.54%	0.06%	-0.74%	3.89
U.S. Agency Pass-Throughs	-0.36%	0.10%	-0.67%	4.62
CMBS (Commercial Mortgage Backed Securities)	-0.77%	-0.03%	-0.53%	5.11
ABS (Asset-Backed Securities)	-0.15%	0.05%	0.23%	2.26
U.S. Corporate Investment Grade	-1.05%	0.00%	-1.27%	8.71
U.S. High Yield Corporates	-0.01%	0.89%	4.53%	3.97
Emerging Market Debt	-2.28%	-1.57%	-0.85%	5.45
Municipal Bond Index	-0.72%	-0.27%	0.79%	5.19
TIPS (Treasury Inflation Protected Securities)	-0.71%	1.75%	3.51%	7.91

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.

RB2021-0805

Robert W. Baird & Co. Incorporated