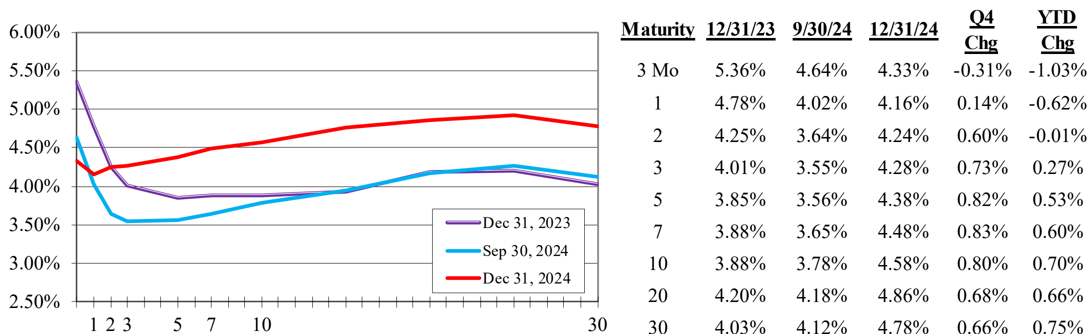
Baird Advisors
Fixed Income Market Commentary
2024 Review and 2025 Outlook

2024 Bond Market Review

Treasury yields rose across much of the curve in 2024, aside from 0–2-year maturities, with a sharp move higher occurring in Q4. Ultimately, the Treasury yield curve moved toward a more normalized slope in 2024, as 2s10s shifted from -37 bps to +34 bps, ending its 26-month period of inversion. The Fed spent much of 2024 holding its fed funds policy rate in the 5.25-5.50% range before commencing the easing cycle with a total of 100 bps of cuts between September and year end, including 25 bps in December. Over this easing period, the yield on the 10yr Treasury rose over 90 bps, capping its see-saw movement for the year in which it traded within a range of 108 bps. To highlight, the 10yr yield began the year at 3.88%, rose to a peak of 4.70% in April on resilient economic growth and higher than expected inflation, then fell to the yearly low of 3.62% on softer economic data and expectations of Fed rate cuts, prior to the Fed's initial 50-bps cut in September. Following the rate cut, the 10yr yield subsequently rose to 4.58% into year-end with expectations for future Fed rate cuts repriced as both investors and the Fed adjusted to an outlook of higher economic growth, inflation and deficits. President-elect Trump was re-elected in a red wave in November as Republicans won both the Senate and House, albeit with narrow margins in each.

The Fed's own Summary of Economic Projections (SEP), released in December, adjusted up their year-end 2025 PCE Inflation projection to 2.5% from 2.1% in the September release, while also removing 50 bps of easing projections in 2025. The Fed noted the "single biggest factor" for the slower pace of easing was that recent inflation had underperformed their expectations. Although the PCE Price Index, which is the Fed's preferred inflation gauge, fell slightly over the trailing 12-month period, from 2.61% down to 2.44%, it inched higher over the most recent three-month period. Shelter components of inflation showed some encouraging signs of easing as the Fed predicted, noting historical lags for inflation on rent data. Housing affordability, however, remained historically low as home supply remains constrained and 30yr mortgage rates ended the year at 6.85%, near the upper end of their 2024 range. The US economy performed well throughout the year with 2024 real GDP expected to be around 2.7%. The unemployment rate ended at a relatively low 4.2%, although up 0.5% for the year. There was one dissenting vote at the December Fed meeting that accompanied the Fed's 25-bps rate cut, as that member preferred to hold rates steady. In addition, Fed Chair Powell struck a relatively hawkish tone in the post-FOMC meeting press conference, likely setting the stage for skipping a move in January.

Treasury Yields



Maturity	12/31/23	9/30/24	12/31/24	Q4 Chg	YTD Chg
3 Mo	5.36%	4.64%	4.33%	-0.31%	-1.03%
1	4.78%	4.02%	4.16%	0.14%	-0.62%
2	4.25%	3.64%	4.24%	0.60%	-0.01%
3	4.01%	3.55%	4.28%	0.73%	0.27%
5	3.85%	3.56%	4.38%	0.82%	0.53%
7	3.88%	3.65%	4.48%	0.83%	0.60%
10	3.88%	3.78%	4.58%	0.80%	0.70%
20	4.20%	4.18%	4.86%	0.68%	0.66%
30	4.03%	4.12%	4.78%	0.66%	0.75%

Continued Spread Tightening for Q4 and 2024

Spreads tightened for most sectors in Q4 and contributed to broad-based tightening for the year across fixed income. Non-Agy CMBS, which was the sole major sector to widen in 2023, led all IG sectors tighter in both Q4 (-22 bps) and for 2024 (-76 bps). ABS also tightened notably for both Q4 (-20 bps) and the year (-24 bps). IG corporates tightened by -9 bps in Q4 and -19 bps for the year, led by the Financial subsector (-30 bps in 2024). IG Corporate OAS finished 2024 at +80 bps, just 6 bps above its 2024 tight of 74 bps. Corporate spreads tighter than +80 have not occurred since 2005 and prior to that in 1998. Spread compression was supported by the resilient economy, strong issuer fundamentals, and continued industry inflows to IG funds, which persisted in each month of 2024. HY Corporate tightened in 2024 (-36 bps), but much less than it had in 2023 (-146 bps). EM Debt spreads, which began 2024 at +598 also tightened to finish the year at +393.

Option-Adjusted Spreads (in bps)

	12/31/23	9/30/24	12/31/24	Q4 Chg	YTD Chg
U.S. Aggregate Index	42	36	34	-2	-8
U.S. Agency (non-mortgage)	17	16	12	-4	-5
Mortgage and ABS Sectors					
U.S. Agency RMBS (Pass-throughs)	47	42	43	1	-4
U.S. Agency CMBS	48	39	35	-4	-13
U.S. Non-Agency CMBS	203	149	127	-22	-76
Asset-Backed Securities	68	64	44	-20	-24
Corporate Sectors					
U.S. Investment Grade	99	89	80	-9	-19
Industrial	90	87	78	-9	-12
Utility	105	92	82	-10	-23
Financial Institutions	112	90	82	-8	-30
Non-Corporate Credit	55	54	55	1	0
U.S. High Yield Corporates	323	295	287	-8	-36
Emerging Market Debt	598	470	393	-77	-205

Source: Bloomberg Indices

Strong Excess Returns for IG Corporate and CMBS in 2024 Despite Modest Agg Returns

The Agg Index total return was just 1.25% for the year as the -1.64% December return and -3.06% Q4 total returns reduced the annual figure. Strong income production from the bond market throughout the year buoyed total returns despite price declines in late 2024. Among IG sectors, excess returns were strongest in Q4 and 2024 for IG Corporate (+0.82%, +2.46%) and CMBS (+0.66%, +2.80%). In the case of IG Corporate this outperformance occurred amid elevated trading volume and the second largest annual issuance total on record ($1.5T '24 vs $1.8T '20 peak). Agency RMBS produced the lowest excess returns among IG sectors for both the quarter (-0.13%) and year (+0.37%). Away from IG, risk appetite was robust in 2024. EM Debt was the only sector to produce double-digit excess returns for the year. HY Corporate excess returns for 2024 were 5.02%, with most of it occurring before Fed easing began in September.

Total Returns of Selected Bloomberg Indices and Subsectors

	MTD Total Return	MTD Excess Return	Q4 Total Return	Q4 Excess Return	2024 Total Return	2024 Excess Return	Effective Duration (years)
U.S. Aggregate Index	-1.64%	-0.05%	-3.06%	0.18%	1.25%	0.78%	6.08
U.S. Gov't/Credit Index	-1.67%	-0.02%	-3.08%	0.28%	1.18%	0.88%	6.11
U.S. Intermediate Gov't/Credit Index	-0.62%	-0.02%	-1.60%	0.18%	3.00%	0.66%	3.72
U.S. 1-3 Yr. Gov't/Credit Index	0.21%	-0.03%	-0.02%	0.03%	4.36%	0.23%	1.84
U.S. Treasury	-1.54%	0.00%	-3.14%	0.00%	0.58%	0.00%	5.81
U.S. Agency (Non-Mortgage)	-0.50%	-0.09%	-1.06%	0.09%	3.16%	0.38%	3.33
U.S. Agency RMBS (Pass-Throughs)	-1.65%	-0.17%	-3.16%	-0.13%	1.20%	0.37%	6.17
CMBS (Commercial Mortgage Backed Securities)	-0.55%	0.16%	-1.48%	0.66%	4.68%	2.80%	4.14
ABS (Asset-Backed Securities)	-0.05%	0.06%	-0.05%	0.61%	5.02%	1.53%	2.69
U.S. Corporate Investment Grade	-1.94%	-0.02%	-3.04%	0.82%	2.13%	2.46%	6.81
U.S. High Yield Corporates	-0.43%	-0.18%	0.17%	1.17%	8.19%	5.02%	3.11
Emerging Market Debt	-0.33%	0.77%	1.72%	4.16%	14.80%	13.41%	4.89
Municipal Bond Index	-1.46%	N/A	-1.22%	N/A	1.05%	N/A	6.21
Taxable Municipal Bond: Agg Eligible	-3.17%	-0.24%	-4.39%	1.11%	0.09%	2.42%	9.20
TIPS (Treasury Inflation Protected Securities)	-1.58%	0.00%	-2.88%	0.00%	1.84%	0.00%	6.46

*Excess return represents the return of a spread sector versus a like-duration U.S. Treasury.

2025 Outlook

Investors are likely to find continued value in the income component of bonds as the rising yields of 2024 offer investors historically attractive income levels to start the new year. With the yield on the U.S. Aggregate Index at 4.91%, well above its five-year average of 3.24%, and with the average yield across the Treasury curve of 4.45%, income should not only provide a reliable source of return but also help cushion against expected market volatility in 2025. With single-party rule across Congress and the White House, we expect President-elect Trump to seek meaningful policy changes in his second term. He has been clear in his desire to extend the lower tax rates from the 2017 Tax Cut and Jobs Act but will need to work with Congress to offset the cost, estimated to be as high as $5 trillion over a 10-year period. Immigration, tariffs, government regulations and efficiency measures are also key policy initiatives for the incoming administration, along with extending the US debt ceiling – it's a full plate. The Fed has lowered rates by 100 bps, but the timing and magnitude of future cuts remains uncertain. Fiscal policy decisions and economic data developments will influence future Fed moves. That said, we do expect a continued trend toward normalization of the yield curve slope, to a steeper structure through lower short-term rates but perhaps even slightly higher long-term yields. Credit spreads start the year at tight levels by historical standards, but strong corporate balances sheets and even stronger demand for income may likely keep spreads range bound in 2025. Investors may look toward highly rated parts of the securitized market as an alternative to credit. However, valuations in risk assets, including spread sectors in fixed income, reflect much of the favorable economic and policy news expected in 2025 thereby increasing the potential fallout from negative shocks. An active, multi-sector, risk-controlled approach within fixed income with layers of liquidity should help to both manage risk while also providing dry powder seeking to capture compelling return opportunities that often arise during bouts of volatility.

Disclosures

Information in this document regarding market or economic trends, or the factors influencing historical or future performance, reflects the opinions of management as of the date of this document. These statements should not be relied upon for any other purpose. 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. *Past performance is not a guarantee of future results.*

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.

Treasury yields are the interest rates that the U.S. government pays to borrow money for varying periods of time.

Option-adjusted spread is the difference between the yield of a security that pays fixed interest payments and the current U.S. Treasury rates, which represents the rate of return on a risk-free investment.

Indices are unmanaged, and are not available for direct investment.

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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