

Baird Advisors
Fixed Income Market Comments
September 2008

Living History

The bond market went into panic mode in September as a lifetime's worth of historic and unprecedented events were packed into a single month. FNMA and FHLMC were placed into conservatorship, Lehman Brothers collapsed, Bank of America is buying Merrill Lynch, the government bailed out AIG and guaranteed money market balances after the Reserve Primary Fund "broke the buck", the FDIC's seizure of Washington Mutual resulted in the largest bank failure ever, Citigroup (and/or Wells Fargo) is buying Wachovia and a \$700 billion mortgage rescue plan was proposed by the Treasury but voted down by Congress.

Reasonable trading in some sectors of the market virtually halted and Treasury yields flailed wildly day to day with the 2-year T-note yield ranging 73 bps from a high of 2.37% on 9/1 to a low of 1.64% on 9/17, the same day the 3-month T-bill yield fell to 0.04%. Treasury yields ended the month 15-80 bps lower with the largest declines on short-term issues (see table above right).

Maturity	Jun 30, 2008	Aug 31, 2008	Sep 30, 2008	1 mo. Change	Q3 Change
3 mo.	1.73%	1.71%	0.90%	-0.81	-0.83
1	2.33%	2.17%	1.79%	-0.38	-0.54
2	2.62%	2.37%	1.96%	-0.41	-0.66
5	3.33%	3.09%	2.98%	-0.11	-0.35
10	3.97%	3.81%	3.82%	0.01	-0.15
30	4.52%	4.42%	4.31%	-0.11	-0.21

Credit Spreads Explode

The crisis of confidence which centered on the finance sector as several stalwart institutions struggled to survive spilled over into the general market and credit spreads exploded to new all-time highs in September. The table at right compares option-adjusted spreads (OAS) over like maturity Treasuries of several sectors as of 6/30, 8/31 and 9/30 and also shows the corresponding performance relative to Treasuries (highlighted in yellow). Yield spreads in the finance sector jumped 236 bps in September (613 bps vs. 377 bps in August) leading to 1,345 bps of underperformance compared to Treasuries. Investment grade bonds as a whole lagged Treasuries by an astounding 718 bps on spread widening of 144 bps. The relative [under]performance of several sectors for the month of September surpassed prior annual records on file. The Mortgage-backed securities sector (all FNMA, FHLMC and GNMA guaranteed) was the lone sector that outperformed Treasuries (by 26 bps) on spread tightening of 12 bps (135 bps vs. 147 bps in August).

	Option Adjusted Spreads			Excess Returns vs U.S. Treasuries		
	6/30/2008	8/31/2008	9/30/2008	September	3rd Quarter	YTD
U.S. Aggregate Index	129	151	176	-190	-263	-383
U.S. Agency (non-mortgage) Sector	67	87	115	-49	-83	-147
Mortgage and ABS Sectors						
Mortgage-Backed Securities	127	147	135	26	-5	-29
Asset-Backed Securities	353	451	584	-325	-569	-1072
CMBS	288	362	480	-504	-809	-1306
Credit Sectors						
U.S. Investment Grade	238	271	385	-718	-884	-1169
Industrial	226	250	325	-448	-574	-838
Utility	232	252	335	-546	-642	-849
Financial Institutions	315	377	613	-1345	-1616	-2060
U.S. High Yield	708	794	1020	-855	-1111	-1488

Source: Lehman Brothers

A Month for the Record Books

The extreme market conditions in September resulted in an unprecedented range of performance across the various sectors of the bond market for the month (and quarter and year for that matter). Benefitting from a pronounced flight to quality, Treasuries, Agencies and MBS managed to post positive returns for the month (0.61%, 0.07% and 0.75%) and quarter (2.30%, 1.09% and 1.87%) – all other sectors were negative. Corporates bore the brunt of the chaos with investment grade issues returning -7.77% (Q3 -7.80%) and high yield issues -7.98% (Q3 -8.89%). With a large concentration in finance, A-rated issues led the decline with a -10.46% return, but higher quality issues also fell sharply (AAA -8.67%; AA -6.33%). Severe liquidity concerns also caused sharp declines in municipals (-4.69%) while fading inflation concerns dragged TIPS (-3.83%) down as well (see table below).

Total Returns of Selected Lehman Brothers Indices and Subsectors

Index/Sector	September	3 rd Qtr	YTD
LB Aggregate Index	-1.34%	-0.49%	0.63%
LB Gov't/Credit Index	-2.53%	-1.64%	-0.67%
LB Int. Gov't/Credit Index	-2.08%	-1.19%	0.22%
LB 1-3 yr. Gov't/Credit Index	-0.59%	0.16%	2.23%
US Treasury Sector	0.61%	2.30%	4.58%
Gov't Agency Sector	0.07%	1.09%	2.80%
Corporate Sector	-7.77%	-7.80%	-8.58%
AAA	-8.67%	-7.59%	-7.55%
AA	-6.33%	-6.25%	-6.75%
A	-10.46%	-10.73%	-11.64%
BBB	-5.02%	-5.01%	-5.95%
MBS Sector	0.75%	1.87%	3.84%
ABS Sector	-2.60%	-3.72%	-6.33%
High Yield Sector	-7.98%	-8.89%	-10.08%
Municipal Sector	-4.69%	-3.21%	-3.19%
TIPS	-3.83%	-3.54%	1.17%