

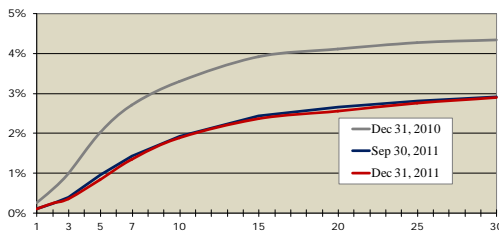


Baird Advisors
Fixed Income Market Comments
December 2011

Treasury Yields Fall, Curve Flattens in 2011

Continued concerns about the European debt crisis, disappointing economic growth (e.g. US GDP < 2%) and the Fed's *Operation Twist* caused Treasury yields to fall sharply in 2011. Most of the declines came in the 3rd quarter, but yields continued to drift lower in the 4th quarter as well. The decline in yields in 2011 came as a surprise to many investors as consensus expectations had been for stronger US economic growth (3-4%) and rising rates. For the year, long-term yields plunged nearly 1½% and the yield curve flattened significantly as the spread between 2 and 30 year Treasury yields declined to 265 bps at year end from 374 bps on 12/31/10 (see chart and table below).

Treasury Yields (Source: Bloomberg)



Maturity	Dec 31, 2010	Sep 30, 2011	Dec 31, 2011	Q4 Change	2011 Change
1	0.26%	0.10%	0.10%	0.00	-0.16
2	0.59%	0.24%	0.24%	0.00	-0.35
3	0.99%	0.40%	0.35%	-0.05	-0.64
5	2.01%	0.95%	0.83%	-0.12	-1.18
7	2.70%	1.43%	1.34%	-0.09	-1.36
10	3.29%	1.92%	1.88%	-0.04	-1.41
30	4.33%	2.91%	2.89%	-0.02	-1.44

Taxable Yield Spreads Widen

In addition to taking the wind out of the sails of the equity markets in 2011, the escalating turmoil in Europe and slower than expected economic growth also caused yield spreads in the bond market to widen dramatically in the 3rd quarter (see table below left). In particular, spreads on high yield bonds, investment grade corporates and CMBS widened sharply as heightened concerns of a double-dip recession reignited investors' sensitivity to risk (aka *risk-off*). While spreads on most sectors did narrow during the 4th quarter as investors saw value and returned to the market, spreads in the finance sector continued to edge slightly wider on concerns that large, global financial institutions will not be completely immune from the debt crisis in Europe.

Option-Adjusted Spreads (in bps)

	12/31/2010	6/30/2011	9/30/2011	12/31/2011
U.S. Aggregate Index	56	54	90	87
U.S. Agency (non-mortgage) Sector	20	21	31	33
Mortgage and ABS Sectors				
US Agency Pass-Throughs	42	37	80	75
Asset-Backed Securities	82	81	77	99
CMBS	254	219	351	308
Credit Sectors				
U.S. Investment Grade	156	153	238	234
Industrial	134	135	190	184
Utility	147	143	192	186
Financial Institutions	191	187	332	337
U.S. High Yield	526	525	807	699

Source: Barclays Capital

Municipal Returns by Quality (%)

	Muni Index	AAA	AA	A	BBB
2011	10.70	8.75	10.28	12.53	11.84
2010	2.38	2.03	2.05	2.23	3.75
2009	12.91	9.06	11.72	15.87	26.09
2008	-2.47	1.61	-0.76	-5.97	-21.33
2007	3.36	3.84	3.52	2.67	-2.73
5-year annualized	5.22%	5.01%	5.25%	5.17%	2.28%

Source: Barclays Capital

Risk-On in Municipals

Municipal investors embraced risk in 2011 despite continued challenging credit dynamics in that market. As a result, lower quality issues outperformed higher rated issues by significant margins (BBBs and As returned +11.84% and +12.53% respectively vs. AAAs at +8.75%, see table above right). Lower quality returns have varied greatly in recent years and have reflected investors' appetite for risk. While state and local municipal revenues have increased in each of the last eight quarters, they are still well below peak levels prior to 2008 and budgetary stress is still prevalent at all levels of municipal government as evidenced by pervasive downgrades (Moody's downgrades outnumbered upgrades 5 to 1 in Q3). The dearth of new issue supply (32% below 2010) was the key driver of strong municipal performance in 2011 and supply/demand technicals appear to have prevailed over credit fundamentals.

Strong 4th Quarter Caps off Exceptional Year

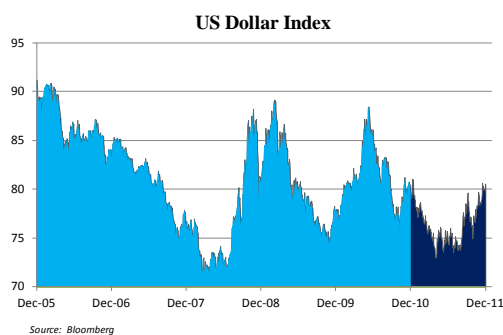
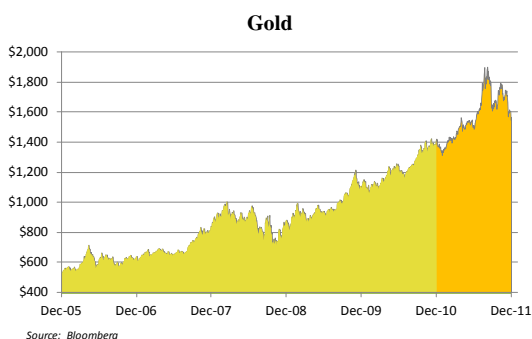
Strong returns in the 4th quarter capped off an exceptional year overall for the bond market (see table on next page). With the decline in yields, Treasuries produced a 9.81% return which provided a solid base for very strong market returns in 2011, but the widening of yield spreads resulted in varied returns across other sectors. Benefitting from weak supply, municipals bounced back after a weak 2010 and returned an amazing 10.70% in 2011. Investment grade corporates had a great December (+2.14%) and, despite the widening of yield spreads in the second half, still managed to deliver an attractive 8.15% return for the year. High yield bonds had an impressive bounce in tandem with equities in the 4th quarter (+6.46%) that brought the sector back into positive territory, but still finished in the cellar for the year (+4.98%). After an eye-popping 2010, CMBS also had a strong 4th quarter (+3.11%) and finished this year with a respectable 6.02% return, as did Agency MBS (+6.23%) and ABS (+5.15%). In spite of considerable concern in the market that the odds of a double dip recession were growing, possibly the biggest surprise of 2011 was increasing demand for inflation protection that propelled TIPS to a staggering 13.56% return. Bond investors again had to endure *pesky* (historically high) volatility in 2011, but patience was rewarded in the end with very strong returns overall.

Total Returns of Selected Barclays Capital Sectors and Indices

Sector/Index	December	4 th Quarter	2011	2010
US Treasury Sector	0.97%	0.89%	9.81%	5.87%
Gov't Agency Sector	0.51%	0.48%	4.86%	4.56%
Corporate Sector	2.14%	1.93%	8.15%	9.00%
MBS Sector	0.70%	0.88%	6.23%	5.37%
CMBS Sector	1.31%	3.11%	6.02%	20.40%
ABS Sector	0.13%	0.23%	5.14%	5.85%
Municipal Sector	1.90%	2.12%	10.70%	2.38%
TIPS	0.04%	2.69%	13.56%	6.31%
High Yield Sector	2.66%	6.46%	4.98%	15.12%
BC Aggregate Index	1.10%	1.12%	7.84%	6.54%
BC Gov't/Credit Index	1.29%	1.18%	8.74%	6.59%
BC Int. Gov't/Credit Index	0.78%	0.84%	5.80%	5.89%
BC 1-3 yr. Gov't/Credit Index	0.10%	0.25%	1.59%	2.80%

Gold and the Dollar

Gold has been on the rise for the past several years (see chart below left) and its ascent has largely been viewed as 1) a proxy for investors' inflation expectations and/or 2) a measure of investors' concern about the overall health and stability of the global financial system and currencies. While the price of gold did rise 10% in 2011 (\$1,564 at year end vs. \$1,421 on 12/31/10), it is worth noting that it ended the year 21.5% off its peak of \$1,900 (on 9/5/11). The sharp decline in gold late in the year could be an indication that investors' inflation concerns are easing and/or that concerns about another imminent global financial meltdown are cooling. In contrast to gold, the US Dollar has been on a volatile, yet generally downward trend over the past several years. The US Dollar Index, which indicates the general international value of the Dollar by averaging exchange rates between the Dollar and other major world currencies, appears in the chart, below right. This descent has reflected 1) the impact of the Fed's zero-rate policy on exchange rates with other countries with higher target rates and 2) concern that global investors will shy away from US assets because of fears that current US fiscal and monetary policies will ultimately lead to a substantial devaluation of the Dollar. While the Dollar essentially finished 2011 right where it started the year, it did manage to stay above the lows of 2007 and also jumped 9.9% from its 2011 low in late April. The Dollar's rise in the second half of 2011 is encouraging and could be an indication that, despite a zero-rate policy in place through 2012, investors' appetite for Dollar-denominated assets may be rebounding as risks in other parts of the world grow.



Outlook

Interest rates –the sharp decline in long-term Treasury yields in 2011 was surprising and we believe that the Fed has been successful in driving [and holding] Treasury yields artificially low. We believe that wider yields spreads are as much the market's acknowledgement that Treasury yields are artificially low as they are a reflection of genuine concern about relative risks in non-Treasury sectors. We would not be surprised if Treasury yields rebounded somewhat in 2012, but with wages and employment still soft, we do not believe inflation will be a major concern in the near future and accordingly, are not looking for market yields overall to rise significantly over the next twelve months.

Sectors –we see limited relative return potential for Treasuries and Agencies in 2012 and, with the widening of yield spreads in 2011, believe spread sectors offer better value. Investment grade corporates look particularly attractive given strong underlying credit fundamentals but we caution that sluggish economic growth could present challenges for many issues in the high yield sector. We believe CMBS structures with superior credit enhancement will perform well and while residential mortgages should benefit from a strong commitment from the Fed to keep mortgage rates low, a wide range of potential developments on the government policy front poses significant uncertainty to that sector. With an expected 20% increase in new issue supply in 2012, municipal returns will likely be softer in 2012, but continued demand should be able to absorb additional supply and keep yields from rising sharply. We again caution investors against going too far out the yield curve or too far down in quality given the high level of global uncertainty and broad spectrum of potential outcomes.