Mesirow

Strategic Fixed Income | Commentary

Market commentary

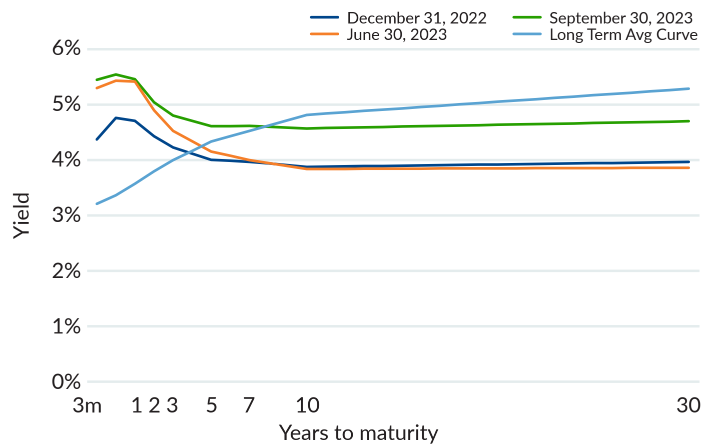
During the third quarter of 2023, fixed income investors endured a difficult market with the Bloomberg Aggregate Bond Index losing 3.23% as interest rates rose meaningfully on the back of continued hawkishness from the Fed. The rates sell off dragged the year-to-date performance into negative territory with a return of -1.21% for the nine months ended September 30.

As we entered the third quarter, investors gained confidence that recession concerns in the US were abating and there was continued optimism that the Fed had engineered an unlikely soft landing. However, the US economy continued to show growth buoyed by continued strength in the labor markets, with positive real wage growth leading to resilient consumer spending.

Interest rates rose across the curve with the rise of more pronounced for longer maturities, resulting in the yield curve steepening. The curve began the third quarter inverted by 106 basis points (bps) between the 2-year and the 10-year yields. By the end of the quarter, this inversion was down to 47bps. Rising rates in the longer part of the yield curve were driven by continued strong economic growth, increasing US Treasury issuance, and the market recognition of the Federal Open Market Committee (FOMC)'s "higher for longer" intentions.

After pausing at the June FOMC meeting, the Fed increased the Fed Funds rate by 25bps to a target range of 5.25-5.50% at its meeting on July 26. In its statement the Committee cited robust job gains with a continued low unemployment rate and noted that inflation remained elevated. The FOMC elected to pause at its September 20 meeting however with an increasingly hawkish stance as the Fed dot plot removed 100bps of cuts in their forward guidance while also pushing the likelihood of any cuts into the fourth quarter of 2024.

CHART 1: US TREASURY YIELD CURVES

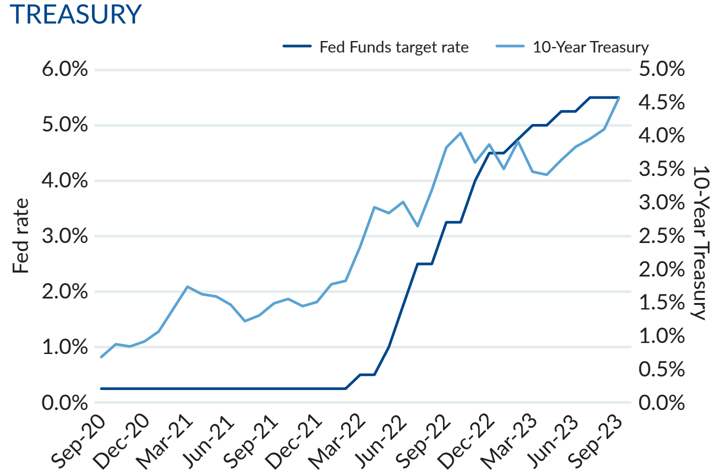


Source: Bloomberg, Mesirow SFI.

	12.31.2022 (%)	6.30.2023 (%)	9.30.2023 (%)	Change from 6.30.2023–9.30.2023
3-Month	4.37	5.30	5.45	15bps
2-Year	4.43	4.90	5.05	15bps
5-Year	4.01	4.16	4.61	46bps
10-Year	3.88	3.84	4.57	73bps
30-Year	3.97	3.86	4.70	84bps

Source: Bloomberg, Mesirow SFI.

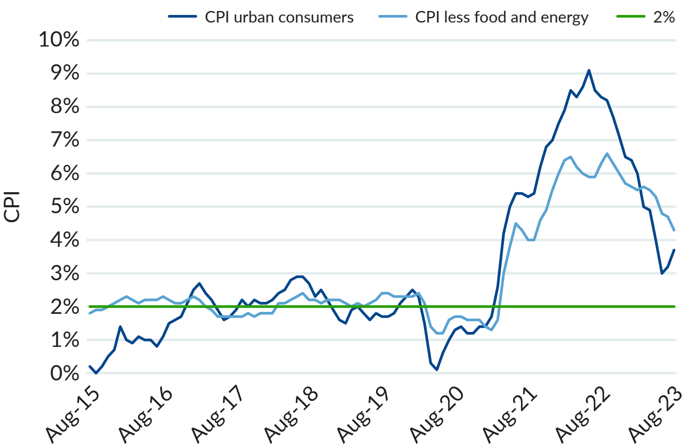
CHART 2: FED FUNDS TARGET RATE VS TEN-YEAR TREASURY



Source: Bloomberg, Mesirow SFI.

Headline CPI re-accelerated to +3.7% year-over-year in the third quarter following the second quarter's moderation to +3.0%. Energy price increases were a large contributor to the higher CPI print as oil rallied +28% to $90.79 during the quarter. Meanwhile, the Fed's preferred inflation metric, Core PCE, continued its trend of moderation on the back of decelerating consumer spending, particularly in services sectors. Despite August's sequential -40bp deceleration to +3.88% year-over-year PCE growth, the measure remains well above the Fed's baseline +2% inflation target.

CHART 3: INFLATION INDICATORS



Source: Bloomberg, Mesirow SFI.

Persistent labor market strength continues to feed "higher for longer" narratives with respect to interest rates. September's preliminary jobs data indicated +336,000 additions to non-farm payrolls, providing a significant upside shock relative to subdued expectations that had called for +170,000 adds. Meanwhile, the unemployment rate did rise slightly from 3.6% to 3.8% by quarter end. However, for now, the 20bp increase in this notoriously lagged indicator provides little evidence of anything beyond slight normalization off of multi-decade lows. As such, +4.2% wage growth year-over-year remains strong enough to prop up headline inflation and keep fears of sticky secular inflation alive.

The Credit Index Option-Adjusted Spread (OAS) rests at the tighter end of its post-COVID range, trading in a tight band between +104 and +116bps during the third quarter before ultimately closing at +112. Sitting +8bps off July's +104 low, credit spreads appear less than attractive relative to their annual range, especially when considering the heightened macro risk backdrop as the lagged effects of monetary policy begin to be felt. That said, a dichotomy exists as these tight spread levels contrast with yields, which have reached their highest level since 2007. As such, traditional yield buyers continue to find spread products attractive, with pension funds being particularly reliable buyers of long-term corporate bonds to hedge their improved funded status. This institutional demand, coupled with underwhelming corporate supply at the long end of the curve, forms a positive technical backdrop, leaving us moderately constructive on credit spread performance near-term.

Within the index, the best-performing industries hailed from the energy sector with Oil Field Services, Refining, and Independent Oil producing strong excess returns on the back of rising oil prices. Other outperformers included Life Insurance, Building Materials and Cable Satellite. Meanwhile, Financials underperformed as elevated interest rate volatility led to increased uncertainty surrounding funding costs and earnings outlook. Banking and Construction Machinery, with their captive finance companies, were clear laggards.

Softening, yet still broadly healthy, credit fundamentals continued to be the primary theme from the tail end of second quarter earnings through the initial results to start the third quarter. Revenue growth continued to decelerate, although year-over-year growth figures looked slightly better compared to the second quarter on a sequential basis. This has been mostly a function of easier second half comparisons versus the prior year. Revenue growth of +1.9% remains insufficient to offset rising input costs and interest expense, although the deceleration in margin declines has invited investor speculation as to the timing of a bottom in the corporate profit recession. Either way, leverage continued to increase toward pre-COVID levels while interest coverage moved further from its cycle peak. We continue to believe that fundamentals will become increasingly idiosyncratic into a lower growth and possibly recessionary environment as higher rates, cyclical forces and secular trend shifts bring greater stress upon certain credits.

The Mortgage-Backed Securities Index OAS widened +14bps during the third quarter to close the month of September at +66bps, leading to a dismal -4.05% total return, pushing the year-to-date figure negative to -2.26%. Up until the last week of September, index spreads had remained rangebound between +48 and +60bps from the end of May until the spike in interest volatility pushed the basis wider. With rate volatility elevated and neither a Fed nor a traditional bank buyer in the market, the OAS has not been able to find stability.

Within the stack, higher coupons found more support than lower coupons amidst the interest rate sell-off. At this point, only premium dollar coupons of 5.50% and higher have held onto year-to-date positive total return, with 6.5%s and 7%s positive on the quarter at +0.01% and +0.65%, respectively. By maturity, conventional 15-year mortgage-backed securities (MBS) outperformed 30-year with total returns of -1.82% vs -4.50%, respectively, while discount dollar prices persist across the MBS index except for 6%s and higher.

Despite the negative pressure from a lack of natural buyers, as alluded to above, a contingent of mortgage bulls have continued to highlight the offsetting positive technicals. Positive bond fund flows at higher rates, lack of new mortgage production and tightening lending standards could be considered positive along with the conclusion of FDIC asset sales from the March regional bank crisis. However, this has not been enough to introduce a new marginal buyer into the market, particularly as investors find difficulties sourcing discount dollar MBS and are able to add duration and convexity in the treasury market.

Market outlook

While the Fed delivered a pause at the September FOMC meeting, it came with a clear message of a "higher for longer" restrictive monetary policy. However, the long-term rates sell-off, driven by the higher for longer narrative and continued flow of better-than-expected macro data has been so significant that economists estimate a restrictive impact equivalent to two to three rate hikes. This reinforces our view that the FOMC will likely remain on pause for the rest of the year as the market has done their job for them.

Additionally, we do not expect a policy pivot until the second half of 2024 at the earliest. We continue to believe it is unlikely that the FOMC will cut rates immediately after a prolonged rate hiking campaign, with inflation indicators still well above the Fed's stated 2.0% inflation target. The Fed's most recent dot plot projections illustrate more uniformity in views with a slight possibility of one more hike before any rate cuts later in 2024.

The dramatic rise in longer-term interest rates in the latter part of the third quarter surprised many market participants but given the Fed's clear hawkish stance coupled with looming Treasury supply, some of the increase was certainly warranted. During the third quarter, the yield on the 10-year US Treasury (UST) rose 73bps to close at 4.57%, meaningfully higher than most expectations. We believe that volatility likely remains elevated for the remainder of the year as the market grapples with the Fed's terminal rate. We expect yields to be range bound at these higher levels, with the 10-year likely trading between 4.40% and 5.10% for the remainder of 2023.

While we expected the US economy to slow down going into the year end, US growth remained relatively strong with a robust job market and continued low unemployment through the first three quarters. As we enter the third quarter earnings season, we will see more evidence of idiosyncratic risks as companies continue to navigate ongoing cost pressures and lower margins. Additionally, we will get more visibility on consumer behavior as they adapt to higher borrowing costs combined with reduced savings and continued inflationary impacts.

Strategy commentary

Within the Mesirow Strategic Fixed Income Core Total Return Composite, our portfolios earned a third-quarter total gross return -3.08%, outperforming the Bloomberg Aggregate Index by 15 basis points. On a net-of-fee basis, our composite earned a total return of -3.12% in the third quarter, bringing our year-to-date performance to -1.06% compared with -1.21% for the Index.

During the quarter, we reduced our exposure to corporate bonds, but we maintained an overweight to the sector. In structured products, our near-market allocation to agency mortgage-backed securities was augmented by an overweight to high-quality asset-backed securities, the latter proving its worth as the only asset class in the Bloomberg Aggregate Bond Index to earn a positive total return for the quarter. We maintained our underweight exposure to US Treasury securities while keeping our duration posture neutral.

Within the Mesirow Intermediate Government/Credit Fixed Income Composite, our portfolios produced a third quarter return that essentially matched that of the Bloomberg Intermediate Government/Credit Index (-0.84% vs -0.83%, respectively) on a gross-of-fees basis. Net of investment management fees, the Intermediate Government/Credit Composite earned a return of -0.89%, trailing that of the Index by 6bps. For the year to date, however, the Intermediate composite earned a gross-of-fees return of +1.09% versus +0.65% for the Index. On a net-of-fees basis, the composite earned +0.91%, outperforming the Intermediate Government/Credit Index by 26bps.

Past performance is not indicative of future results. Please see the following pages for footnotes and additional disclosures.

During the quarter, benefits from security selection and sector allocation were offset by a drag from our curve positioning with respect to interest rates. While maintaining near-neutral duration exposure, we emphasized 10-year maturity corporate bonds while generally underweighting the 2-year part of the curve. This exposure was a result of corporate issuance patterns bringing attractive concessions and relative value opportunities. Yet, this maturity positioning resulted in a marginal drag on performance as interest rates in the 10-year part of the curve rose more than the front end. However, the overweight to corporate bonds and underweight to treasuries was beneficial to performance as corporates outperformed. Additionally, our security selection factor was positive despite the top three outperformers (Fortune Brands, BAT Capital, Johns Hopkins University) all hailing from the underperforming 10-year maturity bucket.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture. To learn more, visit mesirow.com and follow us on LinkedIn.

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Past performance is not indicative of future results. Please refer to the disclosures at the end of this material and the GIPS Report for complete performance information and benchmark /index definitions.

The Bloomberg US Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

The Bloomberg US Mortgage Backed Securities (MBS) Index measures the performance of US fixed-rate agency mortgage backed pass-through securities.

The Bloomberg Intermediate Government/Credit Index is the intermediate component of the US Government/Credit index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the US Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of US Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US Government). The Credit Index includes publicly issued US corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

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GIPS REPORT – CORE TOTAL RETURN COMPOSITE

Gross and Net of Fees Total Returns from January 1, 2000 – September 30, 2023

	Year end			Annual performance results				3-year annualized dispersion[2]	
Year	No. of portfolios	Composite Asset at end of period ($MM)	Total Firm Assets ($MM)	MFIM (gross) Composite (%)	MFIM (net) Composite (%)	Bloomberg US Aggregate Index (%)	Composite Dispersion[1] (%)	MFIM (gross) Composite (%)	Bloomberg US Aggregate Index (%)
2000	5 or fewer	290	n/a	12.51	12.37	11.63	n/a	–	–
2001	5 or fewer	562	n/a	8.59	8.46	8.44	n/a	–	–
2002	5 or fewer	575	n/a	10.69	10.55	10.25	n/a	–	–
2003	5 or fewer	643	n/a	4.49	4.36	4.10	n/a	–	–
2004	5 or fewer	830	n/a	4.83	4.70	4.34	n/a	–	–
2005	5 or fewer	665	1,911	2.53	2.43	2.34	n/a	–	–
2006	9	997	2,258	4.64	4.47	4.33	0.15	–	–
2007	9	1,198	2,684	6.20	6.05	6.96	0.14	–	–
2008	10	1,313	2,971	3.39	3.25	5.24	0.41	–	–
2009	12	1,378	3,251	11.97	11.81	5.93	0.93	–	–
2010	16	1,386	3,241	7.34	7.19	6.54	0.28	–	–
2011	14	1,387	3,516	7.37	7.21	7.84	0.40	2.92	2.78
2012	12	658	4,106	6.00	5.78	4.22	0.33	2.32	2.38
2013	14	805	4,871	-1.90	-2.10	-2.02	0.09	2.73	2.71
2014	15	987	4,972	6.47	6.24	5.97	0.18	2.70	2.63
2015	14	858	4,532	0.04	-0.17	0.55	0.17	2.93	2.88
2016	14	863	4,410	3.27	3.05	2.65	0.26	2.97	2.98
2017	14	941	4,772	3.53	3.32	3.54	0.12	2.74	2.78
2018	13	719	4,161	-0.04	-0.21	0.01	0.15	2.72	2.84
2019	9	612	3,895	9.16	8.94	8.72	0.14	2.80	2.87
2020	10	789	6,706	8.84	8.62	7.51	0.16	3.57	3.36
2021	11	1,099	6,168	-1.65	-1.84	-1.54	0.10	3.67	3.35
2022	7	711	3,616	-12.27	-12.43	-13.01	0.16	5.90	5.77
Current Performance Results									
2023 YTD	10	841	3,737	-0.92	-1.06	-1.21	n/a	6.06	6.12

Past performance is not necessarily indicative of future results

Mesirow Financial Investment Management Institutional Fixed Income claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Mesirow Financial Institutional Fixed Income has been independently verified for the periods 01.01.1996 - 12.31.2021. A firm that claims compliance with the GIPS standard must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with GIPS standards and have been implemented on a firm-wide basis. The Core Total Return Composite has had a performance examination for the periods 01.01.2006 -12.31.2021. The verification and performance examination reports are available upon request.

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The above composite was created on 01.01.2000, the inception date is 01.01.2000.

Core Total Return Fixed Income Composite is defined as U.S. dollar dominated fixed income investment grade securities primarily rated BBB- or better and with a maturity range of one to thirty years at the time of purchase. The Core Total Return composite consists of fixed income fee-paying discretionary portfolios with a minimum of $7,500,000 under management. The benchmark is the Bloomberg Aggregate Index. In March of 2005, the Core Total Return fixed income portfolio management team of an independent investment advisor joined the MFIM Fixed Income portfolio management team. The performance results shown prior to 03.15.2005 reflect the team's performance prior to joining MFIM-Fixed Income. Such returns have been incorporated into the MFIM Core Total Return Fixed Income composite. Upon receipt of client consent, MFIM-Fixed Income obtained the required custody and holdings information from the independent custody firms, or other similar sources, for all clients that have been managed on a continuous basis and that information has been incorporated into the MFIM Core Total Return Fixed Income composite. The list of composite descriptions, the list of pooled fund descriptions for limited distribution pooled funds, and the firm's list of broad distribution pooled funds is available upon request. For the period, portfolios below $7,500,000 are considered nondiscretionary, as MFIM-Fixed Income may be unable to fully and efficiently implement the intended investment strategy of the composite. Effective 01.01.2019, accounts will be temporarily removed from the composite due to significant cash flows of 15% or more of market value. Prior to 01.01.2019, accounts had been temporarily removed from the composite due to significant cash flows of 10% or more of market value. Additional information regarding the significant cash flow policy is available upon request.

Calculation of Risk Measures: Annual / 3 Years Dispersion

(1) Composite dispersion presented is the equal-weighted standard deviation of the gross annual returns of portfolios in the composite for the entire year. Because it is not statistically meaningful, MFIM Fixed Income does not calculate the dispersion of annual returns for the years the composite held five or fewer accounts.

(2) The three-year annualized ex-post standard deviation measures the variability of the composite gross returns, and the benchmark returns over the preceding 36-month period. It is not required to be presented for annual periods prior to 2011 or when a full three years of composite performance is not yet available.

Performance / Net of Fee Disclosure

MFIM-Fixed Income's investment management fees vary based upon account size, with breakpoint deductions for larger accounts and a minimum annual fee of $20,000. The standard fee schedule for Core Total Return Portfolios is listed below:

0.350% on the first $10 million

0.250% on the next $40 million

0.200% on the next $100 million

0.150% on the next $150 million

0.125% on the next $200 million

0.100% over $500 million

Performance information that is provided gross of fees does not reflect the deduction of advisory fees. Client returns will be reduced by such fees and other expenses that may be incurred in the management of the account. Advisory fees are described in Form ADV Part 2 of Mesirow Financial Investment Management, Inc. Net of fee performance is presented utilizing actual client net of fee performance for all accounts included in the composite. We do, however, have clients that pay lower fees than the maximum. Any stated results include the reinvestment of dividend and other earnings. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. Benchmark returns are not covered by the report of independent verifiers.

Benchmark Definition

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GIPS REPORT – INTERMEDIATE GOVERNMENT/CREDIT FIXED INCOME COMPOSITE

Gross and Net of Fees Total Returns from January 1, 1995 – September 30, 2023

	Year end			Annual performance results				3-year annualized dispersion[2]	
Year	No. of portfolios	Composite Asset at end of period ($MM)	Total Firm Assets ($MM)	MFIM (gross) Composite (%)	MFIM (net) Composite (%)	Bloomberg Int. Gov/Credit Index) (%)	Composite Dispersion[1] (%)	MFIM (gross) Composite (%)	Bloomberg Int. Gov/Credit Index (%)
1995	5 or fewer	16	n/a	18.04	17.84	15.33	n/a	–	–
1996	5 or fewer	20	n/a	3.92	3.74	4.06	n/a	–	–
1997	5 or fewer	22	n/a	10.34	10.15	7.87	n/a	–	–
1998	5 or fewer	25	n/a	9.08	8.89	8.41	n/a	–	–
1999	5 or fewer	10	n/a	0.49	0.32	0.33	n/a	–	–
2000	5 or fewer	13	n/a	11.35	11.16	10.10	n/a	–	–
2001	5 or fewer	11	n/a	9.13	8.94	8.98	n/a	–	–
2002	5 or fewer	12	n/a	11.05	10.86	9.82	n/a	–	–
2003	5 or fewer	19	n/a	4.43	4.21	4.30	n/a	–	–
2004	5 or fewer	186	n/a	3.90	3.70	3.04	n/a	–	–
2005	5 or fewer	152	1,911	1.49	1.39	1.57	n/a	–	–
2006	5 or fewer	152	2,258	4.46	4.33	4.06	n/a	–	–
2007	5 or fewer	158	2,684	6.43	6.24	7.40	n/a	–	–
2008	5 or fewer	139	2,971	1.58	1.39	5.08	n/a	–	–
2009	5 or fewer	141	3,251	14.68	14.47	5.24	n/a	–	–
2010	7	223	3,241	7.40	7.20	5.89	n/a	–	–
2011	5 or fewer	206	3,516	5.48	5.28	5.80	n/a	3.20	2.55
2012	6	213	4,106	6.40	6.18	3.89	0.43	2.14	2.16
2013	7	200	4,871	-0.66	-0.87	-0.86	0.03	2.28	2.11
2014	7	210	4,972	3.80	3.54	3.12	0.08	2.10	1.94
2015	6	194	4,532	0.98	0.74	1.07	0.11	2.13	2.10
2016	6	195	4,410	2.30	2.05	2.08	0.09	2.13	2.22
2017	6	205	4,772	2.26	2.02	2.14	0.10	2.01	2.11
2018	7	189	4,161	0.95	0.72	0.88	0.13	1.95	2.09
2019	6	190	3,895	7.19	6.93	6.80	0.12	1.91	2.04
2020	8	228	6,706	7.32	7.05	6.43	0.28	2.45	2.31
2021	8	212	6,168	-1.24	-1.49	-1.44	0.17	2.54	2.34
2022	8	234	3,616	-8.01	-8.23	-8.23	n/a	3.93	3.82
Current Performance Results									
2023 YTD	11	250	3,737	1.09	0.91	0.65	n/a	3.98	4.04

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Calculation of Risk Measures: Annual / 3 Years Dispersion

(1) Composite dispersion presented is the equal-weighted standard deviation of the gross annual returns of portfolios in the composite for the entire year. Because it is not statistically meaningful, MFIM Fixed Income does not calculate the dispersion of annual returns for the years the composite held five or fewer accounts.

(2) The three-year annualized ex-post standard deviation measures the variability of the composite gross returns, and the benchmark returns over the preceding 36-month period. It is not required to be presented for annual periods prior to 2011 or when a full three years of composite performance is not yet available.

Performance / Net of Fee Disclosure

MFIM-Fixed Income's investment management fees vary based upon account size, with breakpoint deductions for larger accounts and a minimum annual fee of $20,000. The standard fee schedule for Intermediate Government/Credit Portfolios is listed below:

0.350% on the first $10 million
0.250% on the next $40 million
0.200% on the next $100 million
0.150% on the next $150 million
0.125% on the next $200 million
0.100% over $500 million

Performance information that is provided gross of fees does not reflect the deduction of advisory fees. Client returns will be reduced by such fees and other expenses that may be incurred in the management of the account. Advisory fees are described in Form ADV Part 2 of Mesirow Financial Investment Management, Inc. Net of fee performance is presented utilizing actual client net of fee performance for all accounts included in the composite. We do, however, have clients that pay lower fees than the maximum. Any stated results include the reinvestment of dividend and other earnings. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Benchmark returns are not covered by the report of independent verifiers.

Benchmark Definitions

The Bloomberg Intermediate Government/Credit Index is the intermediate component of the U.S. Government/Credit index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

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