Mesirow

Capital Markets Brief

Welcome to the 1Q2023 Capital Markets Brief

This quarter, we have expanded our topics to include a more comprehensive set of fixed income markets. While our strongest conviction is knowing that the next wave of volatility will likely come from an asset class that is currently out of focus, we will do our best to provide expertise and information as these extraordinary times continue to unfold.

At his March 22nd press conference, Jerome Powell said the word "bank" (including phrases such as "banking system" and "banking sector") a total of 63 times. It was the primary topic discussed in the meeting's Q&A and, as we all know, was, and remains today, front of mind for virtually everyone working on Wall Street.

What we found equally interesting was the number of times the words "bank" or "banking sector" appeared in Chairman Powell's December 2022 remarks and press conference: Zero. Not one mention of bank distress, mark-to-market risk, or any change in FDIC policy for protecting deposits. Yet, one day in March we woke up and 20% of deposits had left traditional savings accounts, and every banker, portfolio manager and salesperson on the street was an expert in bank balance sheets. It was all anyone could talk about.

In the face of continued, unprecedented uncertainty, other numbers jump off the page and add to the confusion. For the quarter, the S&P 500 advanced 7%, and the Nasdaq was up 17% (led by Meta Platform's astonishing 76% increase). Bond prices also proved resilient, with the 10-year US Treasury posting its largest quarterly decline since 2020 (a 43 basis point drop). Employment data remains sticky, the Federal Reserve continues to unwind the balance sheet while the money supply and inflation continue to drop but remain historically high. If you ask 10 experts if and when the US will be in a recession, you're likely to get 11 different answers.

The question that our clients continue to ask is simple – what comes next? Currently, the market views it as more likely than not that the Federal Reserve will increase rates at its May meeting. However, there is also growing sentiment that the likelihood of a Fed pause at some point this year is now high, which begs the question: Is this a signal of success against inflation, or has the recent bank crisis flipped the hawks into defensive mode? The reality is that nobody knows. How can we? The topic of next quarter's Brief will almost certainly be something that Chairman Powell has not even discussed, and that all of us bankers have yet to become experts on.

Until then, we hope this updated version of our Capital Markets Brief is informative.

Featured insights

Corporate Credit

The fall of Silicon Valley Bank and Credit Suisse blindsided an already unsettled credit market. In our analysis, we assess the events, the aftermath, and what they may portend.

Real Estate

Lenders and Borrowers in commercial real estate remain in a standoff about the best path to refinance assets in a higher rate environment. Rate caps are making a big problem even bigger.

Municipal Bonds

A flight to quality helped give munis their 2nd best March in 27 years. What next? We discuss how bank stress factors and prepay gas bonds may affect the market going forward.

Mortgage-Backed Securities

We examine why, despite recent volatility, we believe prudent investors can build a portfolio of Agency Mortgage-Backed Securities that can perform well for years to come.

Interest Rates

Recently, two themes have ruled the Treasury market: a flight to quality and a flow of cash from banks to money funds. We think this historic volatility may equal opportunity.

Conclusion

Clients investing in the chaotic credit markets are asking "what comes next?" The truth: nobody knows. For now, it's caution and concern.

Corporate Credit Market Insights

What Just Happened?

Prior to the events in the banking sector in mid-March, credit markets were predominately focused on the efforts of global central banks and their fight against inflation. The OAS of the Bloomberg Barclays Corporate Index (Credit Index) stood at +124bp, historically low relative to the 20-year average of +153bp.

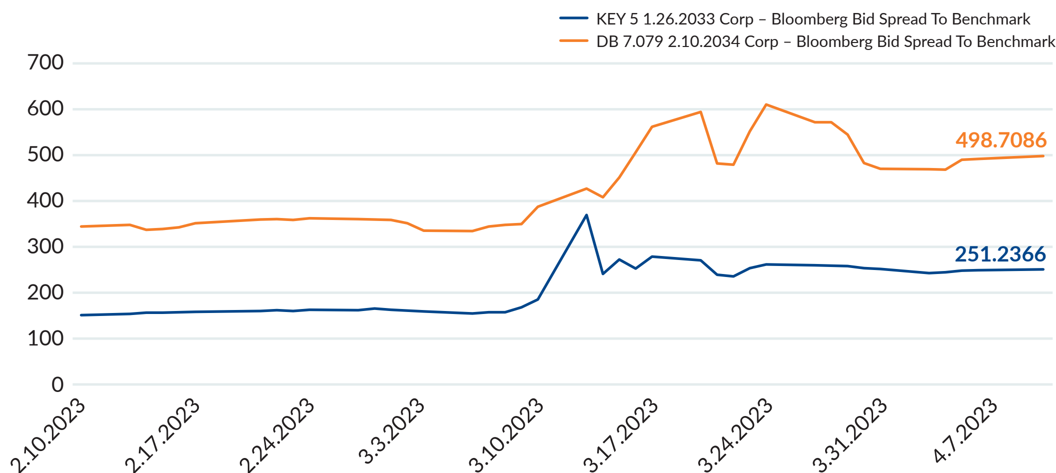
However, market shocks always come from the place least expected – in this case in the form of the largest bank failure since 2008.

On March 10th, Silicon Valley Bank was taken over by the FDIC, after a failed capital raise and a run on its bank deposits. This subsequently led to the collapse of Signature Bank and eventually the end of the Credit Suisse saga, with a government orchestrated takeover by UBS. In an effort to stem a full-scale banking crisis, the Federal Reserve and US Treasury created the Bank Term Funding Program and allowed depositors in the failed banks full access to their funds above the $250,000 FDIC insurance limit.

Credit markets responded to the banking stress by re-pricing risk significantly wider. The brunt of the widening was appropriately centered around financial sector firms, with spreads on US regional banks and European banks experiencing the most pressure. This can be seen in the below chart of spreads on Key Bank and Deutsche Bank bonds.

Greg McKee
Senior Managing Director
Institutional Sales & Trading

CHART 1: **KEY BANK '33 AND DEUTSCHE BANK '34**



Source: Bloomberg; Mesirow research.

At time of this writing, market fears of a systemic banking crisis have somewhat subsided. However, spreads on US regional and European banks remain elevated, showing that investors have lingering concerns around this subsector of the market. Overall, the spread on the credit index has recovered from +162bp to +144bp. Given the historical average spread on the credit index is +153bp, current spread levels do not show a credit market under stress.

The primary market for Investment Grade Credit remains fluid and robust. Despite a brief period when primary markets were closed around the collapse of SVB, issuers came back to market in the second half of March. February 2023 was a record issuance month with $150 billion of volume, eclipsing a record set in February 2021. Month to date, March has seen $100bn come to market. Overall, primary market estimates for the FY2023 issuance are expected to be approximately 10% lower year-over-year due to the lack of large-scale M&As and opportunistic asset liability management. In summary, despite inflation, yield curve inversion, bank worries and uncertainty of Federal Reserve policy, the market remains open for Investment Grade companies to raise capital.

So…where do markets go from here? The debate of soft landing versus hard landing has been at the forefront since the start of the Federal Reserve's tightening campaign last March. It remains one of the biggest questions in the market today. Federal Reserve policy remains more unclear than ever. Currently the market is pricing a more than likely rate increase at the Federal Reserve's May meeting.

Conversely, the market is pricing in at least two rate cuts by January 2024. However, if inflation remains stubborn, will the Fed have the wherewithal to continue to raise rates at the risk of market instability and damage to the economy?

Additionally, the latest turmoil in the banking market has only compounded the recession debate. Will the consumer remain resilient given many are currently worried about the safety of their cash? Will banks cut back on lending to shore up balance sheets in anticipation of further regulation?

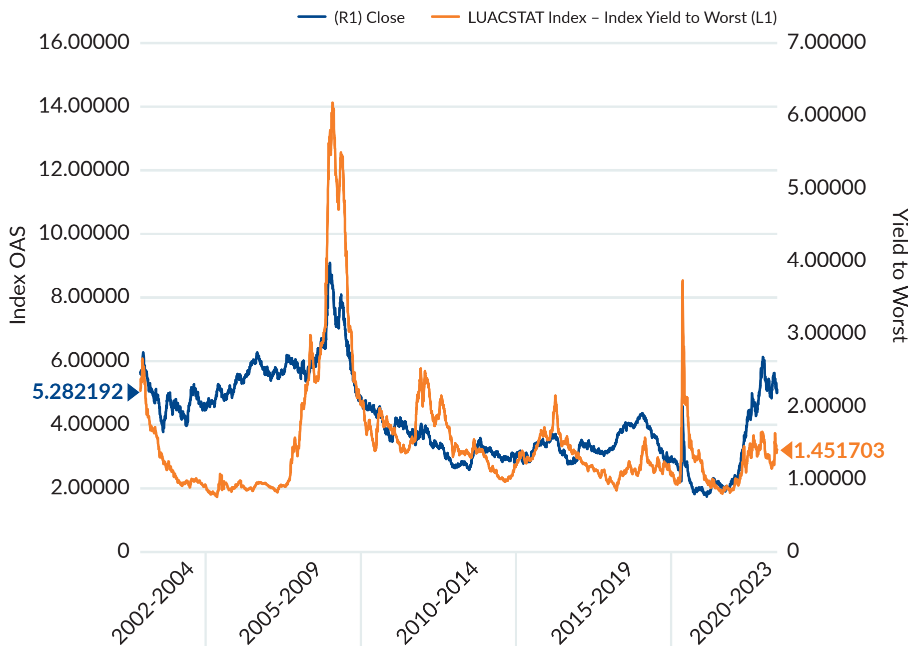
While only time will tell the outcome, credit quality trends for Investment Grade companies were already showing signs of deterioration prior to the collapse of SVB. Looking at the ratio of upgrades to downgrades (S&P ratings) amongst IG credits, there is a reversal in the trend year over year. In 2022, the ratio of upgrades to downgrades was approximately 2 to 1. So far in 2023 that ratio stands at 1 to 2, with S&P issuing twice as many downgrades as upgrades.

Given all these variables, it's hard to imagine credit spreads tightening significantly from current levels. While subsiding fears around the banking system would lead to tightening within the sector; outside of financial sector firms, spreads seem to be fair given the current environment. The weighted average OAS of non-financial issuers within the index currently stands at +131bp. The many plausible outcomes for these variables do not historically bode well for credit spreads. If markets are correct and the Fed will be forced to cut rates by year end, this would be the result of a slowing economy/recession and or significant market instability. Should the market be wrong, and inflation remain elevated, the Fed will be forced raise rates further. This would weigh on asset prices overall and possibly lead to further credit flare-ups similar to last year's LDI crisis and this year's banking crisis. While there is always the Goldilocks scenario where inflation wanes, the Fed can pause, and the economy remains unscathed, this outcome currently seems the least likely of the scenarios.

While we see meaningful spread tightening as unlikely in the near term, there is a silver lining in corporate credit markets: all-in yields. The current yield-to-worst on the Credit Index stands at 5.35%, which is well above the average of 4.30% since 2001. Currently, investors can capture attractive all-in yields in high quality names and defensive sectors like Consumer Staples, Pharmaceuticals, Aerospace and Defense, and Utilities. Thus, we would recommend sticking to these parts of the market, which should provide peace of mind while offering historically attractive yields.

CHART 2: **BLOOMBERG CORPORATE BOND INDEX**

OAS Spread and Yield to Worst



Source: Bloomberg; Mesirow research.

Real Estate Market Insights

The Rate Cap Tug of War: Healthy Assets vs. Unhealthy Cap Stacks

As the Fed intervention in the banking crisis began to calm markets, analysts and much of the financial press seemed to turn their attention to a potential credit crisis that industry experts have been talking about for almost a year – the $150 billion of securitized commercial real estate debt slated to mature in 2023. Making matters worse: Moody's estimates that regional and community banks make up almost 25% of commercial real estate lending. Due to recent events, these banks are largely sidelined, , resulting in a significant increase in the likelihood of maturing loans needing loan extensions or loan modifications. Underpinning this "time bomb" is a new wrinkle that was not a major factor in the GFC fall- out: floating rate extensions and rate cap exposure. This has created a unique circumstance where borrowers of healthy assets are faced with exorbitant costs to simply extend a loan on a performing asset. Although in its early stages, the potential for catastrophic fall-out for borrowers and lenders has caused the CRE lending markets to remain cool (if not frozen) for much of the first quarter.

What are Interest Rate Caps?

In the simplest terms, Interest Rate Caps are an insurance policy that protects both the Lender and Borrower in a variable-rate loan arrangement from extreme upward movements in the underlying rate index – movements that would otherwise cause debt service on the loan to exceed the available cash flow generated from the property.
In technical terms, the Borrower and/or Lender engage an intermediary in a fixed-for-floating arrangement at a "Strike Rate" set at some level well above current rates for the duration of the initial loan term. The intermediary profits if rates stay below the Strike Rate. If rates move above the Strike Rate, the Intermediary pays the difference to the Lender. This allows the Lender to maintain their effective spread to the index while not pushing the Borrower into financial distress. The Strike Rate is typically set at a level so that the Property Debt Service Coverage Ratio (DSCR) remains above the 1.10x to 1.25x range.

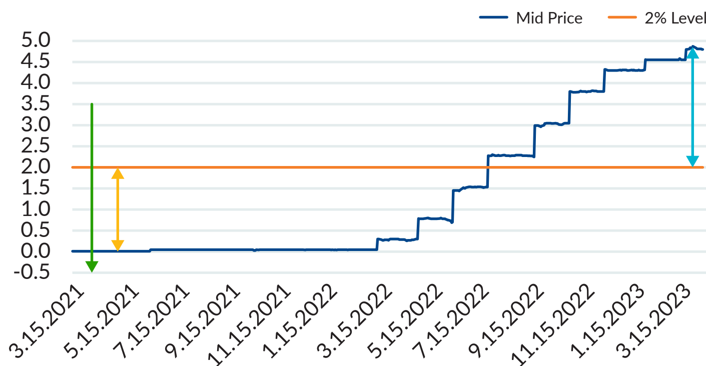
How do Interest Rate Caps block loan extensions?

The Interest Rate Cap is typically purchased for only the initial loan term, the cost of which is typically low because the Strike Rate is well out of the money. However, in a fast-rising rate environment, such as the one we are experiencing now, the Strike Rate can quickly become in the money. When a borrower then goes to extend their loan, the cost of the Interest Rate Cap is exponentially more expensive since the Strike Rate remains the same – yet is now significantly in the money.

Matthew Olsen
Director
Institutional Sales & Trading

Chart 1 provides an example of the potential magnitude of the issue. A 2-year loan originated in March 2021 (the green arrow below), when SOFR was 0.10%, would have a Strike Rate of SOFR 2.00% (the orange line below) providing 1.90% of rate protection on the variable rate (the yellow arrows below). However, when that same borrower goes to extend that loan today at the same SOFR 2.00% Strike Rate, that Strike Rate is now 2.55% "in the money" (the blue arrows below), adding considerable out-of-pocket cost to the borrower to extend the loan:

CHART 1: **SOFR**



Source: Bloomberg; Mesirow Research.

KBRA[1] ran an analysis in December 2022 to determine the magnitude of this additional cost based on a $25mm loan amount. The results are provided in Table 1 below. This analysis indicates that a single 12 month loan extension when the Strike Rate is SOFR 3.00% would result in an additional cost of nearly 180 basis points on the loan amount:

TABLE 1: **COST OF 1-MONTH TERM SOFR IRC FOR A $25 MILLION LOAN**

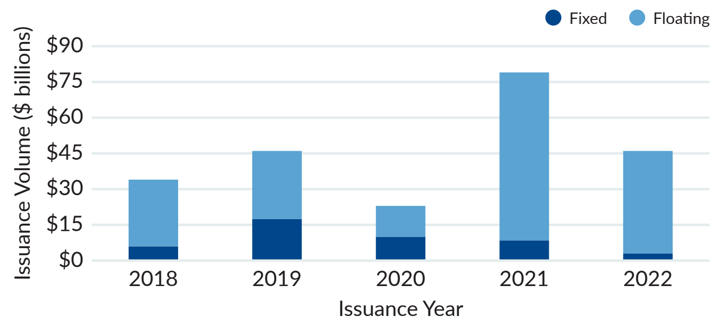
	Term		
Strike Rate	**12 months**	**24 months**	**36 months**
3%	$446,000	$724,000	$946,000
4%	$220,000	$360,000	$493,000
5%	$62,000	$125,000	$207,000
6%	$21,000	$56,000	$102,000

Source: Pensford Interest Rate Cap Pricer (as of December 16, 2022)

How big is the problem?

To understand the magnitude of the problem, it is first important to understand the historic issuance of loans in 2021 due to the historically low-rate environment. Focusing solely on Single Asset Single Borrower (SASB) transactions, of which there was $80B of issuance in 2021, nearly 90% of those loans were issued as floating rate loans (see Chart 3 from the KBRA report below):

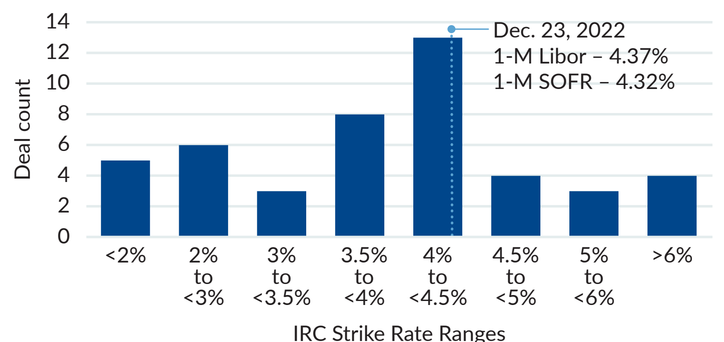
CHART 2: **SASB ISSUANCE 2018 TO 2022**



Source: KBRA, Trepp.

In the SASB universe, approximately $109B of loans are coming due in 2023, of which 90% have extension options available. KBRA analyzed KBRA-rated SASB transactions and determined that 75% of those transactions have rate caps that are currently "in the money" or below the prevailing index (Chart 3):

CHART 3: **CURRENT INTEREST RATE CAPS OF OUTSTANDING KBRA-RATED SASB**

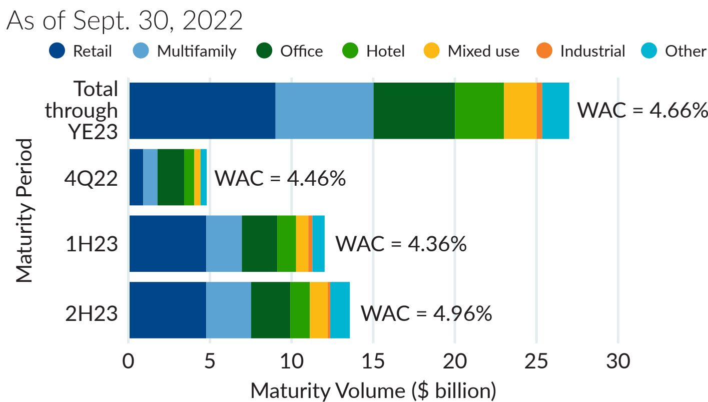


Source: KBRA.

In the Conduit universe, Fitch ran a similar analysis looking at the current Weighted Average Coupons (WAC) of these transactions to estimate the magnitude of the issue. They estimate nearly $26.5B (or 1,493) of Fitch-rated conduit and agency loans are maturing by YE 2023. These loans have a WAC of 4.66%, well below market rates and nearly below current SOFR (Chart 4 of the Fitch analysis below):

CHART 4: **FITCH-RATED US CMBS CONDUIT LOANS MATURING BY YE 2023**

As of Sept. 30, 2022



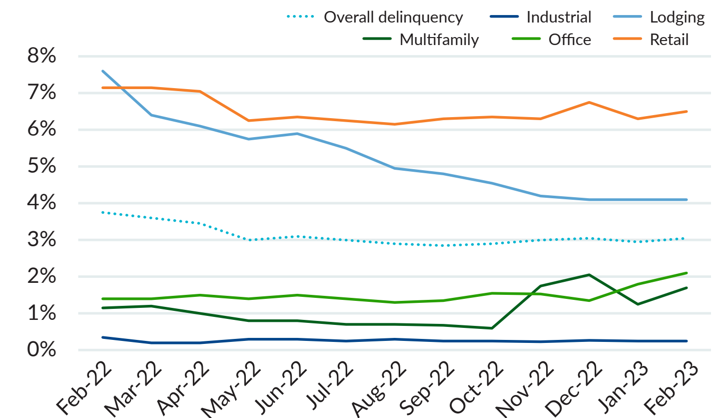
Note: The "other" category includes manufactured housing community, self storage, ground lease, leased fee and parketing garage. WAC – Weighted average coupon. | Source: Fitch Ratings.

What does this mean for Borrowers?

The potential widespread impact and magnitude of issues caused by the Interest Rate Cap in the context of loan extensions, combined with the current lack of liquidity in the new-loan CRE Finance space, will force borrowers to explore the non-traditional real estate finance space to avoid wide-spread defaults. This stress provides a significant opportunity for lenders within the non-traditional real estate finance space, as there has not been a significant deterioration in the performance of underlying assets, broadly.

Chart 5 is from TREPP's February 2023 Delinquency Report, which shows loan delinquency is still sitting at 3.12% overall which is down from 3.87% one year ago and down more significantly relative to the peak of 10.4% in July 2012 (though there are some recent upticks in delinquency in the Office and Multifamily asset classes):

CHART 5: **MONTH-OVER-MONTH DELINQUENCY RATES BY MAJOR PROPERTY TYPE**



Source: Bloomberg; Mesirow Research.

Non-traditional real estate structures, such as those created by Mesirow, will have the unique opportunity to provide financing to potentially high-quality assets at favorable yields to lenders/investors.

1. KBRA – "Nearly 75% of SASB Rate Caps Below Prevailing Index Margin (01.03.2023) | 2. Fitch – "Majority of Maturing US CMBS Conduit Loans Can Refinance" (11.03.2022) | 3. TREPP – "CMBS Delinquency Report" (March 2023)

Municipal Market Insights

Assessing Bank Stress Factors and Prepay Gas Bond Intricacies

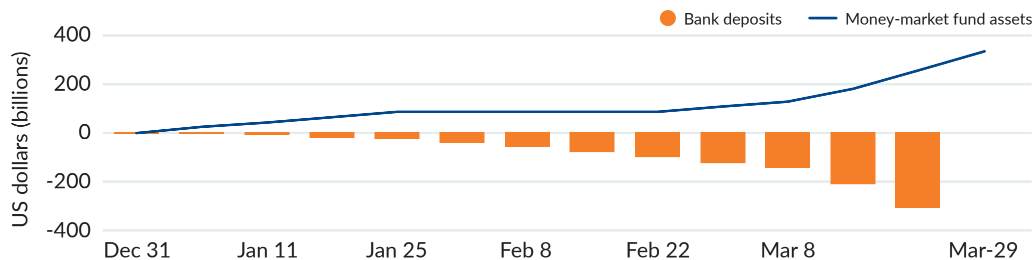
First quarter performance was driven by a general market flight to quality after the second largest bank failure in U.S. history occurred on March 10th. This helped give municipals their 2nd best March performance in 27 years. Outperformance vs Treasuries was driven by 20% lower municipal issuance YTD as state and local governments work down excess ARPA funds. Municipals are directionally starting to show signs of returning to rate-driven performance, as opposed to the credit product behavior the market has experienced since March of 2020. We are less constructive to start the second quarter based on supply build-up, anemic reinvestment dollars, more expensive municipal/treasury ratios, potential less bank buying, and slightly negative flows. A flight to quality, or economic and inflation data that signals we are at the end of fed rate hikes, could offset the aforementioned downbeat technicals. Additionally, we anticipate the start of seasonal heavy summer reinvestment money beginning in May.

CHART 1: **BANK DEPOSITS: WEEKLY CHANGE AT LARGEST AND SMALLEST BANKS**

Source: Bloomberg, Federal Reserve.

CHART 2: **US BANK DEPOSITS ARE SHIFTING TO MONEY-MARKET FUNDS**

Cumulative change since end of 2022



Source: Bloomberg, Federal Reserve, Investment Company Institute.

Mark Whitaker, CFA
Managing Director
Head of Municipal Research
Institutional Sales & Trading

Bing Hsu, PhD, CFA
Managing Director
Institutional Sales & Trading

Recent bank stress has sparked a debate in the market about the impact on ownership of municipal bonds by banks. Banks overall held $384bn of municipal bonds at the end of 2022, or roughly 15% of the market. In Chart 3, we show municipal concentration increases as the size of the bank decreases. These smaller institutions also have increased exposure to commercial real estate loans. In Chart 1, we show that bank deposit outflows were occurring before headlines of bank stress, mostly due to attractive direct investments in money market funds.

CHART 3: **BANK SIZE AND MUNICIPAL CONCENTRATION**

Asset Size	Munis % Total Assets
>1T	0.87
100-999B	0.73
50-99B	1.43
5-49B	2.79
1-4.9B	4.72
500-999M	6.20
250-499M	8.23
1000-249M	8.57
50-99M	8.51
0-49M	7.72

Source: FDIC, Bank Reg Data.

Banks have raised substantial liquidity through Federal Home Loan Bank advances, the discount window, and recently, the Bank Term Funding Program(BTFP), a liquidity facility setup by the Fed to contain bank stress. While the BTFP has favorable terms of up to one year advance and par collateral valuation, the facility is unhelpful for our sector because municipals are not eligible for collateral.

In the long run, we think tax benefits, credit, and performance resiliency are advantages to the asset class for banks to maintain proportionate exposure. In the near term, we are cautious of bank deposit flows in regional and smaller banks and the risk that a pause in bank buying overall could worsen liquidity during a municipal outflow cycle. With an inverted yield curve, we think if there are liquidations, it's possible they will occur out longer on the curve while bond holders keep relatively high-rate short paper. Less direct lending in the system could also bring increased issuance in the public markets.

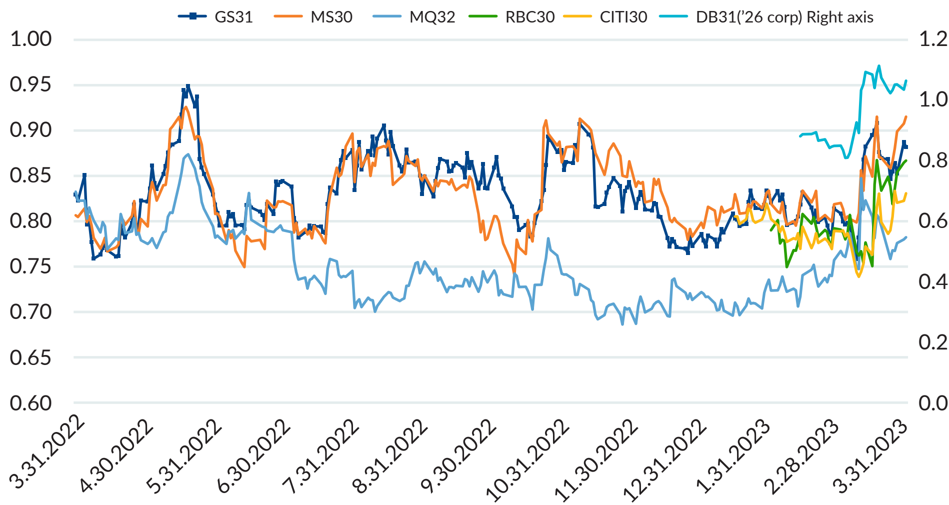
Opportunities in gas prepayment transactions[1]

With bank spreads presenting value across sectors, we highlight gas prepayment transactions, a $50bn corner of the municipal market that has exposure to banks in the form of bank guaranties. These transactions feature tax-exempt debt issued by conduits on behalf of municipal gas or electric utilities, with the bond proceeds transferred to a gas supplier in exchange for future gas deliveries. The gas supplier, usually a commodities arm of an investment bank, is responsible for delivering the gas to the issuer, who then sells it to the utilities at a discount to market prices. Gas suppliers use gas prepayment bonds as a form of funding, benefiting from a favorable spread between tax-exempt and taxable yields to obtain financing at a lower cost than in the taxable market. Banks are incentivized to participate as gas suppliers or guarantors, while municipalities can generate cost savings. Counterparty exposure is the primary credit risk in these transactions, with gas suppliers or their guarantors (banks) providing gas delivery guarantees. Typically, if a transaction terminates early, the gas supplier is obligated to make a termination payment. Below we look at ratios compared to senior unsecured corporate debt, and point out value where there are higher TE/corporate ratios.

1. Source: Moody's, S&P, Fitch

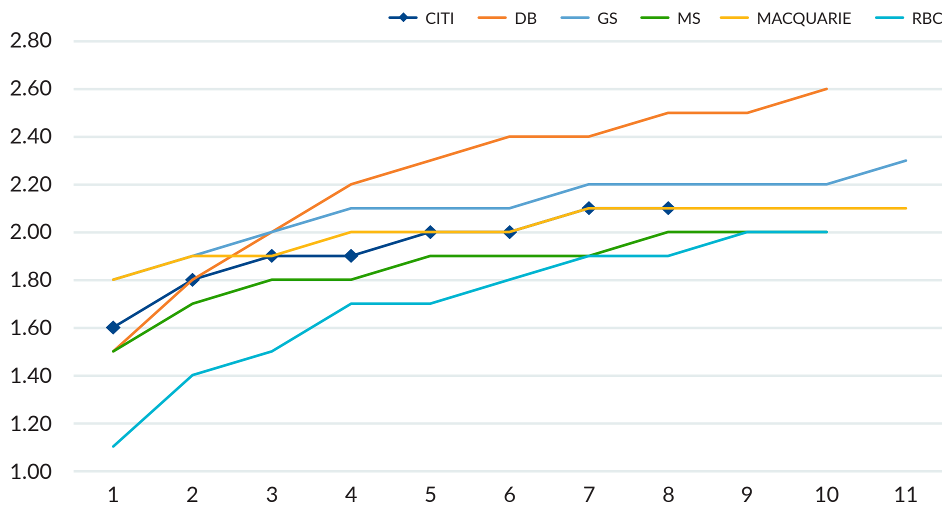
In Chart 4 below, we show our prepay gas curves and pari-debt ratios in the 7–9 years part of the curve. We note most of the sector has become cheaper compared to corporates. Morgan Stanley and RBC look particularly cheap to averages.

CHART 4: 7–9 YEARS TO WORKOUT TE/CORPORATE PARI-DEBT RATIOS



Source: Bloomberg BVAL, Mesirow Research.

CHART 5: TE SPREAD X YEARS TO WORKOUT



Source: Bloomberg BVAL, Mesirow Research.

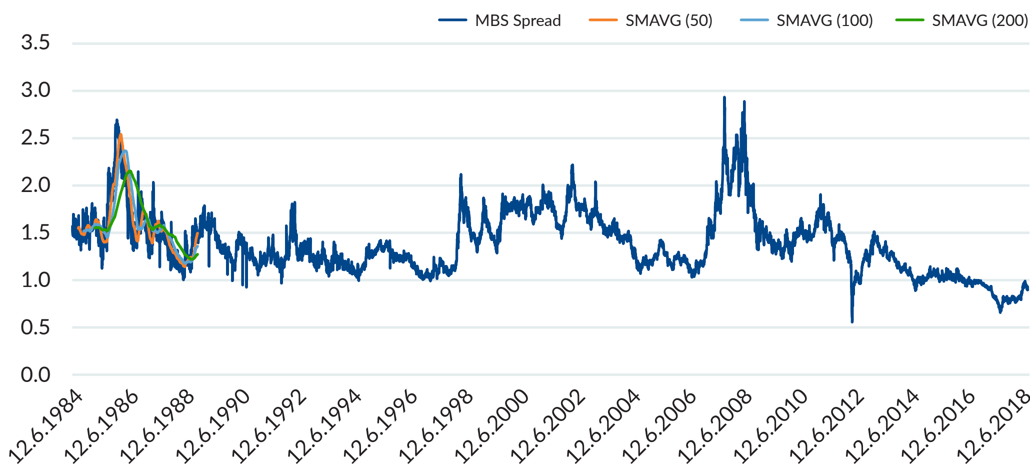
Mortgage Market Insights

Historically Wide Agency Mortgage Basis Provides Attractive Investment Opportunities

Since the beginning of 2022, the Federal Reserve has started the quantitative tightening process by allowing its TSY and MBS portfolio run off. Instead of a being a buyer of Agency MBS, as it was in 2020 and 2021 to the tune of around $600bn, in 2022 the Federal Reserve has been a net supplier of $110bn Agency MBS. In 2023 it is estimated that the Federal Reserve would supply ~$200bn Agency MBS through the run off process.

With this dramatic change of dynamics, mortgage basis, defined as the spread between current coupon and 5yr and 10yr Treasury blended yield, has widened from a tight 60bp during the pandemic to around 160bp, a net widening of close to 100bp.

CHART 1: **HISTORY OF MORTGAGE BASIS**



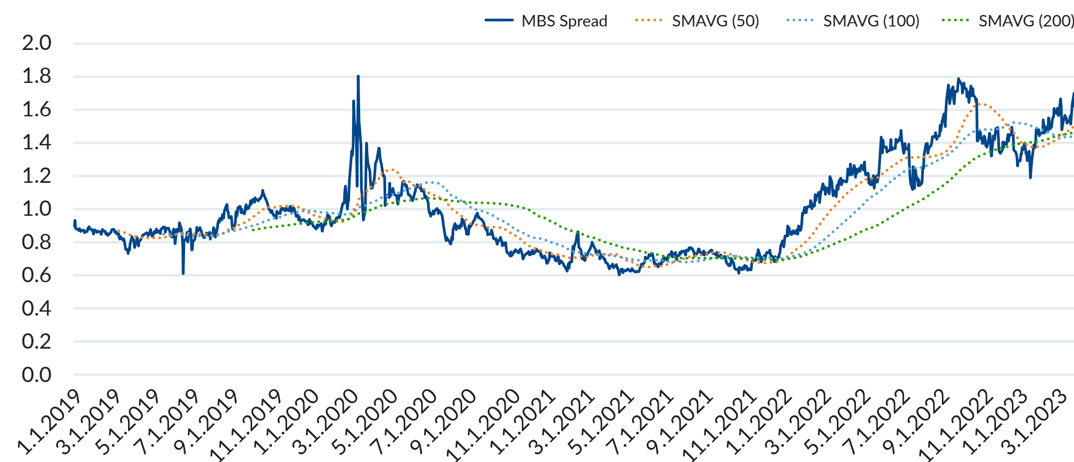
Source: Bloomberg; Mesirow Research.

Matthew Zhang
Senior Managing Director
Institutional Sales & Trading

With the sharp selling off of rates, basis widening, and the inverted yield curve, the current market has proven to be very challenging for the banking community. There is a considerable amount of unrealized and realized losses on bank balance sheets in both Treasuries and MBS. That, combined with deposit withdrawals and higher market funding rates, has resulted in a number of banks failing or in distress. However, both the Federal Reserve and the Department of the Treasury has stepped in forcefully to provide sufficient funding and liquidity to these banks, and we are seeing the market stabilize.

The new Bank Term Funding Program provided by the Federal Reserve further proves that Agency MBS will be a liquid and safe investment product, as long as the duration risk is prudently managed.

CHART 2: **HISTORY OF MORTGAGE BASIS**



Source: Bloomberg; Mesirow Research.

Since the news of Silvergate and Silicon Valley bank, we have seen selling of Agency MBS from Money Managers, Banks and REITs. Most traditional buyers have been on hold. Despite the onslaught of liquidation and selling, the mortgage basis has stayed very stable, with the selling absorbed mostly by the Money Manager community. Given most of this selling is coming in the lower coupons, we think higher coupons or the production coupons in Agency MBS offer a better risk reward profile. In the structured space, we believe Agency CMO Front SEQs offer substantial spread and yield, without risking significant spread duration. The Last Cash Flow in CMOs offers an attractive spread for investors that are comfortable locking in the basis risk at current market levels. Agency floaters are more suitable for investors who are willing to take the risk in spread but not the risk in duration.

From a longer horizon perspective, the current mortgage spread is at the wider end of the historical range, Having only been wider in three instances over the past 20 years: the subprime crisis, the peak of the Covid Crisis in March 2020, and the Iraq war era. Given that, like it or not, Agency MBS has become a permanent Fed policy tool and there is an explicit mechanism for how the federal government would step in to back stop Agency MBS, we believe the basis has become very attractive, especially in an environment where the economy slows down and credit risk starts to get elevated. Despite the near-term volatility, we believe there is going to be an extended period where prudent investors can construct a portfolio of high quality Agency MBS, providing attractive yield and spread, and benefit from it for years to come.

Interest Rate Insights

A Tale of Two Tails

Historic moves in treasury yield weaker than expected data, and robust employment numbers have put the Fed in a very difficult situation. Chairman Powell and the Fed are determined to fight inflation while remaining data dependent. Powell recently noted, "nothing about the data suggests the Fed has tightened too much." The market is pricing in a high probability of another 25 basis point hike in May, which would bring the Fed Funds Rate to 5.00-5.25%. It seems the job market is cooling off and some of the inflationary pressures are easing. The Treasury market is telling a tale of two tails, but is uncertain which is more likely.

George Barbar
Senior Managing Director
Institutional Sales & Trading

Jay Connelly
Managing Director
Institutional Sales & Trading

The 2-year Treasury note has seen historic volatility over the last two months. On February 1st the 2-year Treasury note yielded 4.10%. By March 8th it was yielding 5.07%, its highest level since June 2006, and on April 13th it yielded 3.97%. Since 2018, there have been 16 days where the 2-year Treasury note has had at least 20 basis points of volatility, and ten of these historic days have come this year. Below is a chart displaying the volatility of the 2-year Treasury note since the beginning of the year.

CHART 1: **2-YEAR TREASURY YIELD**

Source: Bloomberg; Mesirow Research.

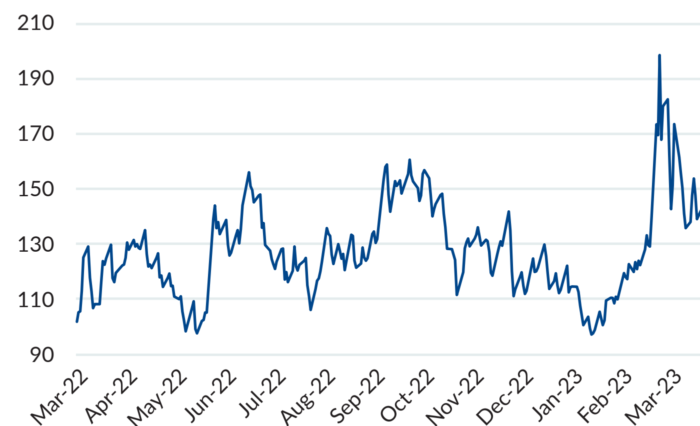
Bankers simply cannot rely upon stable deposit reserves which are a key factor in deciding whether or not to issue new loans. Since the banking crisis began in mid-March, there have been two essential themes in the treasury markets. The first is a flight to quality. This is natural when there is turmoil and is most clearly seen in the treasury markets through T-Bill purchases and the issuance of agency discount notes and floaters.

The second is a redirecting of cash out of banks into US Money Funds. For the first quarter of 2023 the net supply from the Federal Home Loan Banks System, which is all FHLB issuance less any maturing debt, increased by over $296 billion. The two-day period of March 13-14th alone added over $215 billion. The debt issued by the FHLB is being bought by US Money Funds, and then the 11-member FHLB System takes that cash and distributes it back to its member banks. Essentially, the deposits that are leaving the regional banks and going to money funds are coming right back and replacing the deposits in the form of FHLB advances.

Callable bond yields in the agency market remain very attractive. With volatility near the 2023 highs, as seen by the MOVE* index chart shown to the right, spreads on callable agencies continue to look very attractive and billions have been underwritten at the front end of the market. The confusion throughout the market had the MOVE Index at its highest level since '08, which caused structures as short as 1.5 years out to 5 years to have 6.00% coupons - yields investors only dreamed about a year ago. Spread structures with embedded options perform best during periods of stable interest rates, and the Fed's goal would be to bring down inflation to its desired level and hold rates for as long as possible once we reach terminal rate. However, we do think the Fed will be forced to lower rates sooner than they expect due to a downturn in the economy, caused by the significant rise in interest rates, making callable structures with longer lockouts more attractive. Yields across the entire curve have given investors opportunities that they haven't seen in over a decade.

*The ICE BofA MOVE index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30. (Weighted average of 1m2y, 1m5y, 1m10y and 1m30y Treasury implied vols with weights of 0.2/0.2/0.4/0.2, respectively, totaling 100%).

CHART 2: **MOVE INDEX**



Source: Bloomberg; Mesirow Research.

Conclusion

Wall Street in a Maze

As we noted in our opening piece, the most common question we field from clients is "what comes next?" Hopefully some of the content herein has provided some knowledge that can help you design a strategy in each asset class. But, more-so than any previous economic challenge, the truth is that nobody knows. Last year was broadly defined as the year of a duration crisis, in which the Fed hiked rates in seven consecutive sessions from 0% to 4.5%, with two more token 25bps hikes at the start of 2023, taking Fed Funds to 5%. Simultaneously, the Fed began the winddown of their covid fueled balance sheet, which peaked at $8.965 trillion in April 2022, by approximately 95 billion per month.

These activities jolted the 10-year Treasury yields, which started 2022 at 1.76% and hit a high of 4.33% in October of last year. Despite these hawkish Fed policies, employment, wages, and rents remained resilient. Throughout the year, the unemployment rate resided in the 3.6% range, while CPI rapidly increased from 1.4% in the start of 2021 to 9.1% in June of 2022, ending the year at 6.5%. Although the consumer proved resilient, market valuations did not. The S&P declined 19.64%, and the Nasdaq declined 33.5%.HY credit default spreads jumped by 334bps from the start of the year to 626bps in September 2022. Duration wreaked havoc on asset valuations, with a notable exception of housing due to continued limited supply. This dynamic – where the asset bubble appears to be popping but consumer strength continues to linger – does not seem sustainable, and the banking crisis has clearly demonstrated the perilous task the Fed has to manage.

To wit, the market entered 2023 with stronger than expected employment and wages, but with lingering inflation data causing further angst. Market trepidation was best displayed by the near 100bp spike in 2-year Treasury yields to 5.07% in March of 2023. Shortly after this spike, the banking crisis ensued, however, (in what we fear is emerging as a common theme) the banking crisis seems to only be the tip of the proverbial iceberg. Specifically, the marketplace has not fully focused on stressing bank loss reserves, whether from consumer credit cards, residential mortgages, commercial loans, or commercial real estate loans. In 2022, bank loss provisions remained low with modest increases in the 4th quarter. Given historically low unemployment, credit card losses have remained muted, less than 1.75%.

Ali Haghighat
President
Institutional Sales & Trading

Nathaniel Sager
Senior Managing Director,
CTL and Structured Debt
Products | President & Head
of Strategy, Capital Markets

Residential mortgage defaults also remained low given the robust increase in home prices throughout the covid time frame until the middle of 2022. High yield corporate defaults also remained historically low, 1.3%, in 2022. Although commercial real estate defaults were muted, the estimated 1.5 trillion of CRE debt coming due over the next three years looms over all market behavior. It seems unlikely that the short lived "banking crisis" was the end of that story, and, unfortunately, these figures bring into focus how unlikely a "soft landing" may be for the Fed to achieve.

While we have continued concern about the path to a soft landing, there is no doubt there is a long script yet to be written. The first quarter brought a notable increase in US Money Market Funds, currently standing at 5.3 trillion, up from 3.6 trillion at the start of 2020. If the Fed reduces rates at some point this year, the potential impact of these funds moving into equities and bonds can readily mask and possibly resolve existing credit issues by driving borrowing costs lower for stressed entities. For example, capitalization rates for office properties have increased from 4.5% to 9% in certain instances, implying a 50% reduction in valuation; should the fed pause or reduce rates, the equity infusion necessary for a refinancing will be reduced significantly.

Unfortunately, at the moment these silver linings seems to be wishful thinking because rates do not fix two lingering issues: 1) The Fed has made it clear they'd like to reduce their ominous balance sheet, which currently stands at $8.6 trillion, up from $4.2 trillion pre-covid – and yes, this $4.24 trillion increase has far outpaced the 1.7 trillion increase in Money Market Funds over the same period – and 2) The NY Fed Reverse Repo standing at $2.3 trillion, up from $64 billion pre-covid, demonstrates the lack of desire by the banking community to lend. If the Fed continues to reduce their balance sheet and banks continue to choose to park their money at the Fed, we can expect to see dramatic volatility continue throughout the year. We will continue to hunt for silver linings, but for now "what comes next" is caution and concern.

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Contact us

Capital Markets and Investment Banking Marketing
cmibmarketing@mesirow.com

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