Mesirow

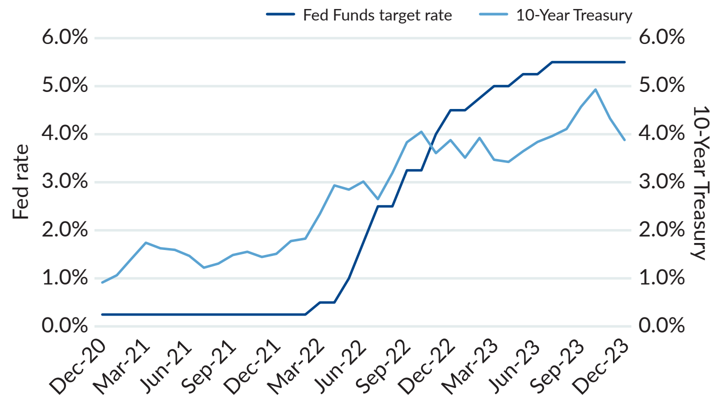
Strategic Fixed Income | Commentary

Market commentary

The Federal Open Market Committee (FOMC) continued its aggressive policy tightening during the first half of the year increasing the Federal Funds Rate 100 basis points during 2023. The last of the FOMC's four hikes came at the July meeting with the current Fed Funds target range at 5.25%–5.50%. The market feels the Fed has reached its terminal rate with inflation on a consistent downward trend. The Fed reiterated its policy would be data dependent while maintaining its goal of returning inflation to 2.00%.

In the first half of the year, March's regional banking crisis brought extreme volatility to the rates complex as the rapid sell off violently reversed course in response to liquidity measures taken by the Fed and bank regulators. Moving into the back half of the year, curves underwent significant bear steepening, although the duration selloff came with less violent volatility than seen in the first half. Nonetheless, the magnitude of the move was impressive as the 10-Year yield rose from 3.84% in July to an eventual peak of 4.99% in mid-October. However, from that point the market's attention turned to a potential Fed pivot, inducing an equally impressive rally which drove 10-Year yields back down to 3.88%, remarkably leaving the yield on the 10-Year US Treasury nearly unchanged on the year.

CHART 1: **FED FUNDS TARGET RATE VS 10-YEAR TREASURY**

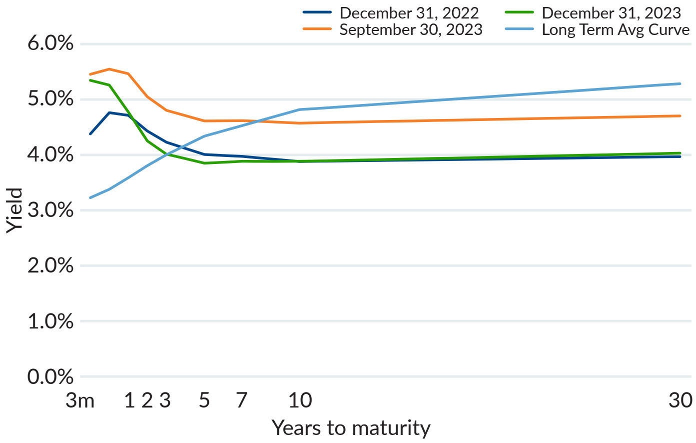


Source: Bloomberg, Mesirow SFI.

One thing did remain consistent throughout 2023 — an inverted yield curve. The 2s10s yield curve achieved its deepest inversion since the 1980s, reaching a peak inversion of -108 basis points at midyear. However, the year-end duration rally brought significant steepening with the 2s10s curve finishing the year at an inverted -37 basis points.

The fourth quarter rally in rates began with market speculation that the Fed had reached the end of its hiking cycle. Subsequently, a very dovish December FOMC meeting gave bulls validation to accelerate the rally, driving positive sentiment in other riskier assets. The market quickly adjusted and priced in four to five rate cuts in 2024 in the spirit of policy normalization, despite strong jobs data and persistent consumer strength. Investors undoubtedly remain focused on the incoming macro data and the Fed reaction function as timing and the number of rate cuts remain the clearest driver of risk sentiment across markets.

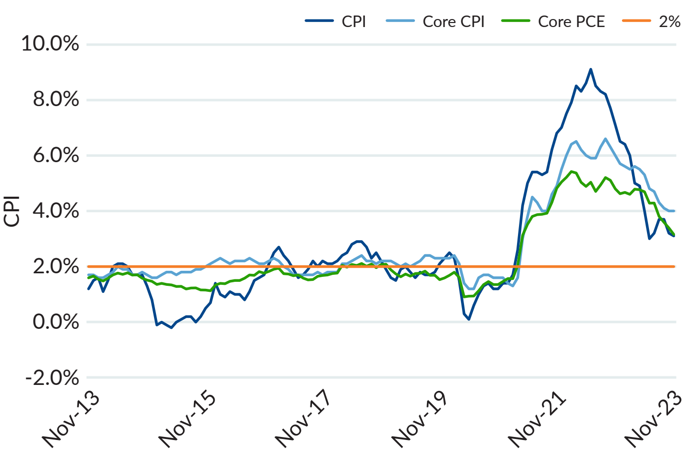
CHART 2: US TREASURY YIELD CURVES



Source: Bloomberg, Mesirow SFI.

Recent inflation data remains less than clean as the Consumer Price Index (CPI) exceeded expectations at 3.4% while Producer Price Index (PPI) registered below consensus. Although individual components are pointing to cooler 1.7%–1.8% inflation in the Fed's favored Core PCE measure, the CPI data continue to show a marked divergence between goods and services inflation. Improved supply chains and more normalized demand have driven rapid disinflation in goods, while services inflation has remained sticky with a strong labor market and wage growth. For now, all three price gauges (CPI, PPI and Core PCE) remain well above the Fed's stated inflation target of 2.0%.

CHART 3: INFLATION INDICATORS



Source: Bloomberg, Mesirow SFI.

The resilient labor market remains a key inflation driver with recent data continuing to exhibit strength as December payroll data came in above expectations at +216K (vs 175K expected). This print represented the biggest increase since September, although October and November included -71K in downward revisions. Remaining near multi decade lows, the unemployment rate decreased to 3.7% on a decline in the participation rate. Most concerningly, wages continue to outpace inflation with average hourly earnings up +4.1% year-over-year in a stronger than expected December. Until wages cool, it seems unlikely that consumer strength will abate in the near term.

After strong third quarter growth, fourth quarter should be much more subdued and is forecasted around 1.5%. Much of the slowing can be attributed to inventories and continued impact of tighter financial conditions. Overall, economic growth will be more challenged in 2024 with expectations in the +1.0–2.0% range for the year. Shallow recession remains a possibility; however, continued strength in the labor market and the potential for the Fed to start easing earlier than expected does modestly lower the odds and/or extend the timeline for a potential US recession.

After two prior annual negative returns, the Bloomberg Credit Index rebounded in 2023 to generate a +8.18% total return. In the first quarter of 2023, the regional banking crisis drove significant spread widening to an Option Adjusted Spread (OAS) of +150 at the height of the panic on March 15. However, from there, spreads mostly tightened through the remainder of the year on the back of favorable technicals. Following 19bps of tightening in the fourth quarter, the Bloomberg Credit Index spread ultimately finished the year 28bps tighter, near the tights at +93.

Across sectors, Energy led credit markets tighter in 2023. Oil Field Services (+753 basis points of excess return) and Midstream Industries (+643bps) were the top performers. Communications (+643bps) was the other outstanding sector, with strong excess returns across its Media Entertainment (+776bps), Cable Satellite (+633bps) and Wirelines (+631bps) industries. In addition, cyclical sectors saw industries including Chemicals (+598bps) and Home Construction (+595bps) perform well. On the flip side, underperformers were led by Construction Machinery, with only 190 basis points of excess return, followed by Banking (+357bps) and Retailers (+367bps).

The Mortgage-Backed Securities (MBS) sector earned positive excess returns of +66 basis points and a total return of 5.05% in 2023. This was the best annual excess return for the Bloomberg MBS index since 2014. Similar to other fixed income asset classes, the best performance occurred in the fourth quarter where MBS enjoyed excess returns of +133 basis points and a total return of +7.48% driven by lower rates, tighter spreads and generous yields.

The OAS of the MBS index began the year at +50, sold off to a high of +82 in late October before finishing 2023 at +46. Across the MBS coupon stack, 3.0% and 3.5% were the best performers in both excess and total return while 30-Year MBS outperformed 15-Year MBS during the quarter and the year.

The MBS market spent much of 2023 struggling with historically elevated rate volatility, leading to wide spreads as the option values became increasingly difficult to judge. Additionally, the elevated rate environment has brought significant changes to the dynamics of MBS supply and demand. Given historically high mortgage rates, new home purchases and mortgage refinancings both declined significantly from historical averages, limiting new production while prepayments declined to multi-decade lows. The average coupon of the MBS index remained at approximately 3.0% given the lack of production while the average rate available for a new 30-Year fixed rate mortgage rose to as high as 8.0% during the fourth quarter. This leaves approximately 97.0% of the Index trading at a discount, something not seen since the 1980s. Despite the appearance of positive convexity in discount dollar prices along with limited production and historically high OAS, the demand story was less than constructive. Banks, one of the primary investors in MBS, spent much of the year adjusting to deposit flows, unwilling to add to MBS holdings. Further, with the Fed continuing to taper and no longer buying MBS, this left asset managers as the only marginal buyer in the asset class. Unfortunately, the group already had an MBS overweight, leaving little room to add.

Market outlook

The market continues to hinge on the timing and amount of Fed easing, which continues to be data dependent. Once again, the communication function between the Fed and market participants is broken, as the market has aggressively priced four to five rate cuts despite the strength in payrolls and hotter than expected inflation data. Given the latest round of jobs, wage growth and retail sales data it seems unlikely that consumer spending will weaken in the near term. This highlights the risk of sticky services inflation preventing the Fed from reaching their 2.0% target near term.

Overall, in our view, this backdrop should challenge the Fed, leaving the likelihood of a March rate cut lower than current market expectations, while putting even greater focus on the Fed's data dependency. Rate volatility should remain elevated given the monetary policy uncertainty, leaving us duration neutral over the near term.

After a strong fourth quarter +8.15% total return, the credit market continues to see a dichotomy between tight spreads and yields that remain attractive at levels last seen following the Global Financial Crisis. A strong technical backdrop, coupled with attractive yields should remain supportive of credit performance in the near-term. That said, the move tighter in spreads makes valuations a bit more challenging; however, pockets of value remain in the current market. Active credit selection looks to increase in importance as a driver of excess returns into a period of slowing growth and rising leverage in 2024.

To start the year, our portfolios continue to be overweight Corporates, Taxable Municipals and ABS while we have neutral positioning in Agency MBS. We continue to manage portfolios with a neutral duration position with underweight exposure to Treasuries, Supranationals, CMBS and Sovereigns.

Strategy summary

The Mesirow Strategic Fixed Income Core Total Return Composite earned a fourth quarter gross-of-fee return of 6.73%, slightly trailing that of the Bloomberg Aggregate Index which earned 6.82%. On a net-of-fee basis, the composite earned a return of 6.68%. During the fourth quarter, our slightly below-market duration hurt portfolio performance as interest rates rallied. Strong sector allocation was offset by security selection effects, especially in the MBS sector in which exposure to lower coupon MBS (2.0%-3.0% coupons) hurt relative performance.

Despite slightly below-market performance in the fourth quarter, the SFI Core Total Return Composite outperformed the Index by 22 basis points (gross of fees) with a 2023 total return of 5.75% (5.55%, net) compared with 5.53% for the Bloomberg Aggregate Bond Index.

Within the Intermediate Government/Credit Fixed Income Composite, our portfolios produced a fourth quarter total return of 4.52% (gross of fees) compared with 4.56% for the Bloomberg Intermediate Government/Credit Index. On a net-of-fee basis, the composite earned a 4.45% return in the fourth quarter. During the quarter, the benefit of our overweight position in corporate bonds and corresponding underweight in US Treasury securities was offset by our emphasis of short-maturity corporates which provided a bit of drag on relative performance. In addition, defensive positioning with a slightly shorter-than-market duration detracted from fourth quarter performance.

Full-year 2023 results were more favorable with the Composite outperforming the Index by 41 basis points gross of fees (5.65% versus 5.24%). Net of investment management fees, the Composite earned 5.41%, outperforming the Index by 17 basis points.

Our Short Term Fixed Income Composite earned a 2.72% gross-of-fee return during the fourth quarter, slightly exceeding that of the Bloomberg 1-3 Year Government/Credit Index by 3 basis points. Net of fees, the Composite earned 2.67% for the quarter. During the quarter, our overweight to corporates and underweight to US Treasuries proved favorable, while emphasis of 2024-2025 maturity corporates provided a slight drag on relative performance. For the full year, the composite produced a 5.01% gross-of-fee return (4.80% net of fees) compared with 4.61% for the Index.

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 – December 31, 2023

Year	Year end			Annual performance results				3-year annualized dispersion(2)	
	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	9	827	3,963	5.75	5.55	5.53	0.22	7.07	7.14

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 - 12.31.2022. 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 -12.31.2022. The verification and performance examination reports are available upon request.

Mesirow Financial Investment Management, Inc. ("MFIM") is an investment advisor registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. The "Entity" as shown represents Mesirow Financial Investment Management Equities and Fixed Income, which is comprised of the GIPS-compliant units of MFIM which specialize in managing portfolios for institutional clients adhering to an investment process geared towards institutional investors. The historical performance presented prior to the creation of the division was managed by MFIM or its predecessor firms prior to 01.01.2005. For purposes of claiming GIPS compliance, as of 01.01.2010, the "Firm" is further defined as the Fixed Income business unit, which manages portfolios primarily for institutional investors adhering to an investment process, incorporating fundamental analysis of security valuation factors and drivers. The composites within this business unit vary primarily by duration and the type of originator of the security. Please note that the 2018 percentage of firm assets have been restated to properly include the addition of assets obtained through the acquisition of the High Yield Team from a former and unaffiliated registered.

Investment Advisor, effective 10.23.2017. On 05.29.2020, MFIM Fixed Income completed the lift out of the Analytic Fixed Income Team from a former and unaffiliated registered Investment Advisor, Chicago Equity Partners (CEP) which its team, became an integral part of MFIM Fixed Institutional Fixed Income. On 05.29.2020, MFIM acquired the asset management rights for a portion of the managed portfolios from an independent investment advisory firm and retained all of the principals and employees related to such portfolios.

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 Strategy are:

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

The Bloomberg U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. 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.

GIPS REPORT – INTERMEDIATE GOVERNMENT/CREDIT FIXED INCOME COMPOSITE

Gross and Net of Fees Total Returns from January 1, 1995 – December 31, 2023

Year	Year end: No. of portfolios	Year end: Composite Asset at end of period ($MM)	Year end: Total Firm Assets ($MM)	Annual performance results: MFIM (gross) Composite (%)	Annual performance results: MFIM (net) Composite (%)	Annual performance results: Bloomberg Int. Gov/Credit Index) (%)	Annual performance results: Composite Dispersion(1) (%)	3-year annualized dispersion(2): MFIM (gross) Composite (%)	3-year annualized dispersion(2): 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	9	239	6,168	-1.25	-1.48	-1.44	n/a	2.54	2.34
2022	8	234	3,616	-7.98	-8.20	-8.23	0.17	3.93	3.82
Current Performance Results									
2023	12	308	3,963	5.65	5.41	5.24	0.09	4.51	4.58

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- 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.