Mesirow

Capital Markets Brief

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S&P 500

QTD & YTD: -4.60%

Treasury 10Y
QTD & YTD: -6.82%

Muni AAA 10Y
QTD & YTD: -8.20%

DXY
QTD & YTD: 2.76%

1Q2022 Review

The invasion of Ukraine by the Russian Federation on February 24, 2022 has resulted in the most significant humanitarian crisis in Europe in decades and created the greatest threat to modern Europe and international order since World War II. Our thoughts remain with all those around the world who are affected by this ongoing war.

As global markets struggle to price a descent from conventional western world order to eastern European turmoil, the impact has varied widely. Some markets have handled the strain in an orderly manner. Others have responded erratically.

US Capital Markets have struggled to reset risk-adjusted values among the geopolitical and economic crosscurrents of 1Q2022. Commodity prices and defense budgets are soaring in the aftermath of the Russian invasion of Ukraine. Energy markets have responded wildly, and the world is re-calibrating risk. But, given an inversion of the yield curve in the last week of March, no small matter, markets have been swayed by inflation signals, stagflation fears and Federal Reserve Board lassitude.

In addition, as global powers struggle to realign and respond to this crisis, western defense planners are gaining a clearer, more prescient understanding of the threat of Chinese hegemonic ambitions in the Pacific Basin and the developing world (commodity resources being the target).

In this issue of the Capital Markets Brief we will try to cut through much of the noise generated in this historic and volatile quarter. We will focus on data and demonstrated behavior to provide some clarity about what underlies market behavior in this violent and often opaque world, and how markets assess and discount present and future risk as they navigate this turbulence.

The Fed awakes

On April 5, Fed Governor Lael Brainard jolted the capital markets with a wake-up call, suggesting that reducing the bloated Fed Balance Sheet is now a tool of choice. Quantitative tightening will become the term of the day. In addition, she laid the groundwork for the release of Fed minutes on April 6, which revealed a significantly more aggressive tightening regime than the markets had been led to expect. The strength of the Fed's new massage was strengthened by its messenger, a future Vice-Chair noted for her "dovish" inclinations.

Readers of this letter will know that the Federal Reserve Board's deviation from its long standing "Longer Run Goals and Monetary Policy Strategy" in August of 2020 should have been understood by the capital markets as a "silent" alarm, ringing loudly in a register that apparently only dogs can hear. While the Fed appears confident in its ability to make politically informed monetary decisions, it at times seems to have little regard for the importance of transparency to one of the world's most efficient markets.

The predictable result has been both fiscal and monetary indiscipline fueling a remarkable asset bubble. As the bubble expanded to historic dimensions, growth and inflation signals went off; overlooked, but hiding in plain sight. The Fed's imprecise and politicized response language (their persistent use of "transitory" being Exhibit A) created an opacity about Fed policy and tactics that lulled the capital markets into an ever-longer "risk-on" trade. Traders rallied to the cry, "you can't fight the Fed", on the assumption that the Fed itself was behaving with its traditional rigor in defense of its two primary Mission Goals.

Federal Reserve mission

The Federal Reserve promotes a healthy economy and financial stability. We do this by:

- Pursuing maximum employment, **stable** prices, and moderate long-term interest rates in the U.S. economy
- Promoting the **stability** of the financial system and **seeking to minimize and contain systemic risks** through active monitoring and engagement

As 2022 has progressed, and the asset bubble measurably expanded, Fed policymakers have begun to sense the increasing likelihood that their dovish proclamations might not come to pass. The CPI data release (7.9% CPI y/y) on March 10, followed by a PPI Final Demand y/y of 10% on March 15, brought this outcome right to their door. The Treasury Bond market that had been fretful for the previous week lost faith and began the race to a plus 2.50% 10-Year, achieved that week. Investors trying to hide in 2–4-year tenors were pounded by the curve flattening. 1Q2022 has been an ugly first quarter for the capital markets; yet to date, the asset bubble continues to float.

We had been assured by policymakers that wise and responsible "tapering" actions are on the horizon. In other words, the level of monetary stimulus will slow. To be clear, the Fed Balance Sheet and monetary measures were likely to INCREASE, but more slowly. That was the message until Fed Governor Brainard's prepared remarks on April 5, 2022, when, in a 180 degree turn, she indicated a more "hawkish" stance and affirmed her inflation-fighter bona fides.

Investors should be wary and mindful, as a safe, soft landing will not be easy.

That said, experienced investors know that opportunity lies in dislocation. Capital Market players have generally longed for a reduced Fed role and a healthy market-driven yield curve reset. The challenge is preserving capital while sailing through the volatility safely and steadily.

Regular readers of our Capital Markets Brief will know that we generally begin and end our discussion of market conditions with the questions of **balance**.

- Are markets pricing risk and reward fairly?
- Are policy makers' responses to market conditions balanced and proportionate?

We will address these questions as we examine the data charts to the right.

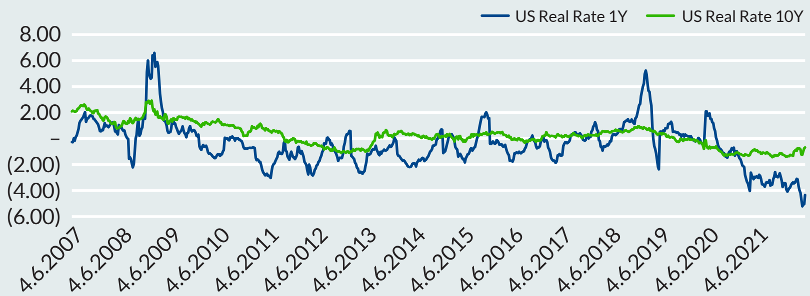
When we compare the 12-month Treasury Bill to the one-year Inflation Linked Note we arrive at a real rate of -3.99%. The 10-year calculation at 3/31 was -0.45%. The Federal Reserve has work to do. Despite recent tightening and taper talk from the Chairman, it's still just talk. Actual rates in the real world are negative and effectively stimulative in this inflationary environment.

Chart 2 speaks for itself. The economic and political considerations are obvious. The 2.85% drop in the Real Weekly Earnings Index over 14 months is material, but it likely understates the impact on working Americans. Energy and food inflation has not fully rolled into this index.

> “you don’t need a weatherman to know which way the wind blows”
> Bob Dylan

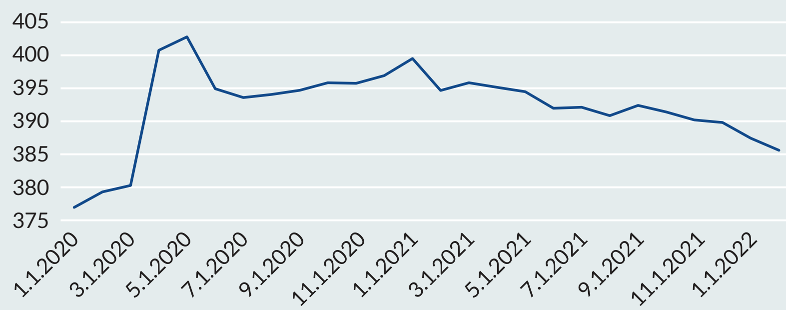
Working folks don’t need an economist’s calculations to understand the issue. At quarter’s end, my own conversations with hard-working tradesmen around the gas pump as they fill up their heavy work trucks are increasingly bitter.

CHART 1: US REAL 1Y & 10Y RATES



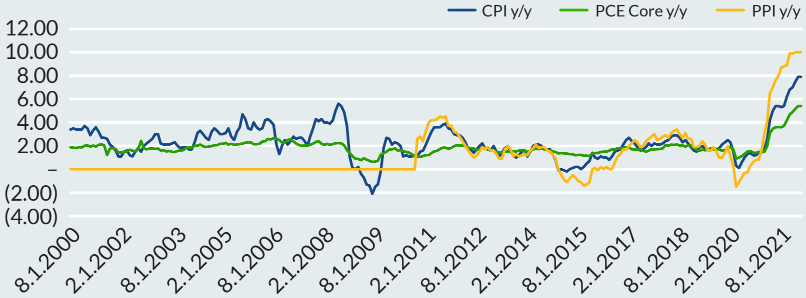
Source: Bloomberg, Mesirow Financial Research.

CHART 2: REAL WEEKLY EARNINGS (AVERAGE OF 82-84 = 100)



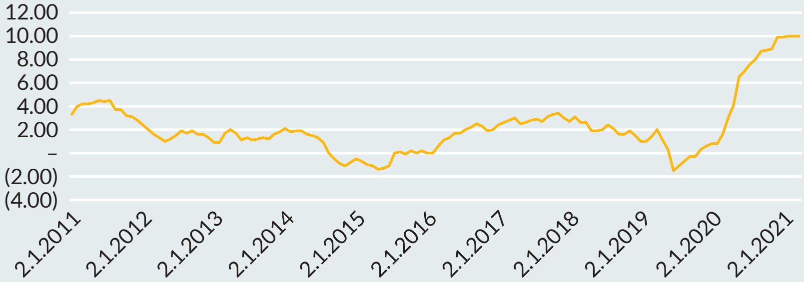
Source: Bloomberg; Bureau of Labor Statistics.

CHART 3: **CPI Y/Y, PCE CORE Y/Y & PPI FINAL DEMAND Y/Y**



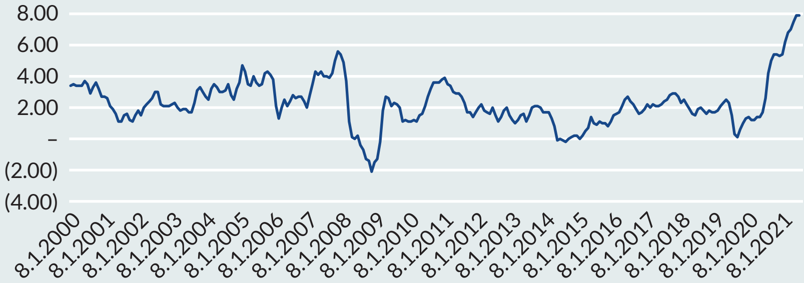
Source: Bloomberg, Bureau of Labor Statistics, Bureau of Economic Analysis

CHART 4: **PPI Y/Y**



Source: Bloomberg, Bureau of Labor Statistics.

CHART 5: **CPI Y/Y**



Source: Bloomberg, Bureau of Labor Statistics

In cold climates, "the last oil tank fill of the heating season" has become a critical family budget consideration. This is real-world kitchen table economics in play, hardships are real.

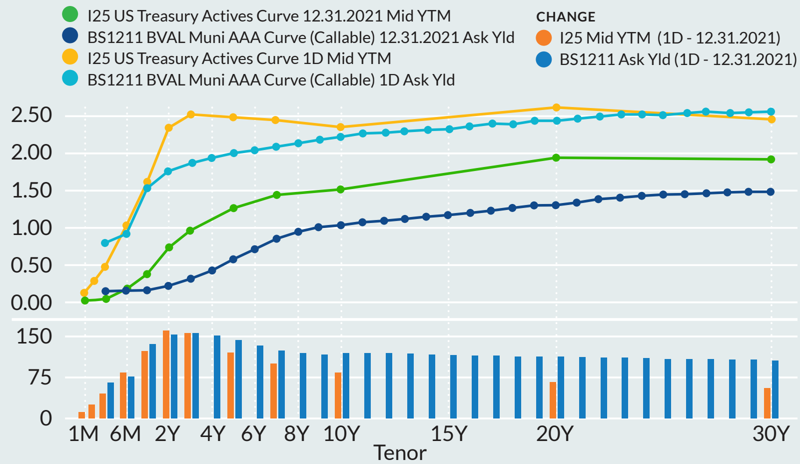
The Fed Governors generally prefer to focus on PCE Core data to gauge inflation. Well, they might, as the headline number is markedly lower. But + 5.4% (03/31/22) (Chart 3) was high enough to blow through their inflation targets!

We posted 10% PPI Final Demand y/y on March 15 (see Chart 4).

CPI y/y was +7.9% on March 10 (see Chart 5). How much of the 10% PPI inflation will flow through into the next CPI data set?

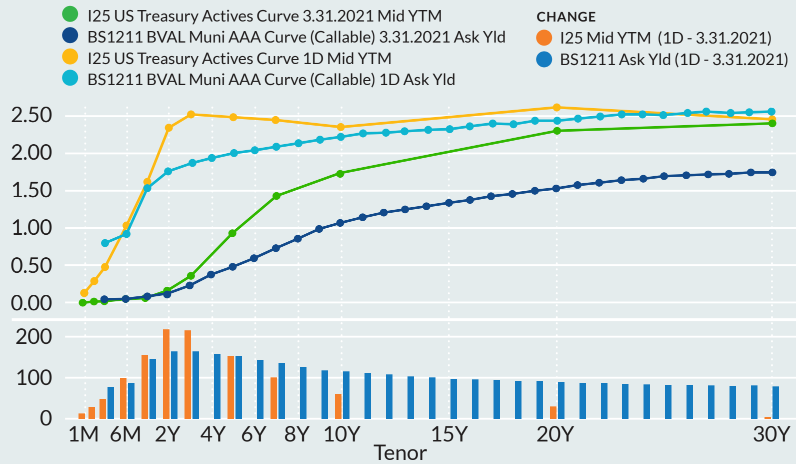
You will note that the powerful Treasury curve movement was largely a 1Q22 event as you compare the 1Q yield curve changes against the changes over one year through 3.31.2022. The greatest movement was in the 2–4-year tenors, although the move was overall a "Bear-Flattener" in market jargon. The level of curve inversion has been changing day to day throughout the last week of March. But we can declare an inverted yield curve is currently the pattern. The historic implications of such an inversion are not positive for investors.

CHART 6: **TREASURY & MUNI AAA CURVE QUARTERLY CHANGE**



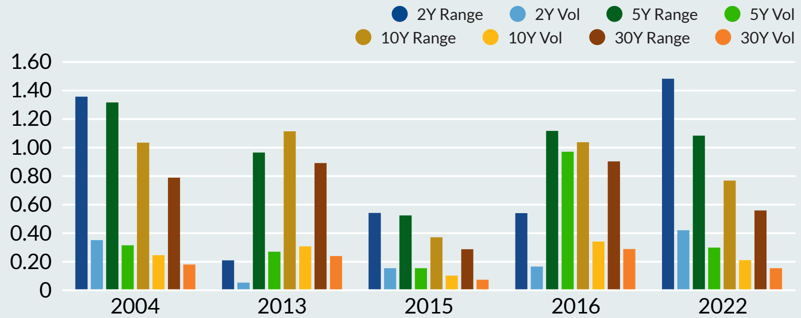
Source: Bloomberg.

CHART 7: **TREASURY & MUNI AAA CURVE 1-YEAR CHANGE**



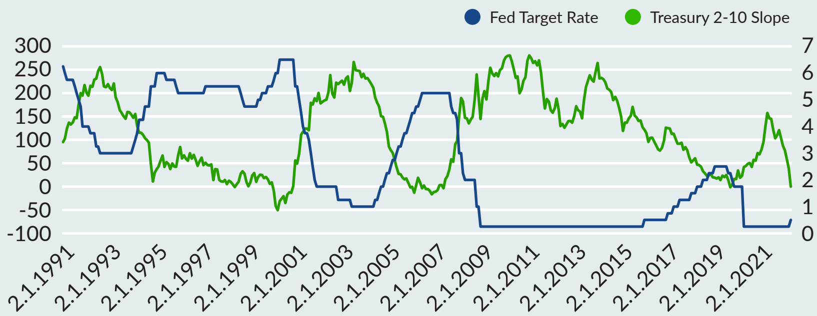
Source: Bloomberg.

CHART 8: **TREASURY YIELD RANGE & VOLATILITY ACROSS CURVE (3 MONTH PRIOR 1ST HIKE)**



Source: Bloomberg, Mesirow Financial Research.

CHART 9: **FED TARGET RATE VS. TREASURY 2-10 SLOPE**



Source: Bloomberg, Mesirow Financial Research.

Compare this graph of Treasury Yield and Volatility changes across 20 years of Fed tightening cycles (see Chart 8). The fit between 2022 and 2004 stands out. In 2004 the first Fed tightening action (+25bp) was June 29, 2004. Credit spreads were tight, bank loan spreads were tight. Equity valuations were relatively high, and housing was "hot." Derivative leverage was not well understood in 2004 but was growing. **This market bubble burst with Bear Stearns and Lehman in 2008.**

In 2022, we recognize many of these conditions PLUS an extraordinary inflation of The Fed Balance Sheet and a historic increase in federal debt.

In 2004, the US stood atop the world as the sole super-power in the wake of the Soviet collapse. Today, China is engaged in a deeply self-serving flirtation with Russia, while Russia has bet its leadership stability on a Euro-proxy-war with Ukraine.

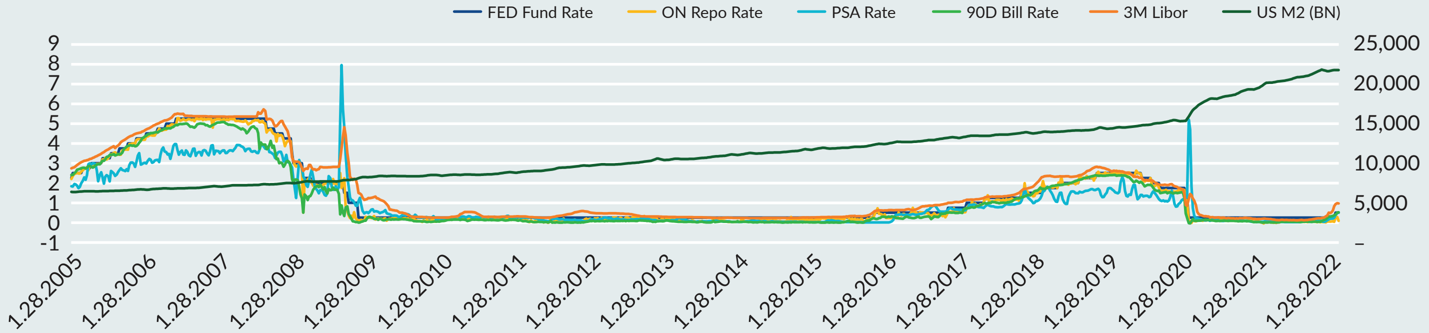
Beware the asset bubble of 2022. Beware the leverage trades that are on to support it.

Note the near convergence of these lines on Chart 9 as Fed target rates rise and the Treasury yield curve flattens. Does this graph signal more Bear-Flattening?

Chart 10 makes several points. We'll call out two. The long and steady expansion of M2, and the rare but episodic risk of spiking municipal short rates under liquidity stress (Muni PSA SIFMA 7-day swap rate as proxy).

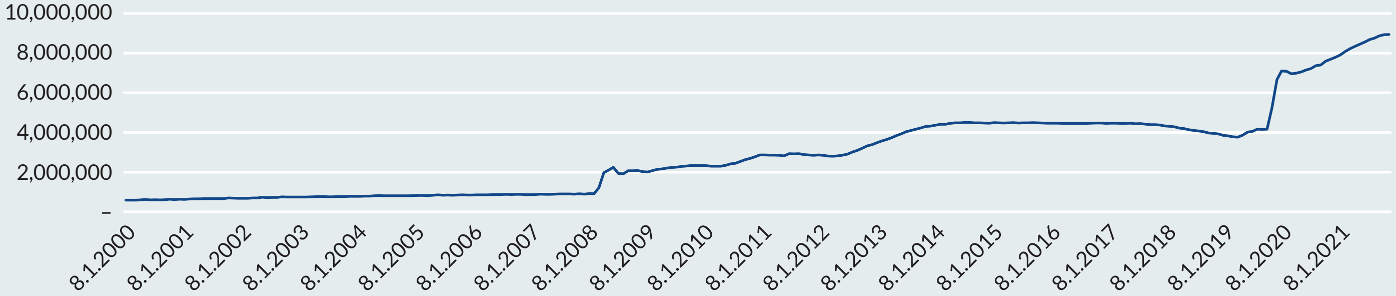
The Fed Balance Sheet (see Chart 11) sails north of $9T (**that's T for Trillion**). Please also note the "leverage" risk implied. This will be unwound partially by a reduction in securities held by the Federal Reserve.

CHART 10: **US FUNDING RATES (%) & M2 (BN)**



Source: Bloomberg.

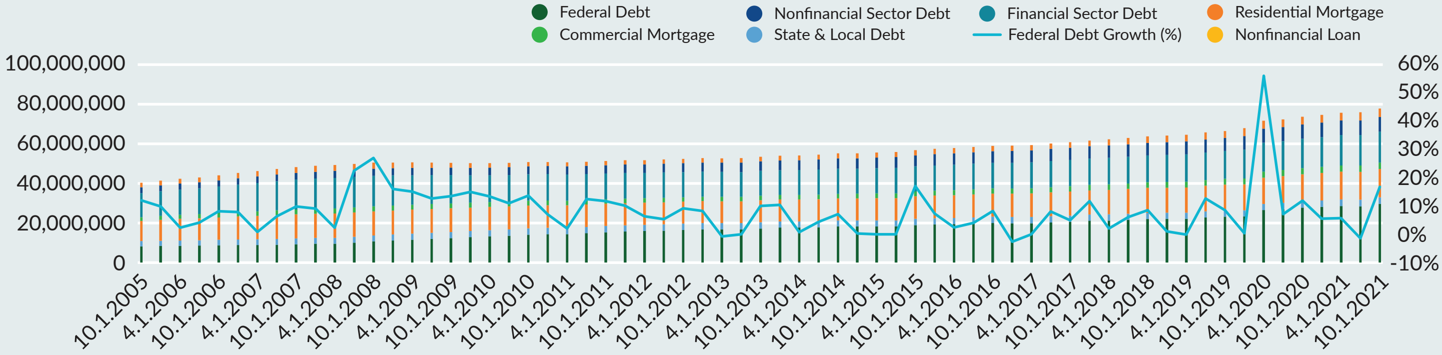
CHART 11: **FED BALANCE SHEET (MM)**



Source: Bloomberg, Federal Reserve.

In all the inferential data presented on Graph 12, please note two trends: 1) the obvious and relentless growth of US Federal debt; 2) the rate of growth currently exceeds 6.6% y/y and was greater than 16% in 1Q. While the explosive growth rates of the early Covid pandemic have receded, the US government is still borrowing at arguably unsustainable levels, given Debt/GDP in the 140% range. Meanwhile, geopolitical defense demands are likely to dictate a prudential rise in Defense Expenditure/GDP. While EU members will struggle to drag themselves toward the 2-3% defense expenditure range in enlightened self-interest, the US Congress will feel unrelenting pressure to increase defense spending dramatically from both the Republican caucus and swing-district centrist Democrats as we approach mid-term elections. An increase from low 3%'s to the 5% GDP range will likely be a long-term Republican talking point, against a background of historically high US Federal debt.

CHART 12: **US TOTAL DEBT OUTSTANDING (MM) & FEDERAL DEBT GROWTH RATE (%)**



Source: Bloomberg, Federal Reserve Bank. Mesirow Financial Research

Chart 13 shows a slow steady rise in the US $ index (DXY) against weakness in Chinese Renminbi and the Ruble collapse; both understandable.

Of additional concern to Americans ought to be the remarkable weakness of Japanese Yen, normally a "haven' currency in times of global stress. American manufacturers and their workers rightly remember and fear the historic effect of a weak yen on pricing power and job security.

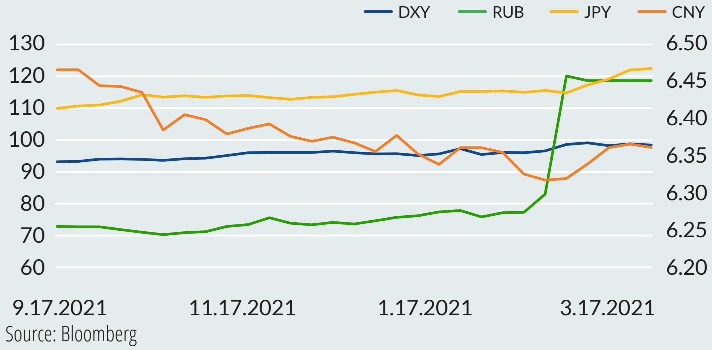
American investors should ask a further question; does this Yen weakness expose the fundamental weakness of Japanese demographics and their endlessly accommodating Central Bank rate policy catching up with them as they consider the defense expenditures required to face a revanchist and ambitious Chinese neighbor? Japan is not alone in this; Pacific Basin neighbors watch the erosion of rule of law in Hong Kong and the emboldened intimidation of Taiwan with alarm.

Is Japan's weakened position a message for the United States? Past economic sins eventually come due. The US government has consistently avoided hard fiscal and economic choices for decades, enjoying the luxury of reserve currency status in a low rate, easy-money global capital markets environment.

Beware...

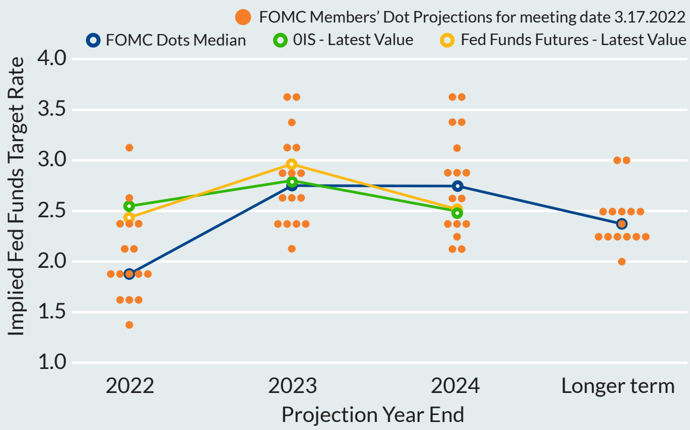
Everyone loves the Fed "Dot Plot" (Chart 14). But it's no longer just a Business-television guessing game. The consensus "Longer Term" target rate of 2.5% does not seem to embrace the "real rates" data considered on Chart 1.

CHART 13: **DXY , RUB (L) & CNY (R)**



Source: Bloomberg

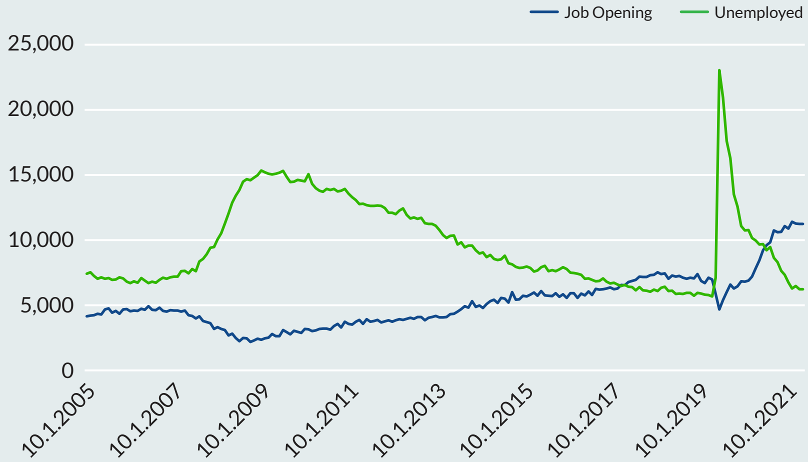
CHART 14: **IMPLIED FED FUNDS TARGET RATE**



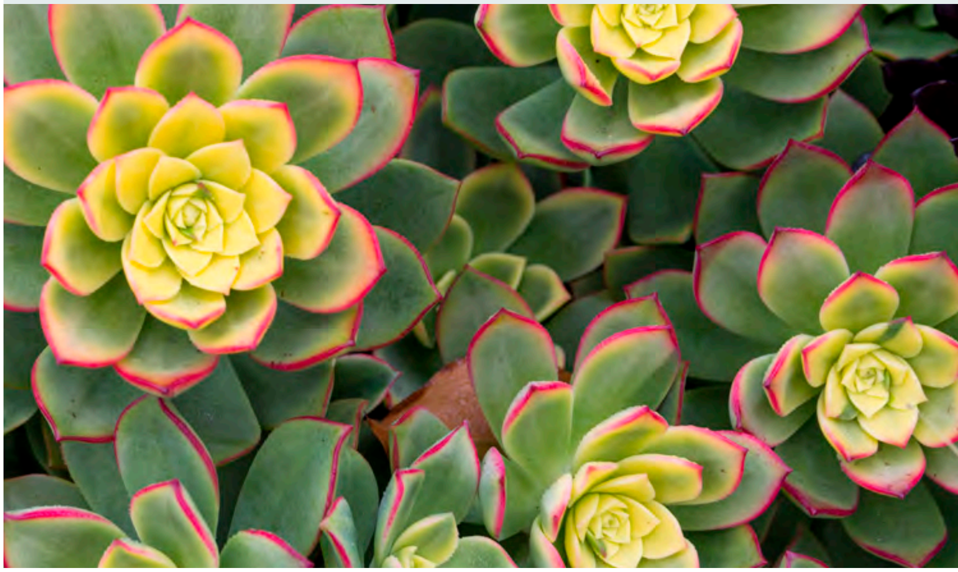
Source: Bloomberg, Federal Reserve Bank

You've all seen the employment crisis in your daily interactions with the service economy; not enough workers. The data (Chart 15) has consistently shown a stubborn 5-6M worker mismatch between job openings and unemployed workers. This is an inflationary pressure with no relief in sight. Both public and private-sector unions are charting this data in anticipation of a harvest. Note the generous terms offered to Connecticut State employee unions on 4.5.2022 as one of many examples. Nonunionized employers are responding to this inflationary pressure in real-time, every day.

CHART 15: **UNEMPLOYED & JOB OPENINGS (000)**



Source: Bloomberg, Bureau of Labor Statistics.

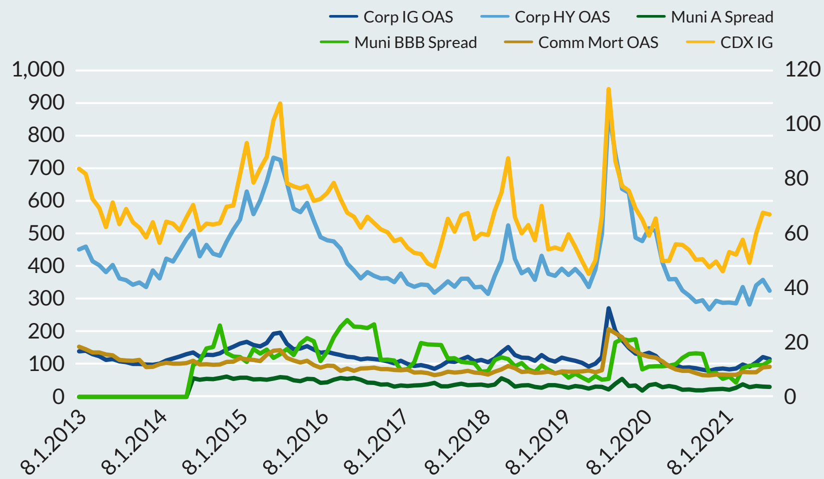


Municipal Bonds

Note that the 2–4-year tenors of the Municipal yield curve have outperformed Treasuries. The Muni curve has a persistent technical bias toward a positive slope, but the difference between the two curves is dramatic on the short end. Does Municipal short paper need to cheapen to Treasuries? Also note, that the strongest high-tax markets, California, and NY have underperformed during 1Q2022 (Chart 17). Market selloffs invariably expose Municipal market liquidity and price discovery weaknesses, consistent with an OTC market structure. The largest and most liquid Investment Grade issuers get hit first, penalized by relatively more efficient price discovery. Look out high yield and off-the-run municipal bondholders.

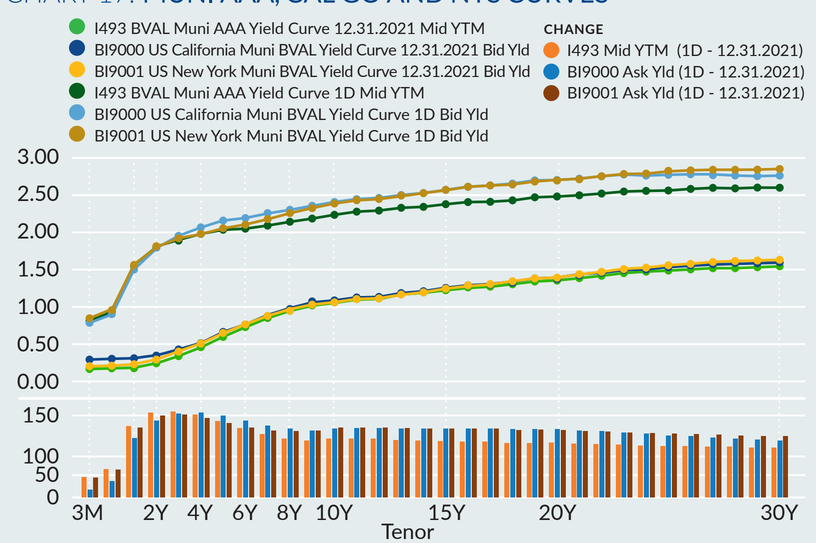
Municipal markets end 1Q2022 with long tax-exempt yields over 100% of equivalent Treasury tenors after a quarter of sustained underperformance. This period of underperformance was largely driven by a technical shift in retail investor demand for municipals that began in the second half of December 2021. Year to date redemptions have totaled just under $13B. Investors, likely spooked by inflation, commodity and jobs data began reallocating away from tax exempts in a duration "risk-off" trade. Rate fears were further triggered by a general relaxing of Covid restrictions that elevated perceived growth risk to the upside.

CHART 16: **CASH BOND CREDIT SPREADS (L) & CDX IG SPREAD (R)**

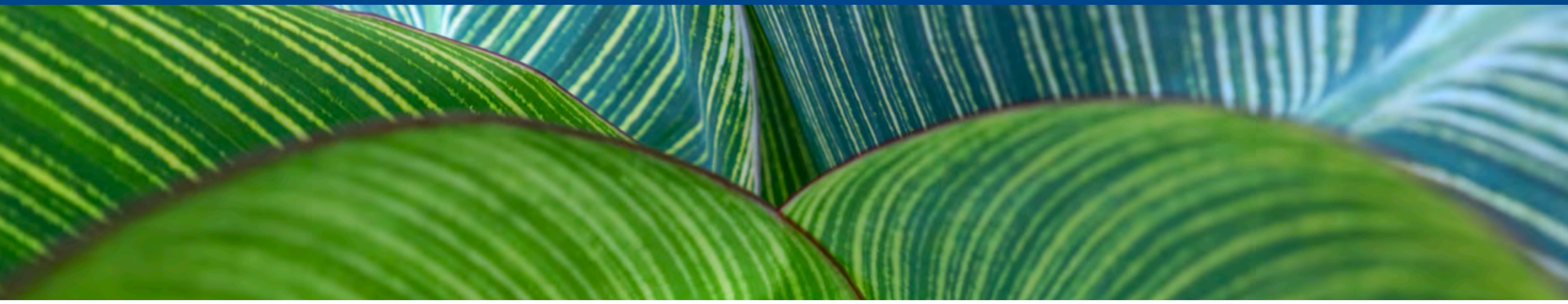


Source: Bloomberg, Mesirow Financial Research

CHART 17: **MUNI AAA, CAL GO AND NYS CURVES**



Source: Bloomberg.



Geo-political fears (Ukraine; China; Iran; NK), that in prior periods might have driven a flight to Treasuries, had a muted effect in the strict context of the Treasury yield curve, where the greatest rise in yields was in the 2–4-year period. The price inflation in food, energy and strategic commodity supply chains created an immediately measurable inflation response that dramatically flattened the curve in these shorter tenors.

Traditional hedging strategies acquired potentially catastrophic risks, while more creative options strategies became viable if executed with the greatest care.
Institutional managers reacted to this risk environment by holding their January 1, 2022, coupon income in cash and selectively liquidating attractive Investment Grade positions (which were most likely to attract a bid from struggling Dealer desks). This shift caught many dealers flat-footed, especially in the bulge-bracket firms, as they were left holding collapsing lower coupon (3%) positions. Meanwhile, bids-wanted doubled to $6B+ by the end of Q1; more than twice the prior 52-week average. Mutual Fund and ETF assets under management (theoretically SHORT a daily "put" to their retail customers) represented just under 30% of municipal bonds outstanding. Dealer capital available to provide liquidity for this rising demand for institutional liquidity was dwarfed by Institutional demand (Mesirow calculates the multiple of Mutual Fund & ETF Assets Under Management versus available Dealer Capital at > 80X).

These pressures revealed themselves in weak NY and California State markets. While counterintuitive, the Municipal market generally re-prices it's stronger/ liquid investment grade issuers down first in periods of market stress. Again, counter-intuitive until one recognizes that these stronger securities can attract trading capital, therefore negative price discovery effects them first. Weak IG and non- investment grade securities are rarely offered under market stress conditions by experienced portfolio managers; thus, price discovery and liquidity premia are very slowly realized on those securities most likely to sustain significant price declines.

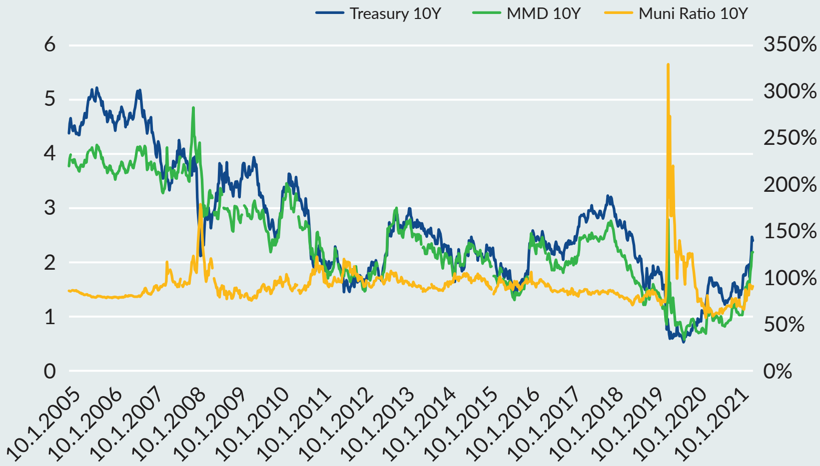
Comparing Treasury yield curve spread widening over one year and latest quarter periods shows spread widening occurred largely during 1Q2022. California, generally among the strongest performers, underperformed the market. NYC and NYS also underperformed (Chart 17) during 1Q. During periods of system illiquidity, portfolio managers sell what they can.

Weaker credits, using the BBB- Hospital curve as a proxy, outperformed Treasuries in 2–3-year tenors, but showed minor weakness from 15-30 years.

Thus far, there has been no major credit event (if we don't count Chinese real estate or a collapse and subsequent transnational manipulation of the nickel markets) associated with this rate back-up. But credit is obviously mispriced relative to high quality State issuers. The liquidity premium for credit risk has simply not been discovered and assigned to these credits. Given the tight spreads graphed on Chart 16, there is significant room to widen.

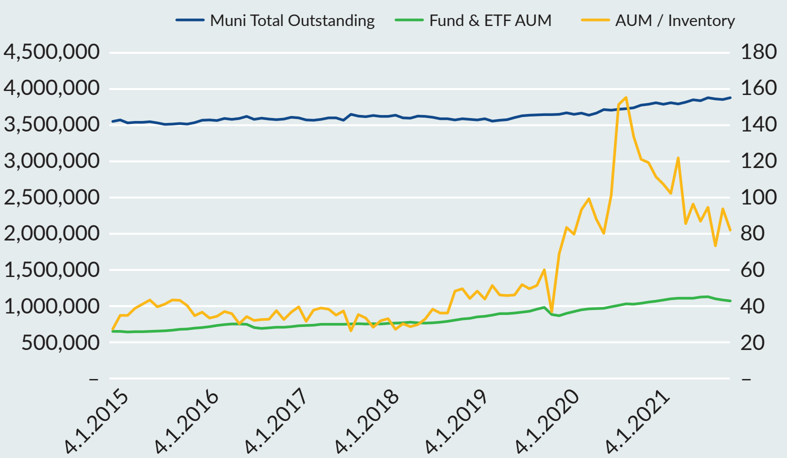
Market carnage has been most pronounced in lower coupon structures (3-4%) and longer maturities (+15 years).

CHART 18: **TREASURY, MMD 10Y YIELD (L) & MUNI / TREASURY RATIO 10Y (R)**



Source: Bloomberg, MMD, Mesirow Financial Research.

CHART 19: **MUNICIPAL TOTAL OUTSTANDING, FUND & ETF AUM (L) & AUM / INVENTORY (R)**



Source: Bloomberg, Mesirow Financial Research

Municipals are cheap compared to Treasuries (Chart 18) and can get cheaper; note the 2–4-year tenor comment above. Are short municipals too cheap to equivalent taxable maturities? With 30-year Municipals yielding >100% of Treasuries are we seeing value, or simply a correct liquidity premium being assigned to an OTC market experiencing negative investor cash flows?

In discussing Municipal market liquidity, Chart 19 is an important graph; one that most Institutional Muni Mutual Fund managers love to hate; it robs them of sleep…

Muni mutual funds and ETFs play the role of intermediary between retail investors and this $3.8T OTC market. They represent approximately 30% of this market in AUM. Almost all these institutional managers are "short" a daily put to their investors (the retail investor's right to make a daily redemption). The ratio between these institutional managers Assets Under Management and institutional dealer capital is 82X (yes, that is **82 times** fund AUM).

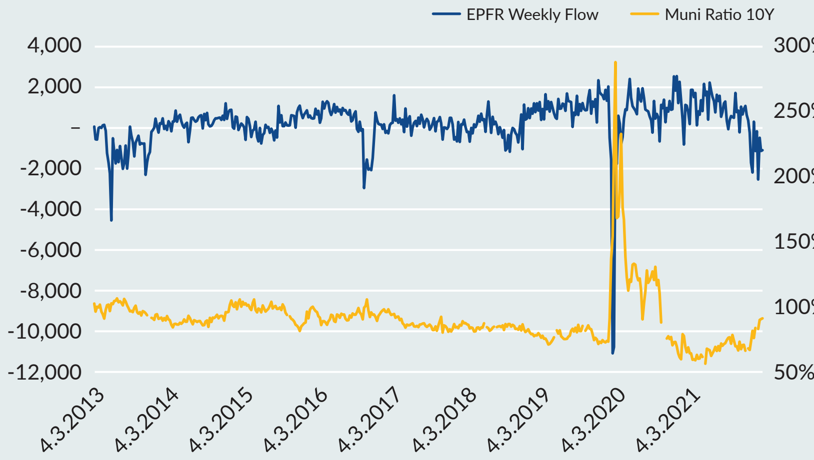
Muni market liquidity is clearly driven by retail investor flows. When these flows weaken and or turn negative, a trend that began in late December 2021 and has accelerated, Municipal market liquidity is priced dearly and very hard to find in institutional block-size.

You don't need a MATLAB program to see the visual correlation between declining Municipal flows and rising Municipal ratios to Treasury bonds. Are long Munis, currently trading at higher yields to equivalent Treasury bonds offering their tax-exemption "for free?" Or perhaps the market is pricing in a much higher liquidity premium in the current "risk-off" fixed income environment. March of 2020 seemed to break the Municipal Market's haven status. Investors apparently have not forgiven that breach.

On Chart 21 notice the impact of the Fed "taper tantrum" in 2013-14. Dealer inventories fell (perhaps due to taps on the shoulder from Dealer risk managers?) while Municipal yields rose quickly and moderated slowly.

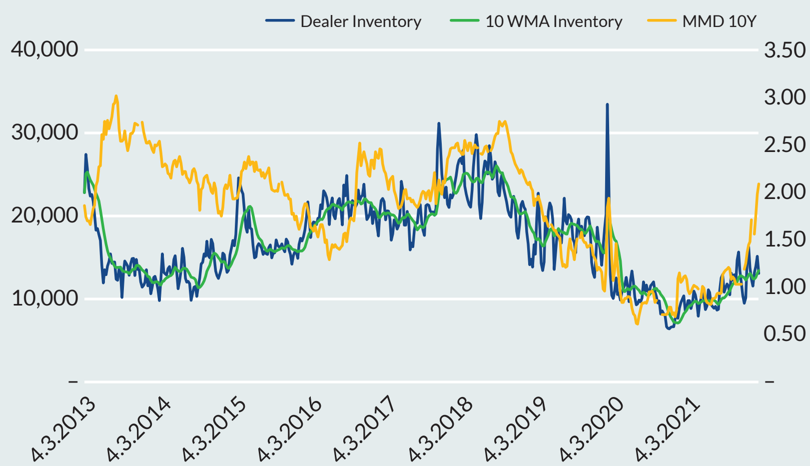
Having reviewed all this data, do you see echoes of 2004 or 2013; both; or something new?

CHART 20: **MUNI/TREASURY RATIO 10Y & EPFR WEEKLY FLOWS**



Source: EPFR, Mesirow Financial Research

CHART 21: **DEALER INVENTORY & MMD 10Y RATE**



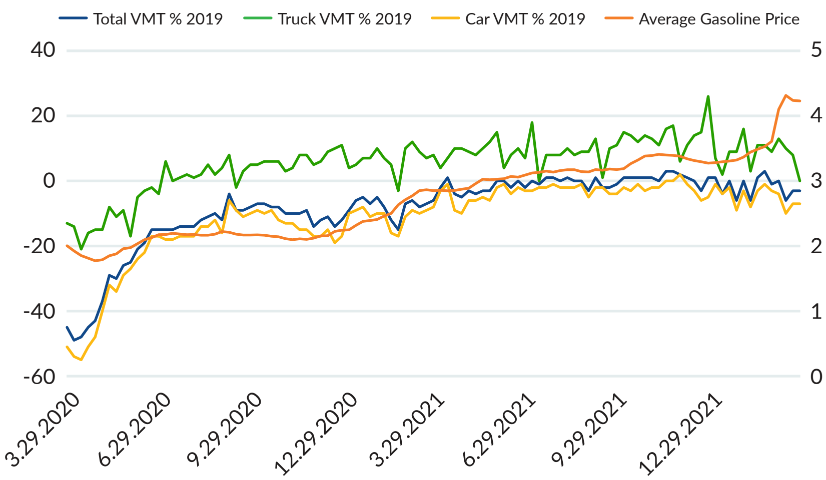
Source: Bloomberg, MMD, Mesirow Financial Research

Transportation

Total public transit ridership reached 57% of pre-pandemic levels in 4Q 2021, according to American Public Transportation Association. The 4Q '21 level is a significant improvement from 4Q 2020 but still far short of Moody's forecast of 85% of pre- pandemic levels by 2024. The sector is challenged by a more permanent shift in work from home flexibility, high labor shortages, growing safety issues and social advocacy around fairness in funding. Mass transit proved essential during the pandemic and received $70bn in stimulus that is expected to broadly cover budget shortfalls over the next 2-4 years. There is concern of a major cliff when systems will need to cover the lost farebox revenue while also addressing significant deferred maintenance and capital programs. Cutting services too much would be self-defeating and reinforce the "work from home" trend or driving. Future budget gaps are too large to rely on traditional fare hikes alone. In high congestion areas where mass transit is integrated and highly essential, State and local governments are likely to draft legislation to expand or levy new dedicated taxes and grants. Analysts should consider overlapping tax and debt capacity and the burdens State and Local governments are likely to face.

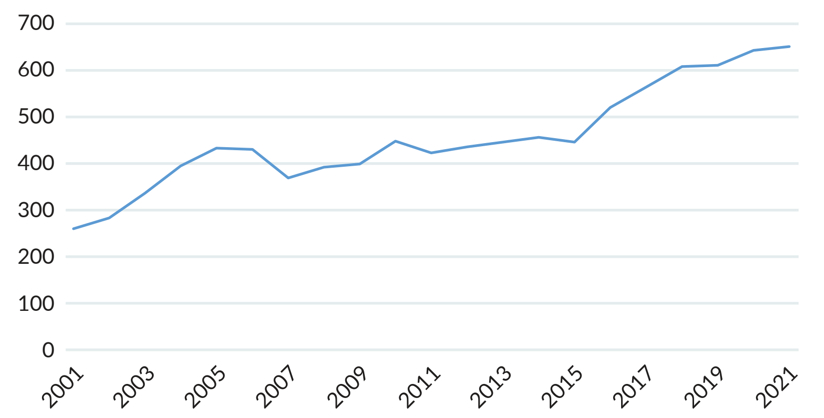
Other examples of alternative funding solutions include dynamic pricing, congestion pricing on automobiles, real estate taxes in transit-oriented development corridors, and direct employer contracts.

CHART 22: **WEEKLY VMT VS 2019 AND AVERAGE GASOLINE PRICES**



Source: US DOT Federal Highway Administration, U.S. Department of Energy

CHART 23: **TOLL SECTOR DAYS CASH ON HAND**



Source: CreditScope

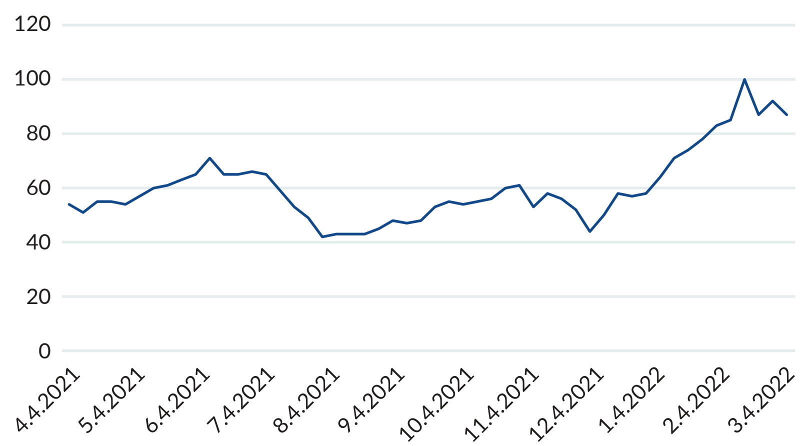
Fuel price increases and gas prices over $4 can produce some positive upside to public transit ridership over longer periods of time, so we may see some steepening in the ridership recovery slope should oil prices remain at high levels for more than a year. Hybrid office models still place an upper limit on the recovery. (Iseki, Ali)

Rating agency 18–24-month outlooks are currently stable, but we expect increased attention to the sector as it nears a federal funding cliff.

Elsewhere in transportation, we recognize a fear of fuel price elasticity against airport enplanements. We expect higher ticket prices to stall bookings going forward, especially for leisure travelers that have led the recovery. Leading up March, there has been very strong demand; scheduled flights for the spring and summer are 25% higher than this time last year and the trend of available seat miles vs 2019 shows improvement throughout the summer. Corporate bookings, a heavy laggard in recovery, continues to show stronger signs of recovery with return to office. We still expect upward enplanement recovery over the spring and summer and will continue to re-evaluate on a weekly basis.

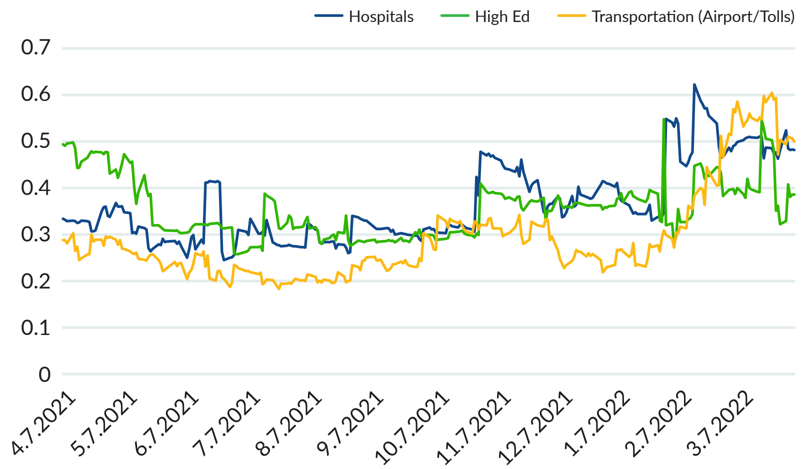
Liquidity was at an all-time high for airports and toll roads pre-pandemic and systems continued to report high levels in 2021. Vehicle miles traveled to date are flat vs 2019 and most toll rates are adjusted annually by the higher of 2% or inflation.

CHART 24: **GOOGLE TRENDS: "GOOGLE FLIGHTS"**



Source: Google

CHART 25: **10-YEAR A-RATED SECTOR SPREADS**



Source: Bloomberg

The positive sector outlooks from rating agencies leave more downside risk to investor sentiment as consumers absorb higher gas and ticket prices.

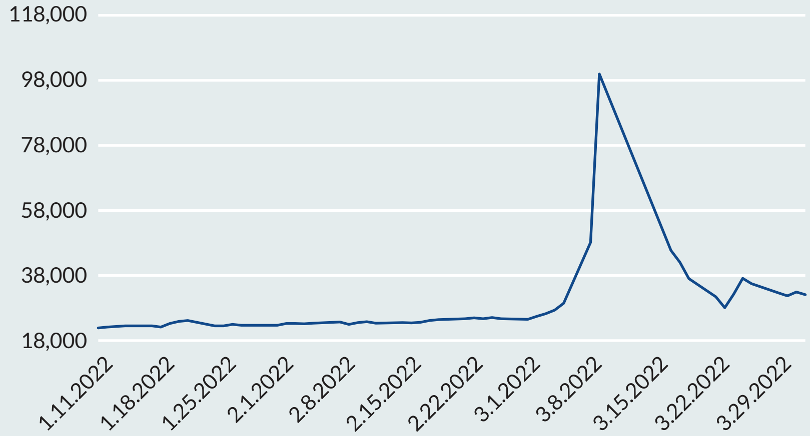
The recent breakthrough of transportation sector spreads going wider than hospitals and private higher education is not likely to hold long term.

Another alarm?

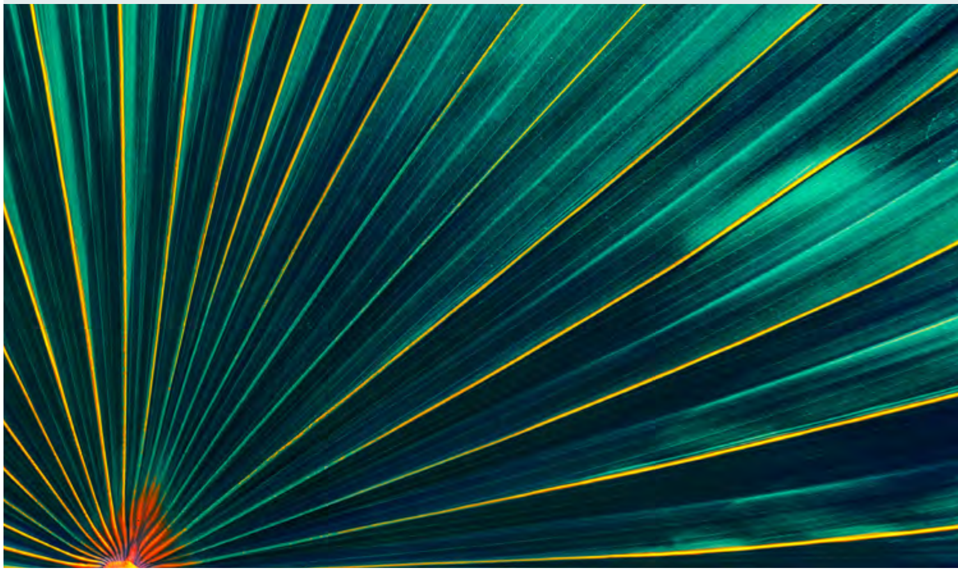
The nickel market "broke" after 18 minutes of trading on the LME Tuesday March 8. Prices went vertical in a violent short squeeze. Trading closed…

This market breakdown was an ugly signal that commodities markets are more than "frothy." Much uglier were the frantic and irregular behind-the-scenes efforts by The London Metal Exchange, traders, market makers, Banks (and a sovereign government or two?) to patch the market back together. Chart 30 is one that prudent investors should bear in mind when pundits are telling them that: asset valuations are fine, the Fed has inflation under control, and the Treasury yield curve inversion is orderly and a "healthy" sign.

CHART 26: **LME NICKEL**



Source: Bloomberg



Conclusion

The questions we originally framed in the 1Q2021 Capital Markets Brief are still relevant:

Are the pandemic impact and response evenly distributed?
No. Despite 80mm recorded US cases of Covid-19 and more than 978,000 subsequent deaths, US caseloads are trending down as the Omicron variant passes its peak. In most of America, life is trending back to a "new normal."

Europe will be coping with at least 4M Ukrainian refugees on the move; mostly women and children. A large, migrant, and under-resourced population is fertile ground for the rampant spread of any new variant. But, in virology, the weak and helpless are the first targets, not the last. Europe beware. Cautionary note: recognizing that data is limited, our analysis suggests a lag (approximately six weeks) between European viral out-breaks and Covid diagnoses rising in US east coast airline trans-Atlantic hub cities. Logic supports short time series data on this.

The disparity between the developed and the undeveloped world remains.

Are markets working to price risk efficiently?
This comment, from our 4Q2021 Capital Markets Brief is still spot on. There are no edits:

"The concerns we have raised in previous Capital Markets Briefs are still very real. Credit remains inefficiently priced. Volatility in the rates markets is rising. Liquidity measures, asset prices, employment data, yield curve twists and supply chain inflation suggest that the markets are struggling to understand the coordinated misjudgments and (related) opacity of central bankers. Market signals are very mixed, and volatility can be expected to increase as risk is repriced."

Energy markets have responded to Russian aggression quite logically. The market appears to be pricing delivery, storage, and distribution infrastructure as carefully as it prices the value of extracted BTU's; rightfully so.

Are central bank and government policy responses balanced and proportionate?
Today's yield curve tells us "Absolutely not."

Two- and three-year Treasury yields have risen approximately 160 basis points over the first quarter. The Treasury curve is inverted 2-30 as we write. The economy is roaring, the asset bubble is expanding, commodity prices are volatile to the point of broken markets (nickel) while the Treasury curve is forecasting recession. There is currently a disconnect between the bond markets and the real economy. Many experienced bond traders believe that the Treasury market is signaling 'stagflation." However, the Fed has so distorted the economy with its easy and expansionary monetary policies and quantitative easing, it's dangerous to be overconfident about past precedents. Investors should be attentive and wary.

Are the impacts of these policy responses creating market distortions or masking unrealized risk?

In a word, yes and yes. We are operating in a high-risk world. The asset bubble continues to expand as the liquidity bubble grows. Credit markets are repricing gently and do not yet fully reflect either the geo-political or economic risks on the horizon. The concerns we have expressed about liquidity, and related volatility spikes, are very much alive at the end of 1Q.

The Municipal market is facing the severe liquidity challenge we have been calling out in the last two quarterly Briefs. Dealer capital is limited, volatility is high and negative retail cash flows drive the imbalance deeper.

These words remain unchanged from our 4Q2021 Brief:

"As we wrote last quarter, in this environment, mindful investors will make value-based, data-driven decisions. They will balance historic reward expectations against the current risk climate, hoping that the Fed drains excess liquidity from the markets deftly. But wise investors will be prepared for the human error and the human emotional over-responses that inevitably follow, and they will price the risk they accept accordingly."

Invariably, investment **opportunities** reveal themselves to strategic investors during periods of high volatility and market dislocation. However, thoughtful capital preservation is a critical component of a wise investor's preparation for harvesting opportunity, once it is revealed.

"Dry powder" is an exceptionally valuable commodity in any liquidity-constrained market.

Why are markets so careless of the conspicuous asset inflation that the Fed liquidity bubble encouraged?

The Capital Markets are no longer careless of asset inflation. Commodity spikes and the failure/manipulation of the nickel market (Chart 30) have alarmed fixed income investors nearly as much as much as Russian revanchism has. The Fed appears to have abandoned its own messaging at the close of 1Q (conspicuously the Chairman and Governor Brainard) a long overdue response to the Fed's prolonged period of indiscipline.

Fixed income markets, notably excepting credit markets, are forecasting stagflation. Market signals are truly mixed, and experienced traders are conflicted and looking for direction, but there are very few care-free "risk-on" bond traders (still employed) …

Where are we in this most unconventional political and business/economic/Fed cycle?

As we have written during the last several quarters, market pricing is non-synchronous.

The Federal Reserve has signaled a hard policy shift on both tightening and quantitative easing, in the face of "hot" consumer inflation, "hot" commodity markets, "hot" energy markets and numerous and distributed "red hot" residential housing markets (especially select suburbs, very high end urban and high-end vacation markets in low-tax jurisdictions). The rates market is responding with a "bear-flattener" and an inverted yield curve. We are at the beginning of this new Fed regime. We carry an extraordinary national debt burden into this rising rate environment.

Equities have responded with negative returns in a largely orderly selloff during 1Q. Tech has dramatically underperformed the broader market.

Real Estate, traditionally an inflation haven, has generally performed well. Supply chain infrastructure stands out. There are likely over-extended pockets given the emerging Fed posture and looming interest and Cap Rate revisions.

Commodities, notably energy and related battery and chip-input markets have rallied into multiple supply chain disruptions (Covid, transportation and geopolitical). There is not much short-term relief in sight. As we have written, expect supply chains to get shorter, more defensive, and where possible, domesticated. These forces will be inflationary.

Labor markets are extremely tight domestically, and appear to be at the early stage of long and inflationary re-pricing. Productivity related corporate spending (CapEx) will be something to look for in future forecasts.

Credit markets have widened very modestly, largely ignoring the Treasury yield curve signals. We have NOT faced a significant domestic credit event in this cycle, yet… Chinese Real Estate and Nickel markets are duly noted.

Lastly, we are seeing a global geopolitical realignment happening violently and in real-time. Russia's hegemonic energy policy has been laid bare for European governments, manufacturers, and consumers. Putin's Ukraine adventure cannot end smoothly, quickly, or clearly.. The possibility of a "frozen conflict" in Ukraine is very real. The human cost, the economic cost to Europe and the global cost for defense/ security will have a very long tail.

As always, we emphasize opportunistic caution in the face of these non-synchronous cycles. High volatility will create opportunities to "rent" liquidity to tight markets if high quality assets underlie the trade. The quality, character, and experience of one's counterparties, whatever the market, will be a critical component of investment success.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with offices 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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The S&P 500 Index is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States and constructed to provide a comprehensive and unbiased barometer of the U.S. equity market.

The credit default swap index (CDX) is a financial instrument composed of a set of credit securities issued by North American or emerging market companies. Currently, the CDX contains 125 issuers and is broken down by two different types of credits: investment grade (IG) and high yield (HY).

A proprietary yield curve Municipal Market Data (MMD) AAA Curve provides the offer-side of AAA-rated state general obligation bonds (GO). The MMD analyst team determines the inclusion of bonds. The MMD AAA curve represents the MMD analyst team's opinion of AAA valuation, based on an institutional block size of $2 million-plus market activity in both the primary and secondary municipal bond market.

US Real Weekly Earnings Index is the weekly earnings of US employees, adjusted for inflation. They provide insight into what an average individual is earning per week and thus is the primary measure of wage growth in the United States.

An exchange traded fund (ETF) is a type of security that tracks an index, sector, commodity, or other asset, but which can be purchased or sold on a stock exchange the same as a regular stock.