LEVERAGED FINANCE MARKET PERSPECTIVE LETTER

Inverted Markets

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Rising rates, soaring inflation, and raging war created extreme volatility in March. The Federal Reserve's hawkish pivot has certainly rattled investor sentiment since last November. While the U.S. Treasury market now shows the 2-10year yield curve is the most inverted since 2007, the equity markets have seemingly ignored this potential recession indicator. As a result, the equity and fixed income markets also became "inverted" in March. The Bloomberg U.S. Aggregate Bond Index fell 2.78% while the S&P 500 index rose 3.71% last month. The U.S. Treasury market not only faced liquidity constraints but suffered the largest quarterly decline since 1980. Concurrently, the S&P Goldman Sachs Commodity Index (S&P GSCI) leaped 29%, the highest quarterly gain since 1990. Clearly, the U.S. Treasury and Investment Grade markets are pricing in a higher risk of recession. Many equity investors believe the current inverted yield curve is a red herring, sending a false signal of a recession; but credit investors are concerned the Fed is significantly behind the curve and will be forced to sharply hike rates to combat inflation. Multiple market forces, including the possible erosion of U.S. dollar reserve currency dominance, the reliance on central bank balance sheets, and the unwinding of globalization may upend investor confidence as the old rules of the financial markets are challenged.