Fixed Income Market Insights

January 6, 2023

Key takeaways

Bond yields were lower this week, with GT2s down 14 basis and GT10s lower by 29 basis points respectively and 2s/10s more inverted by 5 basis points (-70) driven by some early signs of easing wage pressures and slower services demand. On the data front, the JOLTS release revealed the number of available jobs fell 54,000 to 10.46 million in November as durable labor shortages and robust demand continue to drive tight job markets. Headline Non-Farm Payrolls again came in stronger than expected with 223,000 new jobs added in December, led by broad-based gains in services employment, including continued strength in leisure/hospitality and healthcare. The ISM Services PMI index came in weaker than expected during December, driven by steep declines in business activity and orders components, reversing November's outsized read and sparking concerns of weakening demand given durable inflation, rising interest rates and softer economic sentiment.

We suggest

We continue to prefer playing rate defense given elevated inflationary expectations and ongoing FOMC rate hikes. We favor barbell strategies in securitized products, anchored by short, higher current cash flow assets and longer, high quality bonds.

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New Year's Bounce

Both stock and bond markets rallied to start 2023 as investors look forward to the end of the most aggressive FOMC tightening in over 40 years amidst renewed optimism that meaningful inflation reduction can occur without triggering a harder, economic landing later this year. Indeed, today's Non-Farm Payroll data release for December revealed another month of robust job creation and, more importantly, some welcome moderation in the pace of wage growth, surely good news for the FOMC as compensation pressures, particularly in the service sector, are seen as the main impediment to getting core inflation on a sustainable path towards the Federal Reserve's 2% target. Indeed, average hourly earnings growth slowed to 4.6% for 2022, the smallest year-over-year gain since August of 2021, which has given some investors hope that the economy can continue to add jobs without also adding to wage pressures, a trend that, if sustained, may expand the path towards the often illusory economic 'soft landing.' Additionally, today's ISM Services data revealed cooling demand and more moderation in prices, more key data points for Powell and Company that may hasten the end of the latest monetary policy tightening cycle by the end of the first quarter. Of course, these are two data points in a sea of otherwise mixed numbers that will need to be confirmed for trend in the months to follow, with plenty of risk to upside inflation surprises as we move into 2023.

Market Snapshot

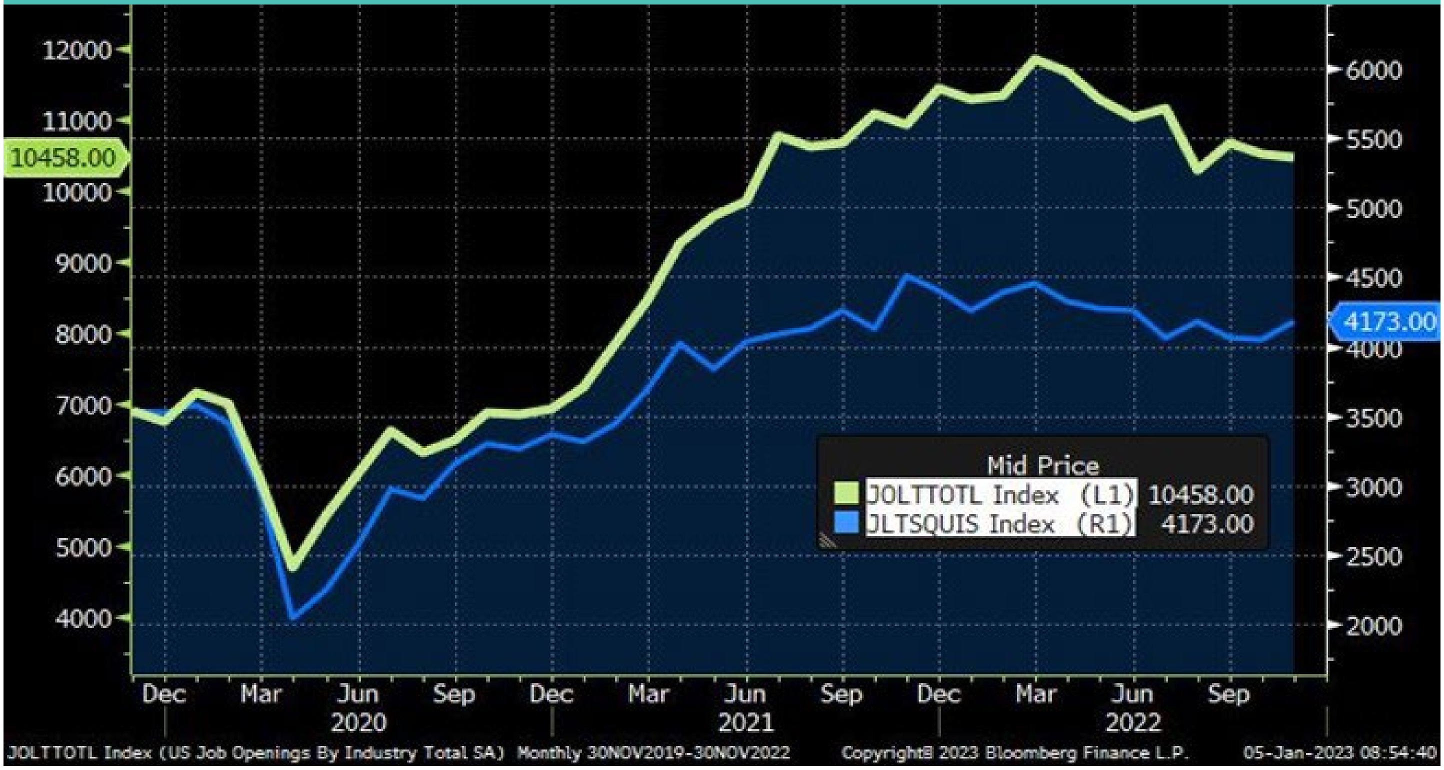
	This week 1/06/23	Last week 12/30/22	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	4.81%	4.77%	4	0.84%	0.84%
SOFR	4.31%	4.30%	1	0.23%	0.23%
2-year US Treasury	4.26%	4.43%	-17	-3.84%	-3.84%
5-year US Treasury	3.71%	4.01%	-30	-7.48%	-7.48%
10-yr US Treasury	3.56%	3.88%	-32	-8.25%	-8.25%
2s-10s UST Spread	-70.00	-55.00	-15.00	27.27%	27.27%
DJIA	33,608	33,147	461.00	1.39%	1.39%
S&P 500	3,894	3,840	54.00	1.41%	1.41%
Spot Gold	1,874	1,826	48.00	2.63%	2.63%
WTI (Oil) Current Contract	73.90	80.26	-6.36	-7.92%	-7.92%
1-year Brokered CD	4.60%	4.60%	0	0.00%	0.00%
5-year Brokered CD	3.90%	4.00%	-10	-2.50%	-2.50%
5-year Bullet US Agency	3.82%	4.08%	-26	-6.37%	-6.37%
5-year/NC1yr Callable US Agcy.	5.15%	5.40%	-25	-4.63%	-4.63%
CDX IG Spread Index	74.75	82.02	-7.27	-8.86%	-8.86%
CDX High Yield Index Spread	101.94	100.62	1.32	1.31%	1.31%
15-yr UMBS	4.32%	4.66%	-34	-7.30%	-7.30%
30-yr UMBS	4.94%	5.33%	-39	-7.32%	-7.32%

Source: Bloomberg data as of 1:30pm ET 1/6/2023 and market close ET 12/30/2022

To start, economic growth could be more resilient than expected and continue the trend from last year where growth expanded at a much faster pace during the second half of 2022 versus the first, a real possibility given additional government stimulus taking effect this year, namely the bloated, $1.7 trillion Federal government funding bill for 2023 and the 8.7% increase in the Social Security cost of living adjustment for over 70 million Americans. Additionally, the incoming congress may continue to advance more outsized spending bills with further disincentives for the unemployed to return to work, one of the primary drivers of inflation this cycle and, if continued, will go a long way to undoing some of the policy tightening by the FOMC via looser financial conditions, a scenario likely to trigger addition rate hikes by the Fed beyond the widely expected 5% terminal rate. While meaningful risks to upside inflation surprises endure as we kick off 2023, the union of cooling goods prices and some early signs of relief in wages and services prices will likely be supportive of some follow through of this week's rally in stocks and bonds and the long-awaited FOMC pause.

All quiet on the fiscal front as the House of Representatives returned from last week's holiday recess, with the election of a new Speaker by the new Republican majority front and center. As of the time of publication and after eleven votes over three days, no GOP candidate has received the required 218 votes to become the new Speaker. Stay tuned!

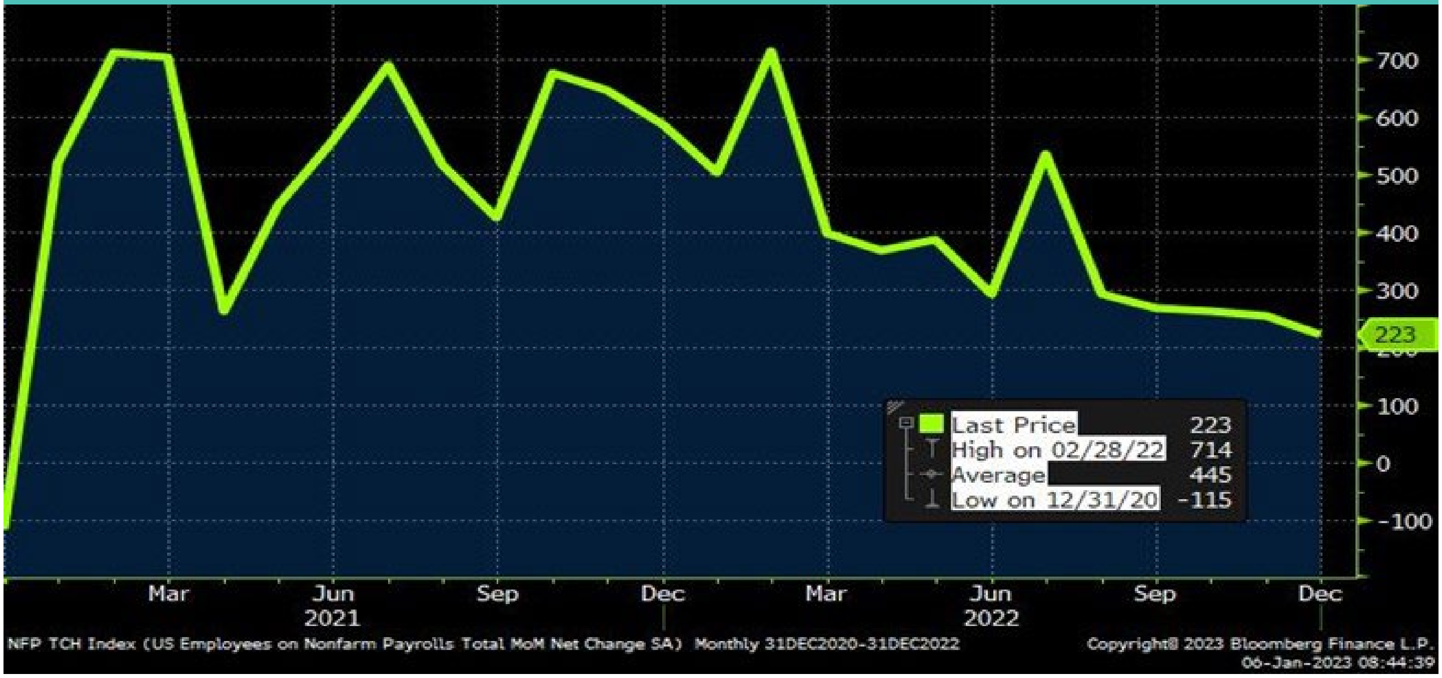
JOLTS U.S. Job Openings & Quits – Monthly – 3 Years



Source: Bloomberg as of 1/6/2023

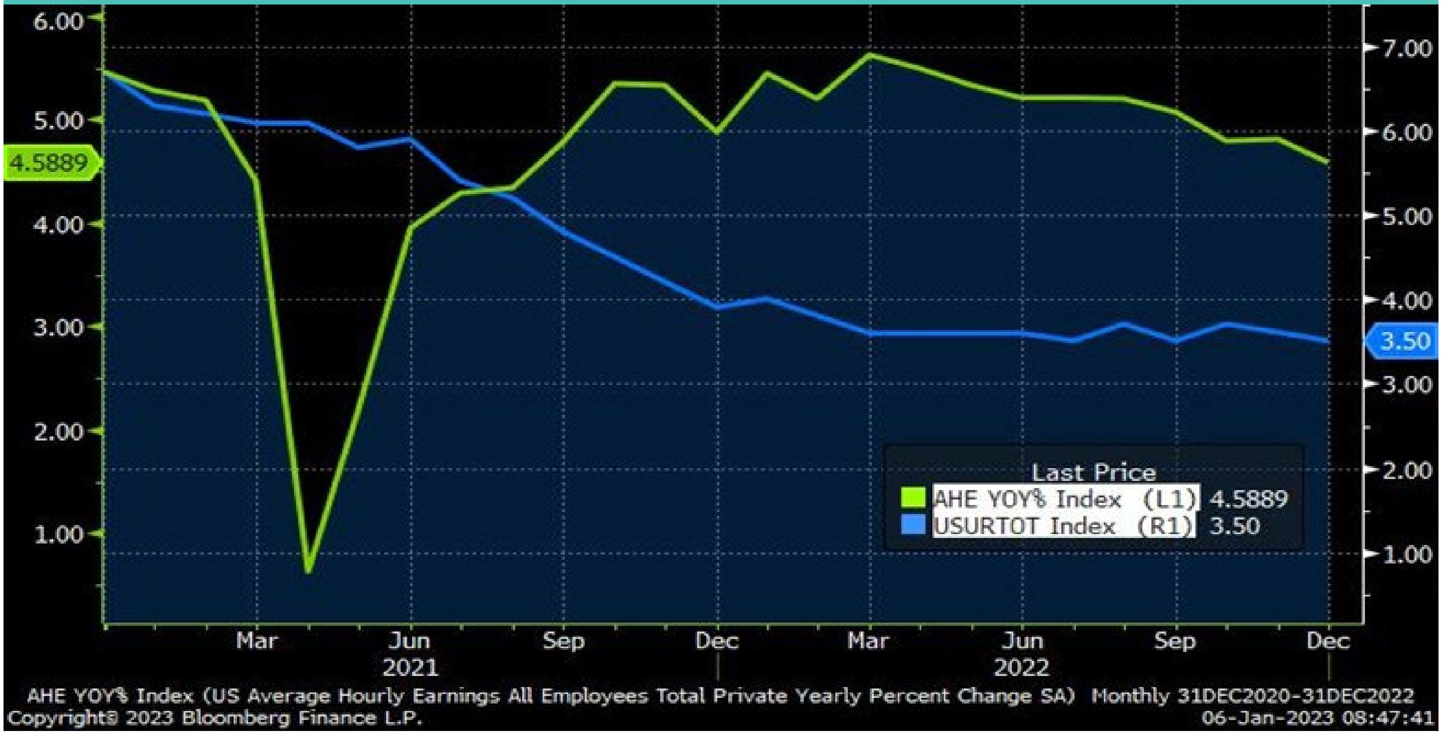
The number of available jobs fell 54,000 to 10.46 million (10.05 million est.) in November as durable labor shortages and robust demand continue to drive tight job markets. By industry, job openings increased in professional/business services (+212,000) and nondurable goods manufacturing (+39,000), with decreases in finance and insurance (-75,000) and federal government (-44,000), as employers continue to report difficulty attracting and retaining enough workers to keep up with still robust demand for goods and services. Indeed, the labor participation rate remains 1.5% lower than its 2019, pre-pandemic peak as higher retirement rates, skill mismatches and mixed participation have stunted employer efforts to add new workers. Additionally, the quits rate, which measures voluntary job separations per month as a percent of total employment, ticked up to 2.7% (4.2 million jobs; 2.3% Dec. 2019), just shy of last December's all-time high (3%), as salary increases, recruiting incentives and the sheer magnitude of job vacancies continue to drive high employee turnover. Further evidence of job market snugness can be seen in the layoffs and discharge rate, which was unchanged at .9% during November (record low .8% December 2021) and the 1.74x ratio of jobs available to each unemployed worker (cycle high 1.99x March 2022; 1.15 Dec. 2019), which eased during the fourth quarter, but still indicative of very tight labor markets. To be sure, chronic labor shortages are forcing companies to increase compensation to attract and retain workers, with little relief expected during the first half of 2023. While selected job market imbalances should subside given FOMC rate hikes and slowing demand, we believe the JOLTS data will remain high as the pandemic and elevated, state-level direct economic assistance drove structural changes to the labor force that have slowed the return to pre-pandemic levels of labor participation. Notwithstanding November's small decline, open positions and the job openings rate (6.4%; 7.3% peak in March 2022) remain historically high and will keep the FOMC on track to continue raising rates during the first quarter as durable labor supply/demand imbalances will likely support solid wage growth and broad-based pricing pressures in the coming months.

US Non-Farm Payrolls MoM Net Change – Monthly – 2 years



Source: Bloomberg as of 1/6/2023

Unemployment Rate and Average Hourly Earnings % YOY Change – Monthly – 2 years



Source: Bloomberg as of 1/6/2023

Unemployment Rate and Average Hourly Earnings % YOY Change – Monthly – 2 years

Source: Bloomberg as of 1/6/2023

Headline Non-Farm Payrolls again came in stronger than expected with 223,000 new jobs added in December (203,000 est.), led by broad-based gains in services employment, including continued strength in leisure/hospitality and healthcare. Taken together with revisions that subtracted 28,000 jobs in the prior two months, job creation remained solid with average monthly gains of 247,000 during the fourth quarter of 2022, a deceleration from the third quarter's 366,000 pace (vs. 349,000 Q2 2022), but historically robust. Looking by industry revealed broad based strength, led by education/health (+78k), leisure and hospitality (+67k), construction (+28k) and durable goods manufacturing (+24k). Beyond the headline number, the big takeaways were the stronger uptick in labor participation (62.3% vs. 62.2% est.) and the moderation in average hourly earnings (+.3% vs. +.4% est./+4.6% YOY vs. 5.0% est.), both reversals of November's outsized changes in both metrics and surely welcome news for the FOMC and investors given the durability of labor market tightness and persistence of outsized, nominal wage gains post pandemic. Indeed, this week's JOLTS job openings (10.46 million), the number of available positions per unemployed worker (1.74) and quits rate (2.7% or 4.2 million jobs) remain historically high, suggesting that wage inflation will remain durable in the months to come. Additionally, labor participation remains over a percentage point lower than the 2019, pre-pandemic high as elevated retirement rates, skill mismatches and increased entrepreneurship have slowed employer efforts to fill millions of open positions. This lower participation has driven down the unemployment rate to 3.5%, matching July's pre-pandemic low of 3.5% (lowest since 1969), and pressured average hourly earnings higher (4.6% YOY), both conditions expected to endure well into 2023. All in all, another solid employment report with some silver linings regarding wage growth moderation and better labor participation, with FOMC still on target for another rate hike (likely 25 basis points) at the February 1st meeting.

ISM Services PMI- Monthly – 3 years

Source: Bloomberg as of 1/6/2023

The ISM Services PMI index came in weaker than expected during December at 49.6 (est. 55.0), the lowest level since May 2020, driven by steep declines in business activity and orders components, reversing November's outsized read (56.5), sparking concerns of weakening demand given durable inflation, rising interest rates and softer economic sentiment. A deeper dive into the survey revealed that the business activity and new orders components of the index both sank by 10 points, the largest declines since April 2020, and delivery times improved dramatically (48.5 vs. 53.8 November), the lowest level in nearly seven years, all suggestive of softer demand and improving supply chain logistics. Additionally, the data also revealed that prices paid by service providers slowed in December (67.6 vs. 70.1 six-month average), the lowest level since January 2021, but still remain historically elevated. All in all, a much weaker report suggesting that the cumulative effects of FOMC rate hikes and stubbornly high inflation are starting to weigh on demand for services.

The Week Ahead

The data calendar picks up over the next week, headlined by CPI, University of Michigan Consumer Sentiment, and NFIB Small Business Optimism. Looking ahead, markets remain focused on inflation, jobs data and further signs of slowing economic activity. On the new issue front, no new ABS deals were priced during the holiday shortened week ($276.7 billion for 2022; $312.6 billion for 2021) and IG corporate issuance surged with $58 billion in deals priced this week through the 5th ($1.26 trillion for 2022; $1.41 trillion for 2021). While new issue supply slowed during 2022 given FOMC rate hikes and elevated volatility, the market is still supportive for selected ABS and corporate issuers as investor demand remains robust.

Monday 1/09
Consumer Credit

Tuesday 1/10
NFIB Small Business Optimism

Wednesday 1/11
MBA Mortgage Applications

Thursday 1/12
CPI; Weekly Jobless Claims

Friday 1/13
UM Consumer Sentiment

About the author

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As a fixed income trader with more than 25 years of experience, David Petrosinelli brings deep knowledge and unique perspectives to InspereX's clients. His background includes sales and trading of mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities, collateralized loan obligations, and collateralized mortgage obligations. Before joining InspereX (formerly known as Incapital) in 2020, he served as a Managing Director at Brean Capital and previously held various positions with Piper Sandler Companies and Shay Asset Management. David closely monitors underlying trends within the bond markets and how those markets are shaped by both American policymakers and the global macro economy. He earned a bachelor's degree in accounting and finance from Northeastern University and an MBA in economics and finance from Loyola University Chicago. He is a CFA Charterholder and holds FINRA Series 7 and 63 licenses. He is based in New York City.