Fixed Income Market Insights

July 20, 2023

Key takeaways

Bond yields were higher this week, with GT2s up 22 basis points and GT10s higher by 10 basis points and 2s/10s more inverted by 12 basis points (-98), as a rebound in consumer sentiment and lower initial jobless claims partially reversed last week's sharp drop in U.S. Treasury note yields. On the data front, the University of Michigan Consumer Sentiment Index again came in stronger than expected at 72.6 in July, the highest level since September 2021, driven by easing inflation and persistent strength in the labor market. Headline retail sales slowed during June with receipts up +.2%, the smallest monthly advance in three months, as higher borrowing costs and elevated prices continue to weigh on consumption, particularly for lower income households. Sales of existing homes during June came in fractionally lower than expected to an annualized rate of 4.16 million homes, extending the resilience from this January's pandemic era low, but well under pre-pandemic averages given higher mortgage rates, low supply and still-steamy prices. Initial unemployment claims eased during the week ended July 15th to 228,000, the lowest level in two months and reflective of durable strength in demand for labor despite the uptrend in layoff announcements, accelerating WARN notices and cooling demand for temporary workers.

We suggest

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

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Debt Distress

As consumers and businesses adjust to higher interest rates and still-elevated inflation, a growing chorus of skepticism has emerged regarding the financial health of those companies that loaded up on debt when rates were near zero during the years prior to the pandemic. Indeed, bankruptcy filings for larger companies have increased sharply versus pre-pandemic run rates as debt-laden issuers have been forced to contend with labor shortages, higher input costs, soaring interest rates, and tighter credit conditions. Consequently, prices for bonds issued by and loans made to economically vulnerable companies have declined, with a growing amount of these obligations now trading below 80 cents on the dollar, a condition that bestows an unenviable label upon these instruments- Distressed Debt. Defined as bonds and loans trading below 80 cents on the dollar (and with a spread greater than 1,000 basis points for bonds), distressed debt has now topped $590 billion globally with more additions likely as slower economic growth, soaring debt servicing costs, 'higher for longer' interest rate stance by most central banks and tighter lending standards portend further strain for credit-sensitive issuers.

Market Snapshot

	This week 7/20/23	Last week 7/13/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.59%	5.57%	2	0.36%	17.19%
SOFR	5.05%	5.05%	0	0.00%	17.44%
2-year US Treasury	4.84%	4.62%	22	4.76%	9.26%
5-year US Treasury	4.10%	3.94%	16	4.06%	2.24%
10-yr US Treasury	3.86%	3.76%	10	2.66%	-0.52%
2s-10s UST Spread	-98.00	-86.00	-12.00	13.95%	78.18%
DJIA	35,331	34,394	937.00	2.72%	6.59%
S&P 500	4,547	4,517	30.00	0.66%	18.41%
Spot Gold	2,010	1,965	45.00	2.29%	10.08%
WTI (Oil) Current Contract	76.00	77.21	-1.21	-1.57%	-5.31%
1-year Brokered CD	5.35%	5.25%	10	1.90%	16.30%
5-year Brokered CD	4.60%	4.45%	15	3.37%	15.00%
5-year Bullet US Agency	4.18%	4.01%	17	4.24%	2.45%
5-year/NC1yr Callable US Agcy	5.65%	5.44%	21	3.86%	4.63%
CDX IG Spread Index	66.26	65.15	1.11	1.70%	-19.21%
CDX High Yield Index Spread	103.05	103.20	-15.00	-0.15%	2.42%
15-yr UMBS	5.09%	4.89%	20	4.09%	9.23%
30-yr UMBS	5.59%	5.37%	22	4.10%	4.88%

Source: Bloomberg data as of 1:45pm ET 7/20/2023 and 3:45pm ET 7/13/2023

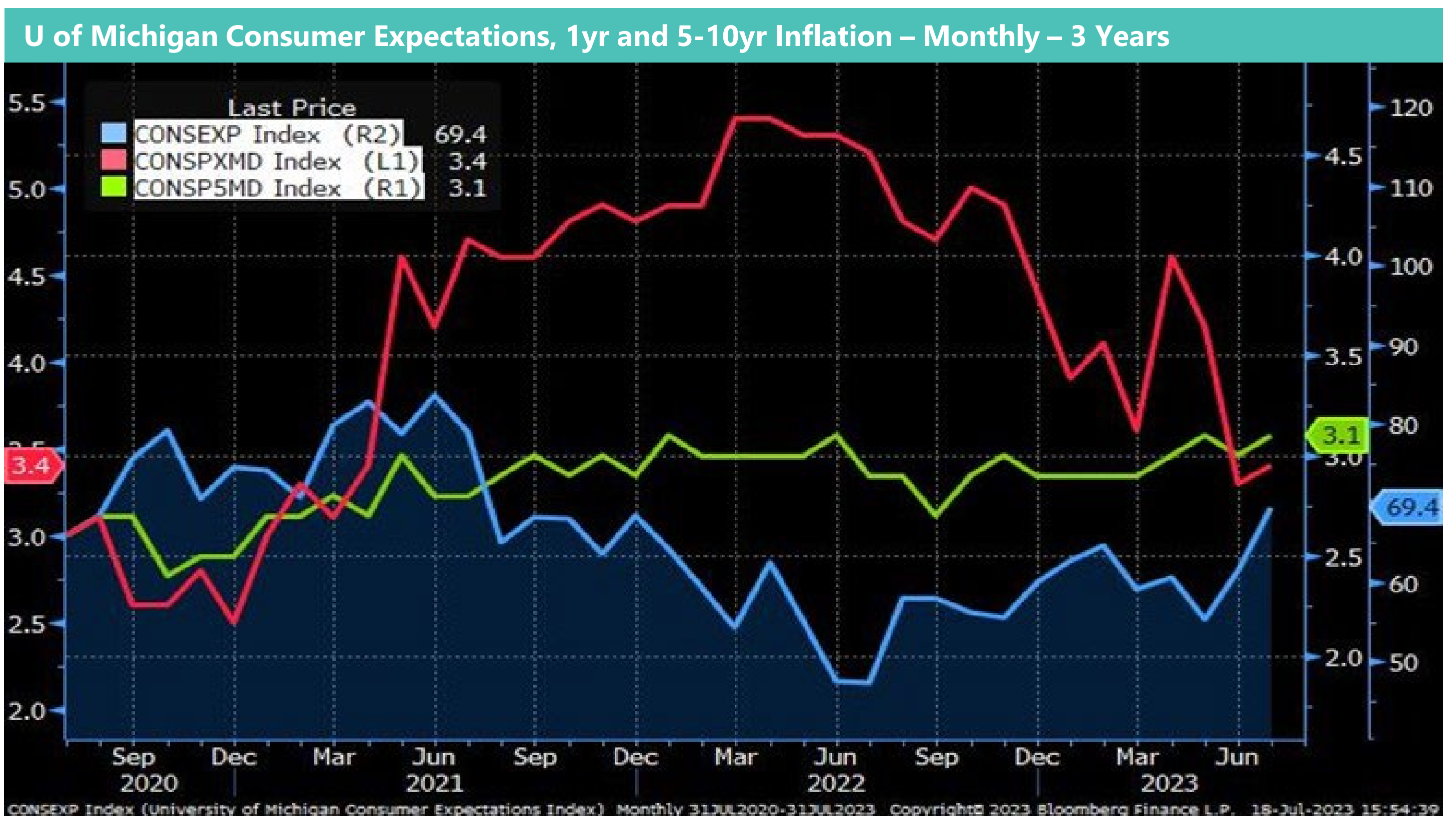
According to Standard and Poors, the amount of high-yield bonds issued by and leveraged loans made to these credit sensitive companies in the United States more than doubled from 2008 to $3 trillion by 2021, just prior to commencement of the most aggressive FOMC rate hiking campaign since the early 1980s. Driven by years of near zero interest rates and investors stretching for yield, these excesses have started to expose cracks in the U.S. market for corporate debt, with bonds and loans now classified as distressed surging by more than 350% since 2021. Should the U.S. economy tip over into recession, the amount of distressed debt will sharpy increase, likely triggering the largest wave of defaults since the Great Financial Crisis (GFC) of 2008-09. For comparative purposes, Moody's Investor Service reported that the global default rate for speculative grade (below BBB rated) companies hit 3.8% for the year ended June 30th, with these failures likely to exceed 5% during 2024 in their base case, with the most pessimistic scenario nearing 14%, which would eclipse the default rate for speculative grade date endured during the GFC. While many believe that a GFC-like default spiral is unlikely given today's robust labor markets, consumer spending resilience and moderating inflation, a durable continuation of this year's upward trend would likely trigger a more protracted economic downturn via more credit contraction and job losses that invariably follow. Judging by the relative tightness of credit spreads across most fixed income sectors in the U.S., including high yield, the market appears to agree with lower end estimates of bankruptcies and defaults, for now.

Still quiet on the fiscal front after last month's debt ceiling deal. To review, the President signed the debt ceiling bill into law in June, known as the "Fiscal Responsibility Act of 2023," averting a U.S. Government debt default and rating agency downgrades. Away from that and as expected, the Supreme Court struck down the Biden administration's Executive Order regarding student loan forgiveness two weeks ago, which attempted to cancel up to $20,000 per borrower and boasted a price tag of at least $400 billion (with some scoring upwards of $1 trillion). Notwithstanding the ruling, the Biden administration announced plans last week to cancel $39 billion of certain federal student loan debt for more than 800,000 borrowers that have been paying down still outstanding loans for more than 20 years, citing the Higher Education Act of 1965 as enabling legislation. Needless to say, this latest move is likely to face legal challenges in the weeks to come. Stay tuned!

U of Michigan Consumer Sentiment – Monthly – 3 Years

Source: Bloomberg as of 7/20/2023

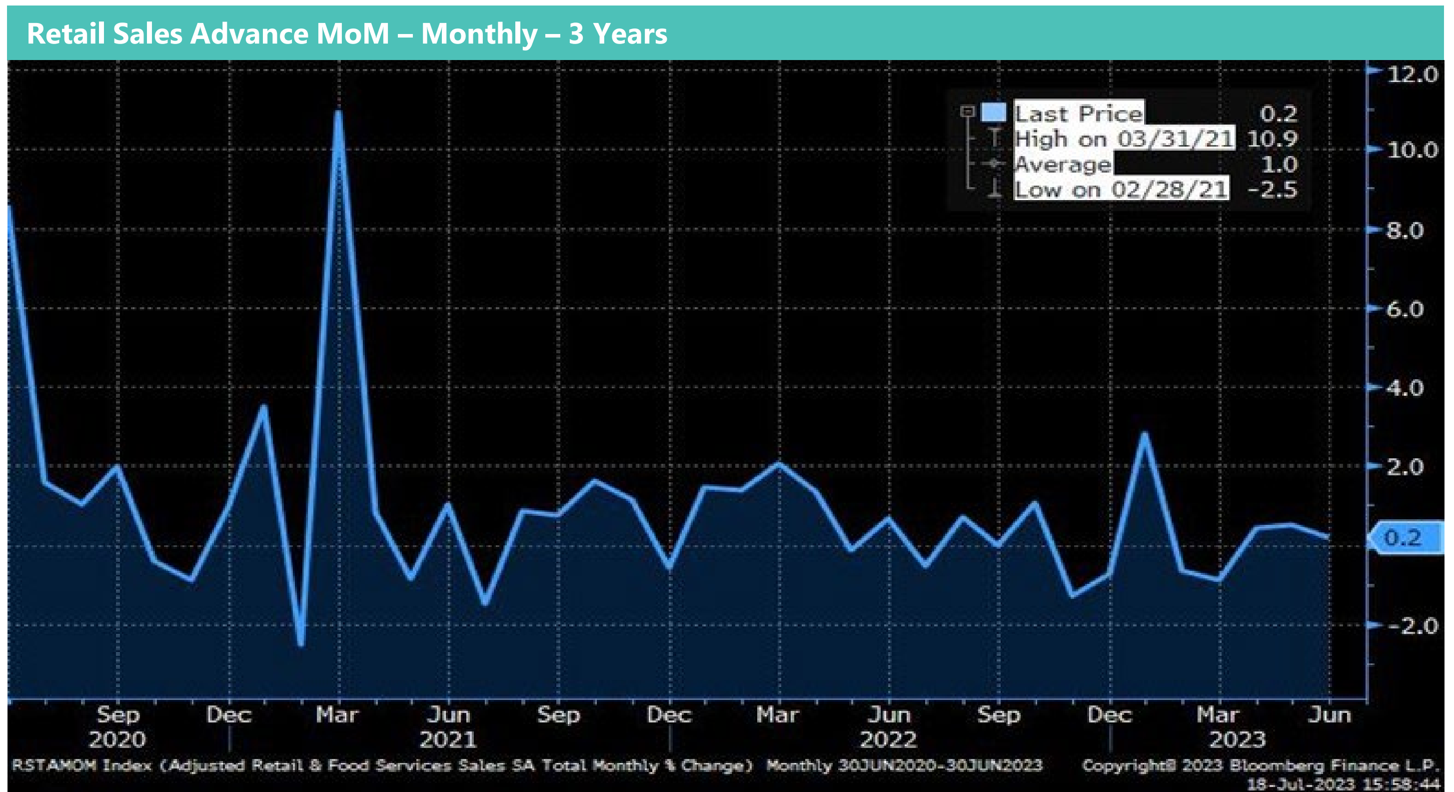
U of Michigan Consumer Expectations, 1yr and 5-10yr Inflation – Monthly – 3 Years



Source: Bloomberg as of 7/20/2023

The University of Michigan Consumer Sentiment Index again came in stronger than expected at 72.6 in July (65.5 est.; 64.4 Jun.), the highest level since September 2021, driven by easing inflation and persistent strength in the labor market. Notwithstanding this improvement, nearly 35% of consumers attributed their negative views regarding personal finances to inflation (41% Jun.; 36% in Jan.), shy of the all-time high during the 2008 financial crisis (49%), and just 21% expect their incomes to rise more than inflation, an improvement over last June's 13% cycle low, but still historically low. Additionally, a mere 33% of consumers expect good economic times over the next year (July 2022 cycle low: 13%) as higher interest rates, elevated inflation and dissatisfaction with government's economic policies (47%; highest since last November) continue to weigh on consumer optimism regarding their near-term financial health. A deeper dive into the survey revealed that both components of headline sentiment were higher, as current conditions jumped to 77.5 (69.0 May; 68.4 Jan) and expectations up to 69.4 (61.5 May; 62.7 Jan), the highest levels since October and July 2021 respectively, but still well below pre-pandemic levels. On the price front, year-ahead inflationary expectations increased fractionally to 3.4%, the second lowest level since March 2021 (2.6% 2019 Average; cycle high 5.4% Mar. 2022) and longer-term expectations were little changed at 3.1% (2.4% 2019 Average; cycle high 3.1% May), both historically high and well above of the FOMC's target of 2%. Looking at the text of the report, the director of the survey stated that "The sharp rise in sentiment was largely attributable to the continued slowdown in inflation along with stability in labor markets," and that "Consumers expect unemployment rates to remain low over the next year, and a majority of consumers expect their incomes to rise at least as much as inflation." Notwithstanding this month's improvement in sentiment, inflation, elevated interest rates and discontent regarding government policies continue to hold down consumer optimism, a landscape that threatens to weaken consumption in the months to come as the cumulative effects of FOMC policy tightening fully make their way through the economy.

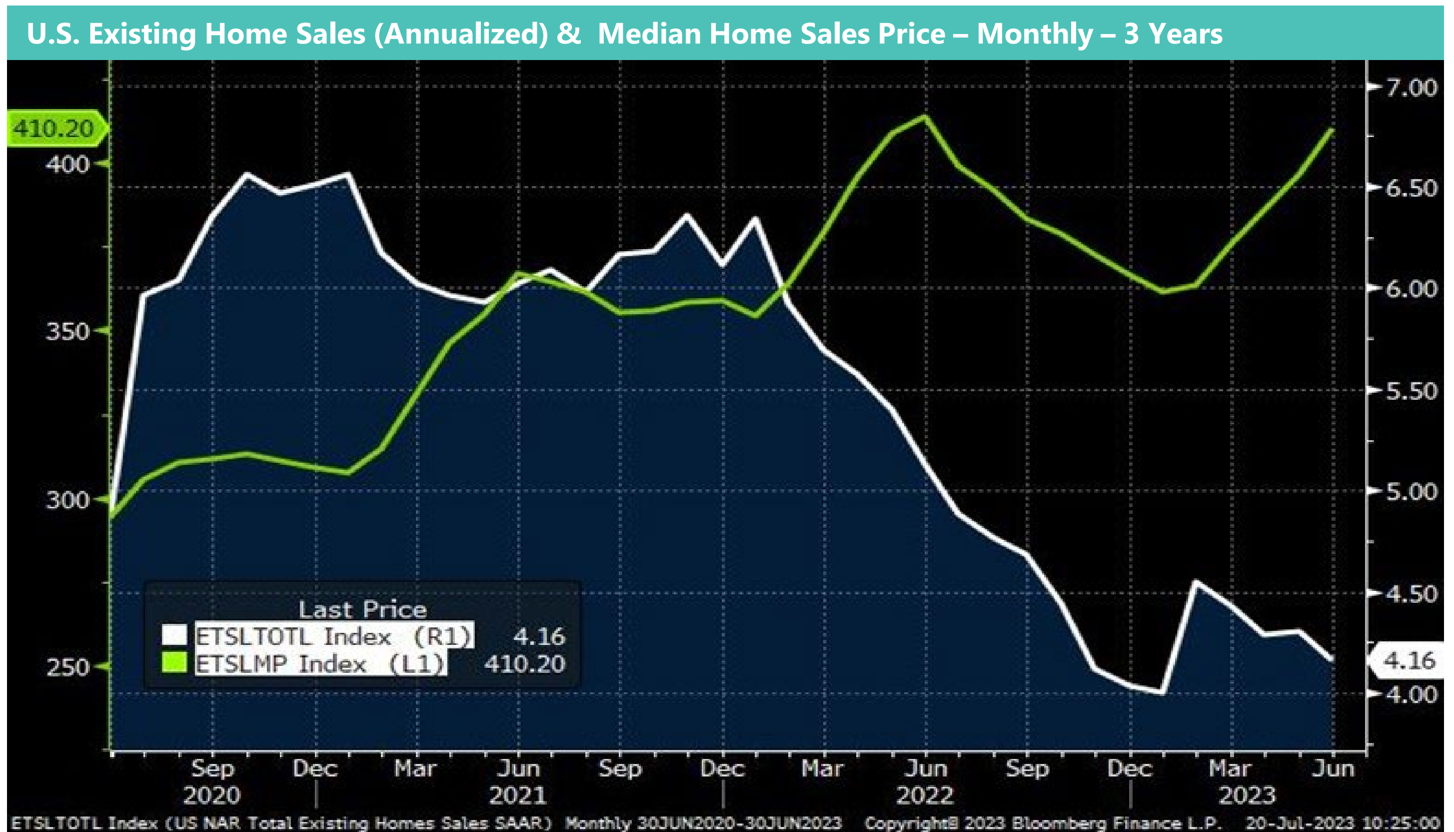
Retail Sales Advance MoM – Monthly – 3 Years



Source: Bloomberg as of 7/20/2023

Headline retail sales slowed during June with receipts up +.2% (+.5% est./+.5% May), the smallest monthly advance in three months, as higher borrowing costs and elevated prices continue to weigh on consumption, particularly for lower income households. In total, 7 of the 13 categories posted gains last month, led by higher receipts for non-store retailers (+1.9%), furniture (+1.4%), electronics (+1.1%), clothing (+.6%), motor vehicles/parts (+.3%), eating/drinking outlets (+.1%), which were partially offset by declines in department stores (-2.4%), gasoline stations (-1.4%), building materials (-1.2%) and food/beverage (-.7%). Additionally, control-group sales, which exclude autos, building-material stores, food services, gasoline stations and feed directly into GDP calculations, rose +.6% in June and were up a modest 2.1% on an annualized basis during the second quarter, a meaningful pullback from the 5.1% advance during the first quarter (+2.0% Q4 2022). While labor market strength and excess liquidity via pandemic stimulus have propelled consumer spending post the darkest days of COVID-19, surging credit card balances and lower savings rates have increased the risks of a more pronounced slowdown in consumption in the months to come, particularly given the likelihood of 'higher for longer' interest rates and the cumulative effects FOMC monetary policy tightening yet to be fully realized. All in all, a weak report that revealed clear signs of deceleration in retail spending, with headline growth (not adjusted for inflation) unchanged on a three-month, annualized basis.

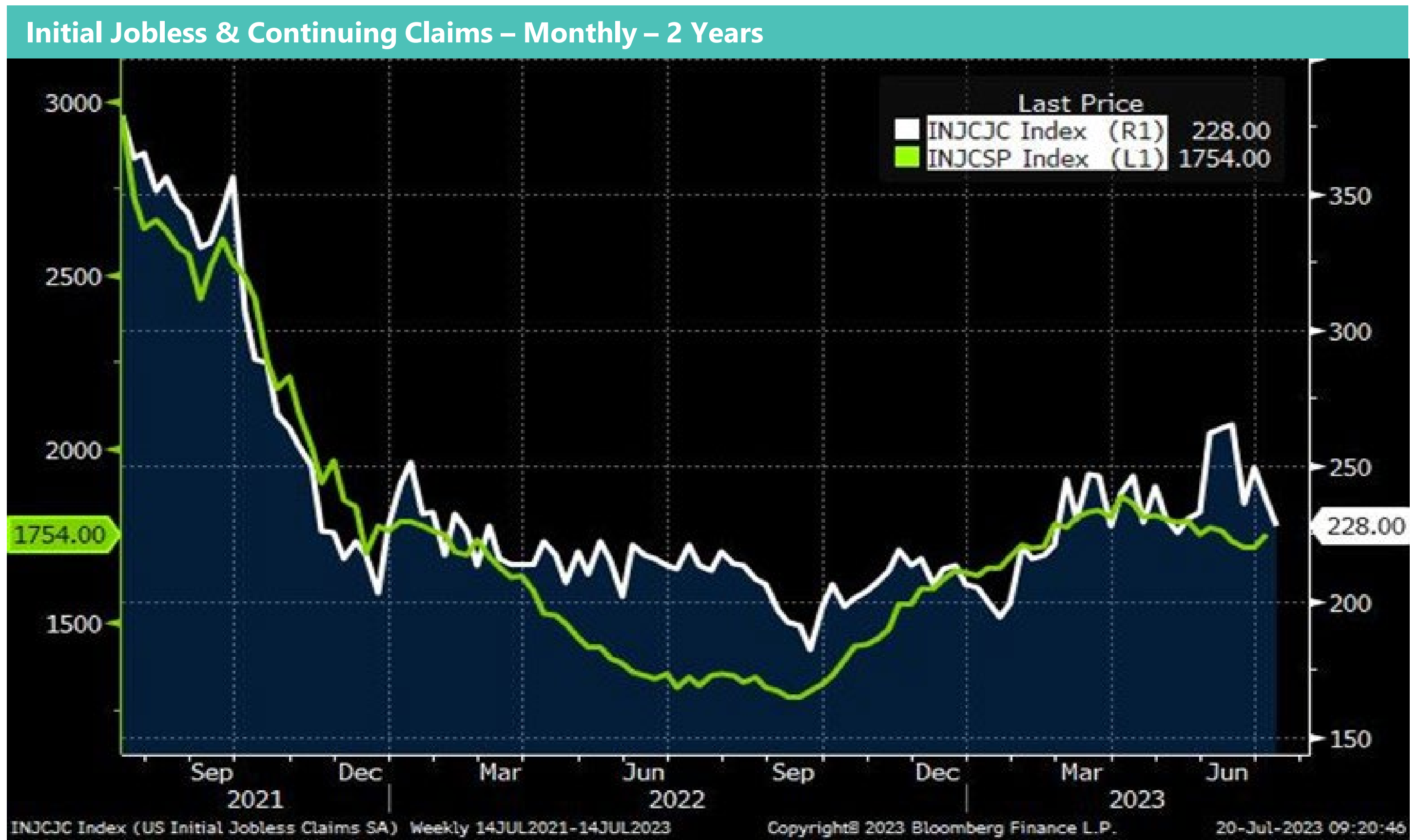
U.S. Existing Home Sales (Annualized) & Median Home Sales Price – Monthly – 3 Years



Source: Bloomberg as of 7/20/2023

Sales of existing homes during June came in fractionally lower than expected to an annualized rate of 4.16 million homes (4.20 est.), extending the resilience from this January's pandemic era low (4.0 million/lowest since 2010), but well under pre-pandemic averages given higher mortgage rates, low supply and still-steamy prices. On the supply front, there were 1.08 million previously owned homes for sale last month (970k Mar.), extending a reversal of the upward trend for much of last year and nearly 14% lower than June 2022 inventory levels (1.25 million), the lowest inventory level for any June on record. Notwithstanding last year's increase in supply from January 2022's cycle low (850,000), housing stocks are historically low (1.92 million peak in 2019) as higher mortgage rates and elevated prices have discouraged mobility. The magnitude of this tighter supply is also apparent in the months of supply and days on the market metrics for June, which came in at 3.1 months (record low 1.8 months) and 18 days (record low 14 days) respectively, both very low by historical standards. As a result, home prices have maintained nearly all of the outsized pandemic era gains with median selling prices coming in at $410,200 last month ($396,400 May), just under 1% lower than last June's all-time high of $413,800, with data showing that low supply is leading to many homes receiving multiple offers, with nearly 35% sold above asking price. Looking at the text of the report, the survey's Chief Economist stated that "There are simply not enough homes for sale," and that "The market can easily absorb a doubling of inventory." Additionally, while steamy home prices and higher mortgage rates have dampened affordability, another negative effect has been the run up in national median rents, which came in at $2,029 during June, up $34 from May (+1.7%) and off a mere $24 (-1.2%) from August 2022's all-time high of $2,053. While steamy prices and higher mortgage rates will likely soften home sales further, we expect demand for housing to remain strong and prices to remain elevated in the near term given historically low inventories and higher likelihood of mortgage rate relief later this year as the cumulative effects FOMC monetary policy full make their way through the economy.

Initial Jobless & Continuing Claims – Monthly – 2 Years



Source: Bloomberg as of 7/20/2023

Initial unemployment claims eased during the week ended July 15th to 228,000 (240k est./237k last), the lowest level in two months and reflective of durable strength in demand for labor despite the uptrend in layoff announcements, accelerating WARN notices and cooling demand for temporary workers. Additionally, the four-week moving average of initial claims, which smooths out outsized observations in the data, edged lower to 237,500, reversing June's melt up, but still well in excess of pre-pandemic averages observed during 2019. Notwithstanding this month's improvement, some signs of labor market cooling appear to be forming with continuing unemployment claims, which came in at 1.754 million (1.645 million on Dec 30th) and include people who have already received unemployment benefits for a week, just shy of this year's highs but still near pre-pandemic averages as employers stretch to fill nearly 10 million open positions forecasted by the latest JOLTS survey. All in all, another moderation in claims that bucks the uptick in layoff announcements and moderation in non-farm payrolls, indicative of still resilient demand for workers and tight labor markets.

The Week Ahead

The data calendar picks up over the coming week, headlined by the FOMC Rate Decision, GDP (2nd Quarter Advance) and Consumer Confidence. Looking ahead, markets remain focused on inflation, employment data and further signs of cooling economic activity. On the new issue front, ABS volumes remained robust this week with ten deals totaling $8.5 billion priced through the 19th and $164.4 billion year to date ($174.8 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance returned in earnest with $29.8 billion priced through the 19th and $754.8 billion year to date ($822.6 billion over same period last year; $1.26 trillion for 2022). While new issue supply has slowed this year given FOMC rate hikes and elevated volatility, market conditions have normalized post first quarter bank failures and the new deal landscape remains favorable for a wider array of ABS and corporate issuers as investor demand remains strong.

Friday 7/21

Bloomberg U.S. Economic Survey (July)

Monday 7/24

S&P U.S. Manufacturing & Services PMI

Tuesday 7/25

Consumer Confidence; CoreLogic CS HPI

Wednesday 7/26

FOMC Rate Decision; New Home Sales

Thursday 7/27

GDP (2nd Quarter/Advance); Durable Goods Orders; Weekly Jobless Claims

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.

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