Fixed Income Market Insights

February 16, 2023

Key takeaways

Bond yields were sharply higher this week, with GT2s up 14 basis points and GT10s higher by 18 basis points and 2s/10s less inverted by 4 basis points (-78), as rebounding inflation and retail sales data fueled concerns that the FOMC would have to raise rates higher and for longer. On the data front, the University of Michigan Consumer Sentiment Index again came in stronger than expected to 66.4 in February, the highest level since January 2022, as a surging stock market and a five-decade low in unemployment bolstered consumer optimism. Headline CPI rebounded in January, rising +.5%, the largest gain since October, and were up 6.4% during the last year, as persistent strength in food, shelter and other core services was accompanied by a rebound in core goods prices and the first jump in energy in three months. Headline retail sales rebounded from last quarter's soft patch and came in much stronger than expected during January with receipts up 3%, the largest monthly advance in two years, driven by broad-based strength across the goods and services sector as robust labor markets and solid wage gains propelled consumer spending to start the new year. Headline PPI came in much stronger than expected during January with prices up +.7%, the largest monthly game since June 2022, driven by rebounding goods prices (energy) and still brisk services gains.

We suggest

We continue to prefer playing rate defense given relatively low market rates, accelerating 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.

Author

David Petrosinelli, CFA
Managing Director
Senior Trader

InspereX

The Response Rate Debate

As financial markets digest the latest economic data pointing to resilient consumer spending, durable labor market strength and chronically high inflation, a disturbing trend of lower survey participation rates for key government statistical releases has evolved over the past several years, one that threatens to undermine the integrity of survey data and potentially roil financial markets if it persists. Indeed, the implications could be far-reaching as lower response rates for high-value data like payrolls and employment, job openings and employment cost indices have the potential to skew the very data relied upon by policymakers and private sector executives to set monetary and fiscal policies and calibrate staffing levels across wide swaths of the economy. For example, the Current Employment Statistics (CES) survey, which produces detailed industry estimates of nonfarm employment, hours, and earnings of workers on payrolls, has seen response rates by employers fall from more than 60% during 2012 to under 45% as of the fourth quarter of last year.

Market Snapshot

	This week 2/16/23	Last week 2/9/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	4.88%	4.86%	2	0.41%	2.31%
SOFR	4.55%	4.55%	0	0.00%	5.81%
2-year US Treasury	4.64%	4.50%	14	3.11%	4.74%
5-year US Treasury	4.07%	3.87%	20	5.17%	1.50%
10-yr US Treasury	3.86%	3.68%	18	4.89%	-0.52%
2s-10s UST Spread	-78.00	-82.00	4.00	-4.88%	41.82%
DJIA	33,697	33,721	-24.00	-0.07%	1.66%
S&P 500	4,090	4,097	-7.00	-0.17%	6.51%
Spot Gold	1,852	1,874	-22.00	-1.17%	1.42%
WTI (Oil) Current Contract	78.49	77.75	0.74	0.95%	-2.21%
1-year Brokered CD	4.85%	4.75%	10	2.11%	5.43%
5-year Brokered CD	4.00%	3.85%	15	3.90%	0.00%
5-year Bullet US Agency	4.17%	3.94%	23	5.84%	2.21%
5-year/NC1yr Callable US Agcy.	5.60%	5.35%	25	4.67%	3.70%
CDX IG Spread Index	73.17	71.15	2.02	2.84%	-10.79%
CDX High Yield Index Spread	101.98	102.72	-0.74	-0.72%	1.35%
15-yr UMBS	4.73%	4.44%	29	6.53%	1.50%
30-yr UMBS	5.37%	5.11%	26	5.09%	0.75%

Source: Bloomberg data as of 5pm ET 2/16/2023 and 3pm ET 2/9/2023

A particularly egregious case is the previously forgettable JOLTS job opening survey that gained prominence during the pandemic given business closures and employee furloughs, which saw response rates plummet from over 70% in 2012 to nearly 30% by the end of 2022. As regular readers of this publication will recall, the Federal Reserve has frequently cited sky-high JOLTS job vacancies as a key measure of chronic labor market tightness and driver of elevated wage gains, data that has contributed to the FOMC's aggressive monetary policy tightening moves over the past year and, perhaps more importantly, supportive of the Committee's current stance that short-term interest rates will need to stay higher for longer. Regarding causation, many market participants cite the invasive nature of survey questions (job status, income, sales revenues), lower trust in government data compilers and time-consuming nature of the surveys as key determinates of falling response rates. For the moment, recent economic data confirms what both consumers and businesses see in real-time, namely higher prices, elevated wages and employee recruiting and retention difficulties. This, however, could change if the current trend of withering participation continues, with the worse cases of eroding confidence in the data and potential policy errors potentially hanging in the balance. More to follow!

Still quiet on the fiscal front during the second full week of February with only the Senate in full session. Among multiple legislative priorities, debate over the debt ceiling will be front and center in the weeks to come. Stay tuned!

U of Michigan Consumer Sentiment – Monthly – 3 Years

Source: Bloomberg as of 2/16/2023

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

Source: Bloomberg as of 2/16/2023

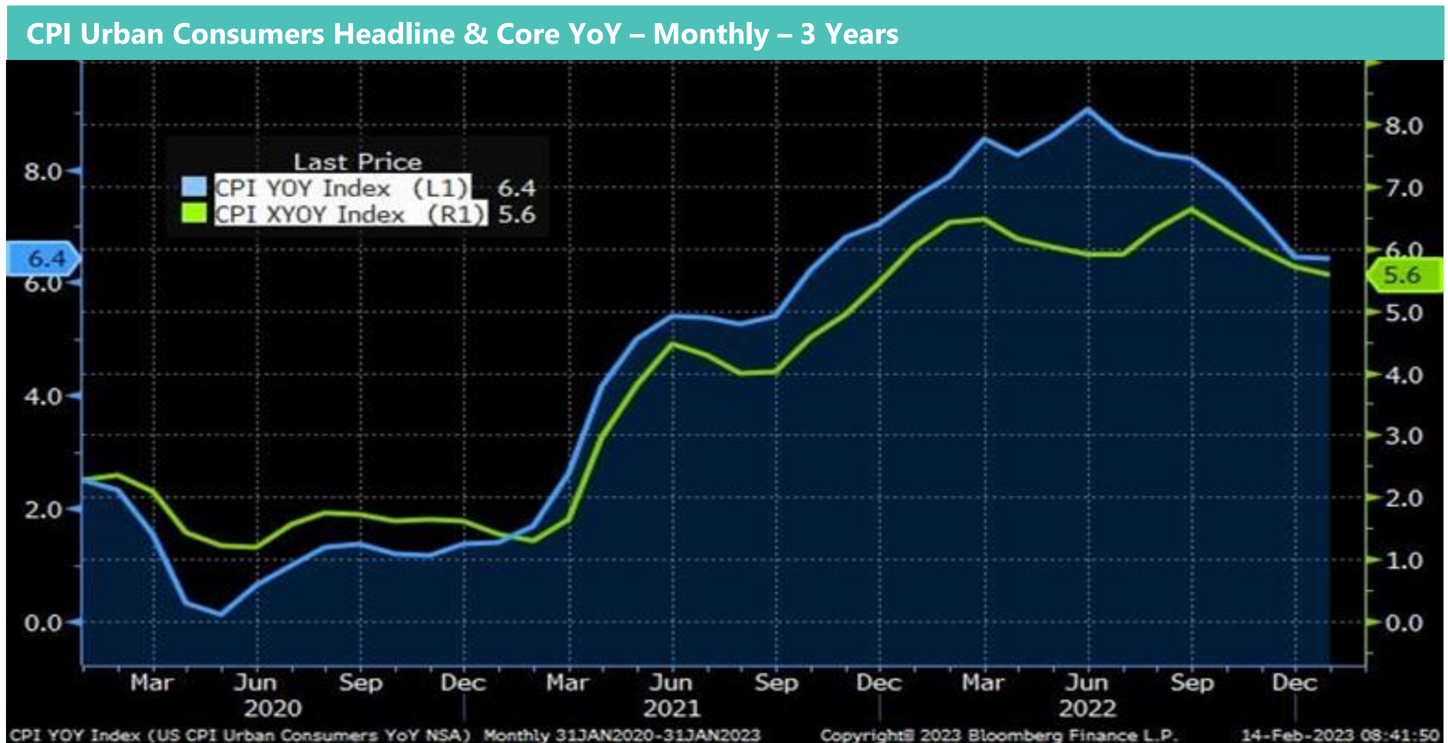
The University of Michigan Consumer Sentiment Index again came in stronger than expected to 66.4 in February (65.0 est.; 64.9 Jan.), the highest level since January 2022, as a surging stock market and a five-decade low in unemployment have bolstered consumer optimism above last June's all-time low of 50. Notwithstanding the improvement, over 38% of consumers attributed their negative views regarding personal finances to inflation (42% in Sept.), shy of the all-time high during the 2008 financial crisis (49%) but still historically elevated, and a mere 15% expect their incomes to rise more than inflation, a slight improvement from June's 13% cycle low. Additionally, just 28% of consumers expect good economic times over the next year (versus July 2022 cycle low: 13%) as higher interest rates, broad-based inflation and geopolitical risks continue to dampen consumer attitudes about their near-term financial health. A deeper dive into the survey revealed that components of headline sentiment were mixed, with current conditions higher to 72.6 (68.4 Jan.; 74.2 Dec 2021) and expectations off fractionally to 62.3 (62.7 Jan.; 68.3 Dec 2021), both at their highest levels in over a year, but still historically low. On the price front, near-term inflationary expectations rose for the first time in four months to 4.2%, the second lowest level since April 2021, due largely to a recent jump in energy prices, but remain historically elevated over the near (1yr. 4.2%; cycle high 5.4% March 2022) and longer terms (5+ yrs. 2.9%; cycle high 3.1% in June), well above of the FOMC's target of 2%. Looking at the text of the report, the director of the survey stated that "Overall, high prices continue to weigh on consumers despite the recent moderation in inflation, and sentiment remains more than 22% below its historical average since 1978," and that "Combined with concerns over rising unemployment on the horizon, consumers are poised to exercise greater caution with their spending in the months ahead." All in all, while the recent improvement in headline sentiment is encouraging, elevated prices and higher interest rates continue to dampen consumer optimism, conditions likely to persist in the near term and threaten the resilience of consumer spending seen over the past year, particularly when the cumulative effects of FOMC tightening take full effect.

NFIB Small Business Optimism – Monthly – 2 Years

Source: Bloomberg as of 2/16/2023

The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, ticked up to 90.3 in January (91 est.; 89.8 Dec.), close to the lowest levels since 2013, as high inflation, worker shortages and softening business expectations continue to weigh on sentiment. On the inflation front, 26% of respondents reported that inflation was their most significant business problem, shy of last July's cycle high 37% print (highest since 1979) and the lowest level in nearly a year, but still historically high and indicative of the durability of inflationary pressures afflicting small businesses. Additionally, a near record high of 45% of small businesses said they had unfilled job openings (51% record high; May 2022) and 46% stated they have increased compensation over the last three months to attract new workers as tight labor markets continue to add to wage pressures. As with other elevated input costs, higher labor expenses are being passed along to customers with 42% of the small businesses surveyed stating that they anticipate higher selling prices, a backup from last March's all time high of 66% (1974 inception) and the lowest share since May 2021, but still historically elevated. The combination of elevated inflation, chronic labor shortages and lingering supply chain challenges have softened optimism with businesses expecting better economic conditions over the next six months advanced to -45% last month (versus -38% pandemic low), an improvement versus June's -61%, but still historically weak. Indeed, the survey stated that "While inflation is starting to ease for small businesses, owners remain cynical about future business conditions," and "Owners have a negative outlook on the small business economy but continue to try to fill open positions and return to a full staff to improve productivity." All in all, continued weakness in small business optimism aligns with consumer sentiment data and highlights growing economic pessimism, withering confidence in policymakers and chronically elevated wage inflation expectations.

CPI Urban Consumers Headline & Core YoY – Monthly – 3 Years



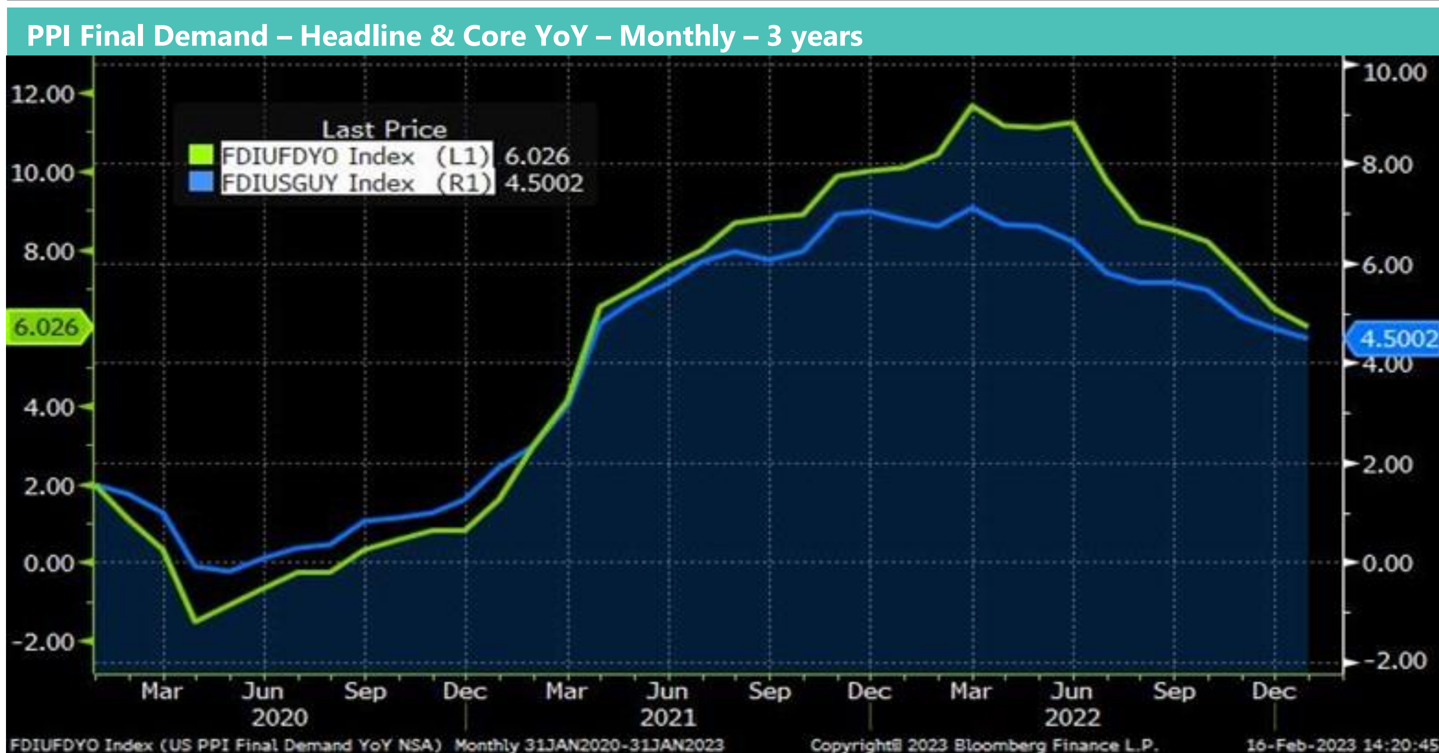
Source: Bloomberg as of 2/16/2023

Headline CPI rebounded in January, rising +.5% (+.5% est.), the largest gain since October, and were up 6.4% during the last year (+6.2% est.), as persistent strength in food, shelter and other core services was accompanied by a rebound in core goods prices and the first jump in energy in three months. Core CPI (less food and energy) was up .4% (+.4% est.) and 5.6% (+5.5% est.) on the same basis, shy of September's year-over-year cycle high (6.6%; highest since 1982), but still historically elevated and indicative of the durable and broad-based nature of inflationary pressures across both services and selected goods. Indeed, the breadth of price gains remains troublesome, with nearly 61% of index components up by more than 5% on an annualized basis, down from nearly 44% in December, but more than double the pre-pandemic run rate. From a contribution standpoint, services continue to run hot and again drove last month's advance in prices, up .6% (worth +.34% Headline) in January and 7.6% from a year ago, another new cycle high and the largest annual advance in more than 30 years (shelter component of services +.7%/worth .24% Headline). Additionally, energy prices higher for the first time since October, up 2% in January (worth +.14% Headline), while used cars and medical care fell -1.9% and -.4% respectively (worth just under -.10% Headline). Drilling down into headline CPI components, prices were mostly higher, with the largest gains seen in gasoline (+2.4%), housing (+.8%), apparel (+.8%), food/beverage (+.5%), and recreation (+.5%), which were partially offset by declines in airline fares (-2.1%), used cars (-1.9%), and medical care (-.4%) as discretionary goods spending moderates and pivots towards services. Additionally, real estate prices remain high, with values at or close to record levels in many parts of the country, driving another large increase in owner's equivalent rent during January (+.7%; +7.8% year over year), another record high, annual advance. Given that inflation expectations are closely tied to food, energy and shelter costs, the chronic nature of elevated prices across these aggregates has unmoored near-term, consumer expectations away from the FOMC's 2% target, a key consideration for policymakers and one likely to extend the FOMC's tightening cycle in the months to come. All in all, while last month's reversal of goods disinflation was widely expected, the breadth of inflationary pressures remains broad-based, particularly in food, shelter and other services, all but cementing a 25-basis point rate hike at the March 14th FOMC meeting.

Source: Bloomberg as of 2/16/2023

Headline retail sales rebounded from last quarter's soft patch and came in much stronger than expected during January with receipts up 3% (+2.0% est./-1.1% Dec.), the largest monthly advance in two years, driven by broad-based strength across the goods and services sector as robust labor markets and solid wage gains propelled consumer spending to start the new year. In total, all 13 categories posted gains last month, led by higher receipts for department stores (+17.5%), eating/drinking outlets (+7.2%), motor vehicles/parts (+5.9%), furniture (+4.4%), electronics (+3.5%), general merchandise (+3.2%), clothing (+2.5%), health/personal care (+1.9%) and non-store retailers (+1.3%). Additionally, control-group sales, which exclude autos, building-material stores and gasoline stations and feed directly into GDP calculations, surged +1.7% in January and were up 1.8% on an annualized basis over the last three months, a meaningful pullback from the 7.4% advance during the third quarter. While labor market strength and excess liquidity via pandemic stimulus have propelled consumer spending, with retail sales up 6.4% over the last twelve months, surging credit card balances and near-record low savings rates have increased the risks of a slowdown in consumption in the months to come, particularly given the likelihood of more rate hikes and the cumulative effects of last year's monetary policy tightening. All in all, a solid report that offset last quarters weakness and all but cements more rate hikes in during the first half of this year.

PPI Final Demand – Headline & Core YoY – Monthly – 3 years



Source: Bloomberg as of 2/16/2023

Headline PPI came in much stronger than expected during January with prices up +.7% (+.4% est.; +6.0% last 12 months), the largest monthly game since June 2022, driven by rebounding goods prices (energy) and still brisk services gains. In the aggregate, both goods and services prices were up, with goods surging +1.2% (+7.5% year over year/-1.4% Dec.), the largest monthly gain since last June, and services higher by +.4% (+5.0% year over year/+.4% Dec.) as upward revisions to December's headline read (-.2% vs. -.5%) and last month's reacceleration underscored the broad-based durability of inflationary pressures and dashed hopes for more disinflation in the near term. Core PPI (less food, energy and trade) also came in hotter than expected with prices up +.6% last month (+.2 est.; +4.5% last 12 months), well off March's 9.7% cycle high, but still indicative of elevated inflationary pressures away from food and energy. As with much of the past two years, the durability of these cost increases has enabled businesses to raise prices, which have been passed along to consumers and served to keep inflation expectations elevated above the FOMC's stated target of 2%. As reported in the NFIB Small Business Optimism index this week, more than 42% (all-time high of 66 in March 2022) of small businesses surveyed stated that they raised selling prices last month and a near record 46% of respondents said they raised compensation to attract and retain employees, both likely to add to pricing pressures in the months to come. That said, loosening supply chain bottlenecks and slower goods demand have dampened the cost of processed goods for intermediate demand, reflecting prices earlier in the production pipeline, which rose +1.0% in January (+3.8% year over year), the first advance since last June, driven by a 10.9% jump in diesel fuel, which accounted for over 50% of last month's increase. , All in all, a much stronger report (including December revisions) that underscores the broad-based nature of inflationary pressures and dashes hope for goods disinflation follow through in the near term, unwelcome news for the FOMC that increases the likelihood of more rate hikes at the meetings to come and supports the notion of a higher Federal Funds rate for longer.

The Week Ahead

The data calendar slows over the next week, headlined by FOMC Meeting Minutes (Feb 1st), Existing Home Sales and S&P Global Manufacturing and Services. Looking ahead, markets remain focused on inflation, employment data and further signs of slower economic activity. On the new issue front, ABS volumes slowed during the second full week of February with six deals totaling $3.97 billion priced through the 15th and $33.5 billion year to date ($37.8 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance soared with $48.5 billion in deals priced through the 15th and $236.2 billion year to date ($199.9 billion over same period last year; $1.26 trillion for 2022). While new issue supply slowed during 2022 given FOMC rate hikes and elevated volatility, market conditions have improved significantly since the start of 2023 and the new deal landscape is again attractive for a wider breadth of ABS and corporate issuers as investor demand remains robust.

Friday 2/17
Leading Index; Import/Export Prices

Monday 2/20
President's Day – Market Closed

Tuesday 2/21
Existing Home Sales; S&P Global Manufacturing/Services

Wednesday 2/22
FOMC Meeting Minutes [Feb 1st]; MBA Mortgage Applications

Thursday 2/23
Weekly Jobless Claims

About the author

David Petrosinelli, CFA
Managing Director
Senior Trader

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.

This message was prepared by InspereX LLC as of 2/16/2023 at approximately 5pm ET for informational and educational purposes only. The author of this material is a Managing Director and Senior Trader for InspereX and is not a Research Analyst. Any opinions expressed herein may differ from opinions expressed by other departments of InspereX. The information and data contained herein is subject to change without notice. Additionally, the content of this material was obtained from sources believed to be reliable, but InspereX does not warrant the accuracy or completeness of any information contained herein and provides no assurance that this information is, in fact, accurate. The information contained herein is for illustrative purposes only and may not represent specific securities available at any given time.

InspereX LLC ("InspereX") and its affiliates explicitly disclaim any responsibility for product suitability or suitability determinations related to individual investors. This information should not be regarded by recipients as a substitute for the exercise of their own independent judgment and the information provided herein is not an offer, solicitation, or a recommendation to buy, sell or hold any security or investment strategy. This material should not be considered, construed, or followed as investment advice, an investment recommendation or research material. InspereX does not provide financial planning, legal, or tax advice. Past performance is not indicative of future results.

This material may include discussions of securities or financial products in which InspereX may have positions, long or short, held proprietarily or in trust. InspereX may execute transactions that may not be consistent with any discussion or conclusion contained herein. InspereX may also have received compensation for performing investment banking services or be (or previously been) engaged in soliciting or performing other services for the issuer(s) of the securities discussed herein. Further, InspereX may have received compensation as a manager or co-manager in a public offering for the issuer(s) mentioned herein.

Investing involves the risk of loss. Investments discussed here may not be suitable for all investors. You should not purchase an investment product until you have read the specific offering documentation and understand the specific investment terms and risks of such investment. The information contained herein does not constitute an offer to sell or a solicitation of an offer to buy securities. Investment products described herein may not be offered for sale in any state or jurisdiction in which such an offer, solicitation or sale would be unlawful or prohibited by the specific offering documentation.

All bonds and fixed income products are subject to a number of risks, including the possibility of issuer default, credit risk, market risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities. Lower-quality fixed-income securities generally offer higher yields, but also carry more risk of default or price changes due to potential changes in the credit quality of the issuer. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities and, as a result, they may have a higher probability of default.

©2023 InspereX℠. All rights reserved. Securities offered through InspereX LLC, Member FINRA/SIPC. InspereX and insperex.com are trademarks of InspereX Holdings LLC.