Fixed Income Market Insights

August 3, 2023

Key takeaways

Bond yields were mixed this week, with GT2s down 4 basis points and GT10s higher by 19 basis points respectively and 2s/10s less inverted by 23 basis points (-70), driven by Fitch Rating's downgrade of U.S. government debt, a sharp increase in projected borrowing needs this quarter and continued resilience in the services sector. On the data front, Headline PCE prices came in as expected during June and were up +.2%, as lower food and durable goods prices were offset by advances in energy, housing and other services. The number of available jobs came in as expected during June at 9.6 million, the lowest level since April 2021, but still reflective of durable labor markets tightness driven by chronic worker shortages and robust demand. The ISM Services PMI index came fractionally lower than expected at 52.7 during July, the second highest level since February, as still robust new orders, employment and business activity blunted concerns that durable strength in services may be slipping given the weight of higher prices, elevated interest rates and tighter credit conditions.

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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Changing Fortunes

For just the second time in history, the sovereign debt rating of the United States government was downgraded below AAA, the highest credit rating, and notched one level lower to AA+ by Fitch, matching the move made by Standard and Poors (S&P) in 2011. Citing repeated debt-limit battles, last-minute solutions and rapidly mounting debt burden, the rating agency lamented that eroding confidence in the country's fiscal management and worsening estimates of prospective deficits have increased America's vulnerability to future economic shocks. Specifically, Fitch stated that "the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to 'AA' and 'AAA' rated peers over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions." Regarding the mounting debt burden, Fitch highlighted that the United States is running far in excess of the AAA median for sovereigns of just over 39%, with forecasts revealing even further deterioration over the next few years. Indeed, the federal debt measured as a percentage of GDP has been on the rise for decades but picked up in earnest since the start of the Great Financial Crisis (GFC) in 2008, ballooning from 62.7% at the start of 2009, to a staggering 118.6% by the end of the first quarter of 2023.

Market Snapshot

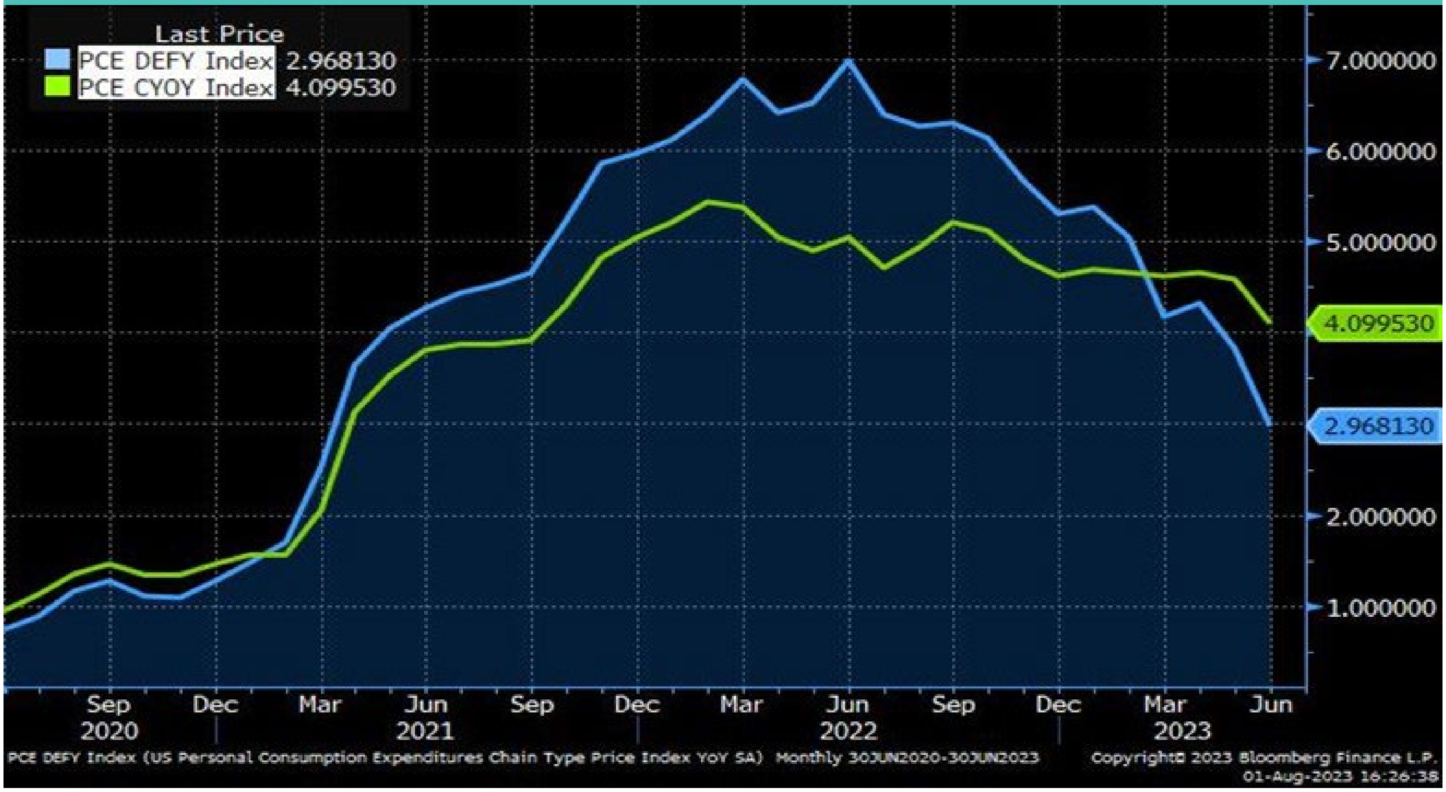
	This week 8/3/23	Last week 7/27/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.63%	5.63%	0	0.00%	18.03%
SOFR	5.30%	5.31%	-1	-0.19%	23.26%
2-year US Treasury	4.89%	4.93%	-4	-0.81%	10.38%
5-year US Treasury	4.29%	4.24%	5	1.18%	6.98%
10-yr US Treasury	4.19%	4.00%	19	4.75%	7.99%
2s-10s UST Spread	-70.00	-93.00	23.00	-24.73%	27.27%
DJIA	35,248	35,283	-35.00	-0.10%	6.34%
S&P 500	4,510	4,537	-27.00	-0.60%	17.45%
Spot Gold	1,970	1,985	-15.00	-0.76%	7.89%
WTI (Oil) Current Contract	81.55	80.09	1.46	1.82%	1.61%
1-year Brokered CD	5.25%	5.30%	-5	-0.94%	14.13%
5-year Brokered CD	4.50%	4.35%	15	3.45%	12.50%
5-year Bullet US Agency	4.40%	4.35%	5	1.15%	7.84%
5-year/NC1yr Callable US Agcy	5.72%	5.75%	-3	-0.52%	5.93%
CDX IG Spread Index	67.09	64.96	2.13	3.28%	-18.20%
CDX High Yield Index Spread	102.74	103.06	-0.32	-0.31%	2.11%
15-yr UMBS	5.44%	5.29%	15	2.84%	16.74%
30-yr UMBS	5.91%	5.74%	17	2.96%	10.88%

Source: Bloomberg data as of 2:30pm ET 8/3/2023 and 5:00pm ET 7/27/2023

Taken together with the rapid rise in market yields since the start of FOMC rate hikes in March 2022, the cost of servicing the nation's burgeoning debt jumped by 25% during the first nine months of the fiscal year, reaching $652 billion, or more than 2% of GDP and to the highest level since 2000. Surely more daunting, estimates from the Congressional Budget Office (CBO) and other researchers have interest costs surpassing defense spending by the late 2020s, and to hit an all-time high as a percentage of GDP of 3.2% by 2030, with this share more than doubling by the early 2050 to a dizzying 6.5%. Notwithstanding this unprecedented deterioration, the initial tendency of many market participants has been to compare this week's AAA downgrade by Fitch to the same move made by Standard and Poors in 2011, where the latter sparked a broad-based selloff in stocks and triggered a 'flight to quality' move that pushed many investors into U.S. Treasury debt as investors sought out the safe-haven status of U.S. dollar-denominated assets. Indeed, economic landscape just prior to the August 2011 by S&P stands in stark contrast versus today- most markets then were in 'risk-off mode,' with interest rates falling, credit spreads widening, and stocks in correction mode as the economy limped out of the fallout from the GFC. That said, today's more sanguine economic environment may not be enough to buffer what will likely be a more challenging growth period as we approach year-end, as higher interest rates, still elevated inflation, depletion of pandemic-era excess savings and mounting credit card debt should slow down today's resilient consumer sector. While we agree with those market participants postulating that Fitch's downgrade will not upend near term demand for U.S. Treasury debt, nor challenge the status of the U.S. dollar as the world's 'reserve currency,' we believe that longer-dated U.S. Treasury debt yields will drift higher in the months to come given the impetus for this week's rating action- Continued debt ceiling squabbles, rapidly expanding budget deficits, surging debt carrying costs and a mounting lack of confidence that policymakers can agree and implement measures to address this fiscal deterioration. Judging by the sell-off in longer-dated U.S. Treasury debt and the large jump in this quarter's borrowing estimates to fund the government reported earlier this week, many investors appear to agree, for now.

All quiet on the fiscal front as Congress remains in summer recess for the balance of August. Away from that, the Biden administration continues to promote plans 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. Given the legal battles regarding the initial Executive Order and its ultimate demise in the Supreme Court, this latest move is likely to face legal challenges in the weeks to come. Stay tuned!

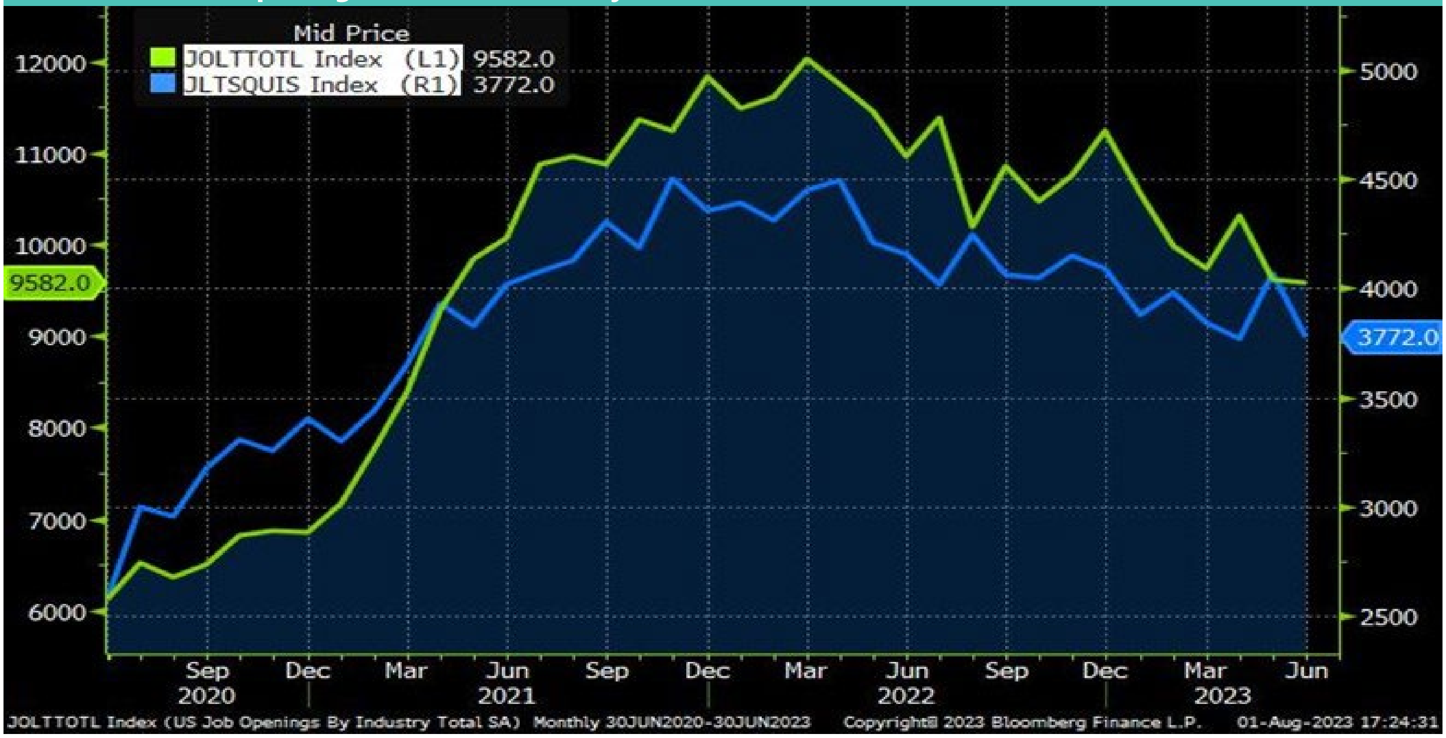
PCE Deflator YoY% & CORE PCE Deflator YoY% – Monthly – 3 years



Source: Bloomberg as of 8/3/2023

Headline PCE prices came in as expected during June and were up +.2% (+.2% est./+.1% May), as lower food and durable goods prices were offset by advances in energy, housing and other services. Indeed, June's continued moderation has mitigated concerns that April's reacceleration in prices would be sustained, with goods prices down -.1% and services higher by +.3% during the month, and -.6% and +4.9% on a year-over-year basis, as PCE Supercore (Services ex. housing and energy) advanced +.2% (+4.1% YOY), the matching the slowest monthly advance since last July. In the aggregate, headline PCE prices were up 3.0% during the past year, the smallest annual advance since March 2021, but still a stubbornly slow descent from last June's 7% cycle high, which was the largest annual increase since December 1981. This closely followed inflation gauge, known as the 'PCE Deflator,' has soared since the first quarter of 2021 as higher food and energy prices and elevated rents and other services costs have pushed prices progressively higher. The Core PCE Deflator (excluding food and energy) slowed during June, up +.2% for the month (+.3% May) and higher by 4.1% over the past year, a small step-down versus last December's 4.6% annual increase and reflective that broad-based inflation remains stubbornly high and durable. Indeed, Core PCE price index advances have proven sticky since the end of last year, running 3.8%, 4.3% and 4.7% (Jun.-Apr.) on a three-month annualized basis, data supportive of the narrative by FOMC policymakers that more work needs to be done to dampen price gains to a sustainable path towards the FOMC's 2% target rate. All in all, services inflation remains resilient and continues to offset progress on the goods front, a condition driving the current, 'higher for longer' interest rate posture by the FOMC.

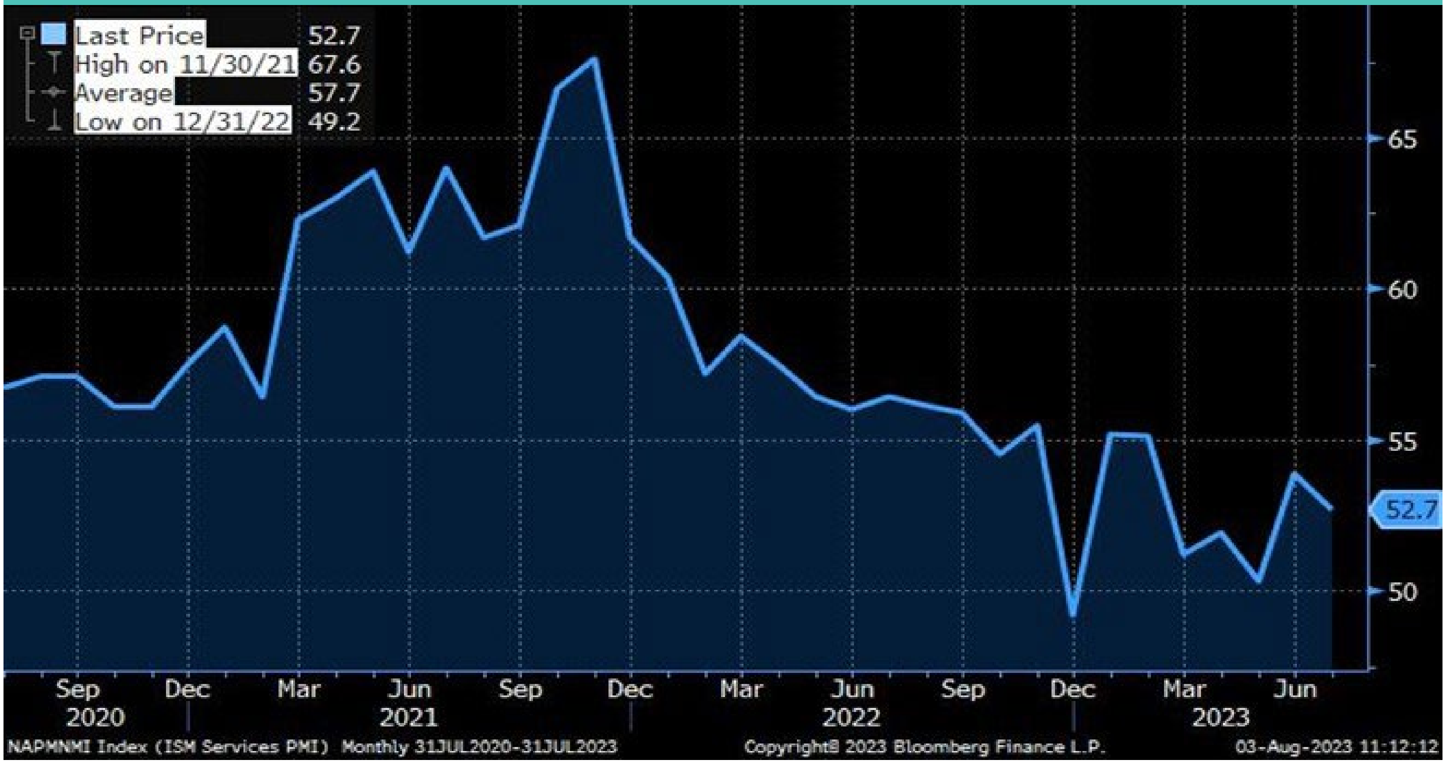
JOLTS U.S. Job Openings & Quits – Monthly – 3 Years



Source: Bloomberg as of 8/3/2023

The number of available jobs came in as expected during June at 9.6 million (9.6 est./9.6 May), the lowest level since April 2021, but still reflective of durable labor markets tightness driven by chronic worker shortages and robust demand. By industry, job openings decreased in leisure & hospitality (-81,000), transportation (-78,000), retail trade (-36,000) and manufacturing (-26,000), with increases in healthcare (+136,000), state/local government (+32,000) and wholesale trade (+17,000) as employers continue to report difficulty hiring and retaining enough workers to keep up with demand for services and selected goods. Indeed, the labor participation rate remains roughly 1% lower than its 2019, pre-pandemic peak as higher retirement rates, skill mismatches and mixed participation have slowed employer efforts to add new employees. Additionally, the quits rate, which measures voluntary job separations per month as a percent of total employment, ticked down to 2.4% (3.8 million jobs), shy of last March's all-time high (3%) but still elevated, as higher compensation, new employee incentives and the sheer magnitude of job vacancies continue to drive elevated employee turnover. Additional evidence of job market tightness can be seen in the layoffs and discharge rate, which was unchanged at 1.0% during June (record low .9% December 2021) and the 1.6x ratio of jobs available to each unemployed worker (cycle high 1.99x March 2022; 1.15 Dec. 2019), a pull-back from January (1.9x), but still reflective of tight labor markets. To be sure, durable labor shortages have forced employers to raise compensation to recruit and retain workers, with little relief expected in the near term. While labor market imbalances should improve given FOMC rate hikes and slower consumption, we believe the JOLTS data will remain high in the months to come as the pandemic and elevated, state-level direct economic assistance triggered structural changes to the labor force that have slowed the return to pre-pandemic levels of participation. While demand for labor appears to be cooling given the cumulative decline of over 1.6 million job vacancies during the first half of this year, open positions and the job openings rate (5.8% Jun.; 7.4% peak Mar. 2022) remain historically elevated and are likely to promote robust wage growth in the near term as labor supply and demand imbalances endure.

ISM Services PMI – Monthly – 3 years



Source: Bloomberg as of 8/3/2023

The ISM Services PMI index came fractionally lower than expected at 52.7 during July (est. 53.1/53.9 Jun.), the second highest level since February, as still robust new orders, employment and business activity blunted concerns that durable strength in services may be slipping given the weight of higher prices, elevated interest rates and tighter credit conditions. A deeper dive into the survey revealed relatively broad-based gains across industries (14 of 18 reporting growth), with new orders slightly lower by .5 points (55.0/55.0 Jun.), employment softer by 2 points (50.7/53.1 Jun.), and delivery times little changed (48.1/47.6 Jun.), with recent delivery times running at the fastest pace since 2009 and reflective of vastly improved supply chain logistics. Additionally, the data also revealed that prices paid by service providers rose slightly for the first time in three months during July (56.8/68.1 Dec.), the third lowest level since March 2020 and more in-line with historical averages. Looking at the text of the report, the Chairman of the survey committee stated that “There has been a slight pullback in the rate of growth for the services sector. This is due mostly to the decrease in the rate of growth for business activity, new orders and employment, as well as ongoing faster delivery times. ,” and that “The majority of respondents are cautiously optimistic about business conditions and the overall economy.”   All in all, another strong report suggesting that demand for services remains in expansionary territory despite the effects of FOMC rate hikes, chronically high inflation and tightening credit conditions.

The Week Ahead

The data calendar remains full over the coming week, headlined by the Non-Farm Payrolls, CPI, NFIB Small Business Optimism and Weekly Jobless Claims. Looking ahead, markets remain focused on inflation, employment data and signs of slowing economic activity. On the new issue front, ABS volumes picked up during the first week of August with eight deals totaling $5.4 billion priced through the 3rd and $173.6 billion year to date ($185.4 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance ramped up with $32.4 billion priced through the 3rd and $802.2 billion year to date ($889.7 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 8/4
Non-Farm Payrolls

Monday 8/7
Consumer Credit

Tuesday 8/8
NFIB Small Business Optimism; Trade Balance

Wednesday 8/9
MBA Mortgage Applications

Thursday 8/10
CPI; 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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