Fixed Income Market Insights

July 27, 2023

Key takeaways

Bond yields were again higher this week, with GT2s up 9 basis points and GT10s higher by 14 basis points respectively and 2s/10s less inverted by 5 basis points (-93), driven by stronger than expected 2nd Quarter GDP and increased optimism regarding the prospects for a soft economic landing. On the data front, consumer confidence was again stronger during July and came in at 117.0, the highest level since July 2021, led by continued strength in labor market expectations and easing pessimism regarding near term business prospects. The S&P CoreLogic Case-Shiller 20-city home price index rose +.99% in May, the fourth consecutive monthly gain and largest since May 2022, as the combination of low affordability and higher mortgage rates has been offset by historically light inventories and resilient demand. Real GDP was up for the fourth consecutive quarter and grew at a faster than expected 2.4% annualized rate during the second quarter, as a rebound in business fixed investment and durable strength in consumer spending growth were partially offset by another decline in residential investment. As expected, the FOMC raised the Federal Funds rate to 5.50% by a unanimous vote of 11-0, the eleventh hike in seventeen months and the highest level since January 2001.

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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Credit Cracking?

While economic activity continues to surprise to the upside and confound those calling for one of the most anticipated recessions in history, credit conditions for many Americans appear to be deteriorating given the weight of elevated inflation, higher interest rates and depleted savings previously supercharged by pandemic-era stimulus. Add in the resumption of federal student loan payments for nearly 27 million borrowers in October, and the credit outlook, particularly for those with lower income, is likely to deteriorate further as we get closer to 2024. Indeed, a recent survey by Bloomberg Economics revealed that the average household in the bottom 40% of income earners has roughly $1,200 less liquid assets versus pre-pandemic levels when adjusting for inflation. Taken together with higher financing rates, this liquidity drain has started to bleed through in auto loan delinquencies, particularly for Subprime borrowers, where 2023 year-to-date high in 60 day+ late payments in May set a new, all-time record, surpassing the previous high-water mark of 5.96% in October 1996 according to Fitch Ratings. Perhaps more troubling, this credit deterioration has also afflicted prime auto loans, where delinquencies edged up to the highest level in 12 years during May, according to S&P Global Ratings.

Market Snapshot

	This week 7/27/23	Last week 7/20/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.63%	5.59%	4	0.72%	18.03%
SOFR	5.31%	5.05%	26	5.15%	23.49%
2-year US Treasury	4.93%	4.84%	9	1.86%	11.29%
5-year US Treasury	4.24%	4.10%	14	3.41%	5.74%
10-yr US Treasury	4.00%	3.86%	14	3.63%	3.09%
2s-10s UST Spread	-93.00	-98.00	5.00	-5.10%	69.09%
DJIA	35,283	35,331	-48.00	-0.14%	6.44%
S&P 500	4,537	4,547	-10.00	-0.22%	18.15%
Spot Gold	1,985	2,010	-25.00	-1.24%	8.71%
WTI (Oil) Current Contract	80.09	76.00	4.09	5.38%	-0.21%
1-year Brokered CD	5.30%	5.35%	-5	-0.93%	15.22%
5-year Brokered CD	4.35%	4.60%	-25	-5.43%	8.75%
5-year Bullet US Agency	4.35%	4.18%	17	4.07%	6.62%
5-year/NC1yr Callable US Agcy.	5.75%	5.65%	10	1.77%	6.48%
CDX IG Spread Index	64.96	66.26	-1.30	-1.96%	-20.80%
CDX High Yield Index Spread	103.06	103.05	0.01	0.01%	2.42%
15-yr UMBS	5.29%	5.09%	20	3.93%	13.52%
30-yr UMBS	5.74%	5.59%	15	2.68%	7.69%

Source: Bloomberg data as of 5:00pm ET 7/27/2023 and 1:45pm ET 7/20/2023

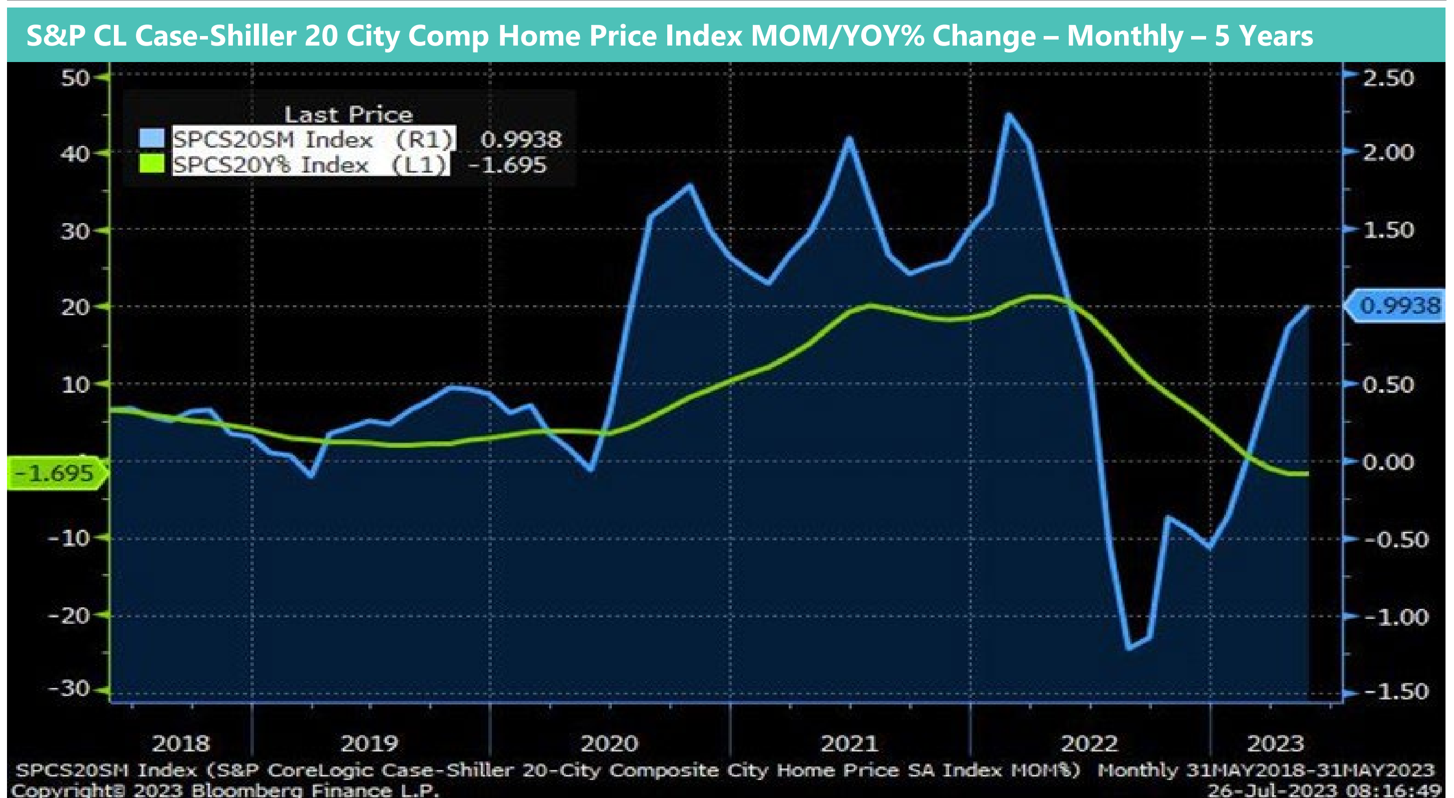
Additionally, rejection rates for credit cards and mortgages both rose in June from the first quarter according to a recent survey by the Federal Reserve Bank of New York, more evidence of tighter credit conditions, particularly for those with less than spotless credit histories, data that portend further deterioration in payment performance and worsening access to financing. With credit card and auto loan financing rates at all-time and 16-year highs respectively, a growing number of market participants are calling for more retrenchment by already financially tapped consumers, which would further slow consumer spending and hasten the most anticipated recession in history given that consumer outlays account for roughly two-thirds of all economic activity in the United States. While recent economic activity data have generally come in stronger than expected during the second quarter, we believe that the burden of higher interest rates, reduced access to credit, the resumption of Federal student loan payments and still-elevated inflation will likely interrupt what has been a surprisingly resilient economy that has taken 525 basis points in FOMC tightening in stride, for now.

Still quiet on the fiscal front after last month's debt ceiling deal. 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). Shortly after the ruling, the Biden administration announced 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 wrangling regarding the initial Executive Order, this latest move is likely to face legal challenges in the weeks to come. Stay tuned!

Consumer Confidence & Expectations – Monthly – 3 Years

Source: Bloomberg as of 7/27/2023

Consumer confidence was again stronger during July and came in at 117.0 (112 est./110.1 Jun.), the highest level since July 2021, led by continued strength in labor market expectations and easing pessimism regarding near term business prospects. Leading this month's advance was the expectations component, a measure of consumers' six-month outlook, which surged to 88.3 (80 Jun./83.4 Dec.), the highest level since January 2022 and above the recessionary reading (80) for the first time since last December, as fewer respondents expect business conditions to worsen (14.0% vs. 17.7% Jun.) and a lower share see fewer jobs being added (14.8% vs. 16.7% Jun.). Adding to this month's advance was the current conditions component, which rose to 160.0 (155.3 Jun./147.4 Dec.), driven by more respondents stating that jobs are plentiful (46.9% vs. 45.4% Jun.) and fewer stating that jobs were hard to get (9.7% vs. 12.6% Jun.), one of the lowest levels on record. Looking at the text of the report, the chief economist of the survey stated that "Headline confidence appears to have broken out of the sideways trend that prevailed for much of the last year. Greater confidence was evident across all age groups, and among both consumers earning incomes less than $50,000 and those making more than $100,000," and that "The proportion of consumers saying recession is 'somewhat' or 'very likely' to occur ticked up in July, contrary to the Expectations Index spiking this month above the threshold of 80. Still, recession expectations remained below their recent peak, suggesting fears of a recession have eased relative to earlier this year." On the jobs front, labor market conditions appear to have tightened again this month, fully reversing May's outsized loosening as July's Labor Index metric, which measures the labor differential of jobs plentiful less hard to get, came in at 37.2% (32.8% Jun./36.5% Mar.). While the second consecutive, stronger than expected report led by more optimistic expectations for the labor market and economy, we still expect further weakness in consumer spending as higher interest rates, low personal savings rates and soaring consumer debt are likely to dampen confidence in the months to come.



Source: Bloomberg as of 7/27/2023

The S&P CoreLogic Case-Shiller 20-city home price index rose +.99% in May (+.70% est./-1.70% YOY), the fourth consecutive monthly gain and largest since May 2022, as the combination of low affordability and higher mortgage rates has been offset by historically light inventories and resilient demand. While this price moderation was inevitable given the sharp rise in prices from mid-2020, housing market technicals continue to be very favorable as supply remains tight in many localities (3.1 months in Jun./record low 1.8), listings continue to sell quickly (18 days on market in May/record low 14) and the rental market remains firm. Regarding inventories, June's existing home sales data revealed that there were just 1.08 million previously owned homes for sale, down nearly 14% since last June (cycle low 850,000, Jan. 2022), which should provide a buffer to more meaningful depreciation in the coming months. In total, 10 of the 20 cities continued to show annual price gains, albeit well-off of their cycle highs last year, with Chicago (+4.6%), Cleveland (+3.9%) and New York (+3.5%) posting the largest annual gains, with Las Vegas (-7.8%), San Francisco (-11.1%) and Seattle (-11.3%) rounding out the bottom three. On a national basis, the housing price index fell -.46% for the year ended May, a sharp reversal from last March's 20.8% all-time record high (1988 index inception) and the largest year-over-year decline since April 2012. Looking at the text of the report, a director of the survey stated that "Home prices in the U.S. began to fall after June 2022, and May's data bolster the case that the final month of the decline was January 2023," and that "The last four months' price gains could be truncated by increases in mortgage rates or by general economic weakness. But the breadth and strength of May's report are consistent with an optimistic view of future months." All in all, while market participants expected lower home prices given the steep rise in mortgage rates and the sheer magnitude of price appreciation during the pandemic, the union of tight supply and still resilient demand have firmed up prices since the start of the year.

US Real GDP & GDP Price Index Annualized QoQ Change – Quarterly – 2 years

Source: Bloomberg as of 7/27/2023

Real GDP was up for the fourth consecutive quarter and grew at a faster than expected 2.4% annualized rate during the second quarter (+1.8% est.; +2.0% Q1), as a rebound in business fixed investment (+1% of top line) and durable strength in consumer spending growth were partially offset by another decline in residential investment. On the consumption side, consumer spending moderated from last quarter's blistering pace to +1.6% during the quarter (+4.2% Q1/+1.0% Q4 2022), with continued resilience seen in both goods and services, which came in at +.7% and +2.1% respectively. Surely a bright spot was durable strength in real (inflation-adjusted) final sales to private domestic buyers, a key measure of underlying demand that subtracts out the trade, inventories, government spending and investment, which advanced +2.3% during the quarter (+3.2% Q1/+0% Q4 2022), indicative of persistent strength in consumer spending buoyed by strong labor markets, higher wages and moderating inflation. Additionally, inflation-adjusted business and residential fixed investment data were mixed, coming in at +7.7% and -4.2% respectively, with the former driven by a rebound in equipment spending (+10.8%/-8.9% Q1/-3.5% Q4 2022), and the latter triggered by slower housing turnover given the sharp rise in mortgage rates. On the inflation front, today's report revealed a welcome deceleration in the Core PCE deflator to a +3.8% annualized increase (+4.9% Q1/+4.4% Q4 2022), the smallest advance since March 2021 but still elevated, indicative that the cumulative effects of FOMC tightening may finally be bleeding more fully into the economy. All in all, a stronger than expected, near-trend growth report, surely welcome news for a Federal Reserve attempting to slow the economy enough to dampen inflation, whilst avoiding a deeper contraction in growth, otherwise known as a 'soft landing.' That said, residential and business investment are likely to be challenged in the months to come as the negative impact of higher interest rates and elevated inflation continue to weigh on consumers and businesses.

FOMC Rate Decision & Statement Analysis

As expected, the FOMC raised the Federal Funds rate to 5.50% by a unanimous vote of 11-0, the eleventh hike in seventeen months and the highest level since January 2001. As has been customary during this tightening cycle, Chairman Powell reiterated the Committee's resolve to reduce inflation and maintained that a pathway to a soft economic landing still exists, which he stated was now his 'base case' forecast for the economy given the recent firming in activity data. Indeed, the Committee appeared to subtly convey this uptick in economic expectations by adjusting statement language regarding growth from 'modest' to 'moderate,' likely signaling that most members want to leave the door open for another rate hike. Amplifying this change, the Chairman stated "That we've been able to achieve disinflation so far without any meaningful negative impact on the labor market, that's a good thing. But, at the margins, stronger growth could over time lead to higher inflation and would require an appropriate monetary response." As with past meetings, the Chairman reiterated that inflation remains too high and labor markets are still very tight, stating that while "Inflation has moderated somewhat since the middle of last year, nonetheless getting inflation down to 2% has a long way to go," and that "the labor market remains very tight; job gains are running at a pace below rates seen earlier in the year, but still at a strong pace. " That said, there were some dovish undertones during the post meeting press conference, notably the Chairman's repeated references to the softer than expected CPI print for June and that the real (inflation-adjusted) Federal Funds rate is 'meaningfully' in positive territory and "well above" the neutral rate. While Powell again delivered the Committee's party line on inflation and growth, that we understand the hardship and believe that a 'soft landing' is possible, we still remain skeptical that the Federal Reserve can break inflation without tipping the economy over into recession, particularly given tighter credit conditions and the low probability of rate cuts during the balance of 2023. To be sure, the likelihood of further credit contraction, surging consumer debt, the cumulative effects of 525 basis points of rate hikes and resumption of student loan repayments for nearly 27 million borrowers in October have increased the risk of a more meaningful contraction in consumption and investment later in 2023. While the Chairman stated that the September and November meetings remain live regarding another hike, we believe that the FOMC's tightening cycle is likely done if June's news regarding cooling inflation and moderating job creation carries through to the next FOMC meeting on September 20th.

Comparing July and June statements, the changes were minor and made to reflect the resumption of rate hikes and a slight tweak to the Committee's appraisal of economic activity.

"Recent indicators suggest that economic activity has been expanding at a moderate pace," which replaced "Recent indicators suggest that economic activity has continued to expand at a modest pace,"

"In support of these goals, the Committee decided to raise the target range for the federal funds rate to 5-1/4 to 5-1/2 percent," which replaced "In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 5 to 5-1/4 percent."

All and all, Chairman Powell delivered, on balance, a somewhat dovish performance during the post meeting press conference, frequently referencing June's favorable inflation data and that the real (inflation-adjusted) Federal Funds rate is 'meaningfully' in positive territory and "well above" the neutral rate, seemingly a nod to the likelihood that the FOMC is either done or one and done. Stay tuned!

Date	Target	BN Survey	Survey vs Actual	Direction	Change	Discount	Vote
07/26/23	5.25%-5.50%	5.25%-5.50%	Expected	Tightening	0.25%	5.50%	11-0
06/14/23	5.00%-5.25%	5.00%-5.25%	Expected	None	None	5.25%	11-0
05/03/23	5.00%-5.25%	5.00%-5.25%	Expected	Tightening	0.25%	5.25%	11-0
03/22/23	4.75%-5.00%	4.75%-5.00%	Expected	Tightening	0.25%	5.00%	11-0
02/01/23	4.50%-4.75%	4.50%-4.75%	Expected	Tightening	0.25%	4.75%	12-0
12/14/22	4.25%-4.50%	4.25%-4.50%	Expected	Tightening	0.50%	4.50%	12-0
11/02/22	3.75%-4.00%	3.75%-4.00%	Expected	Tightening	0.75%	4.00%	12-0
09/21/22	3.00%-3.25%	3.00%-3.25%	Expected	Tightening	0.75%	3.25%	12-0
07/27/22	2.25%-2.50%	2.25%-2.50%	Expected	Tightening	0.75%	2.50%	12-0

Source: Federal Reserve and Bloomberg as of 7/27/2023

The Week Ahead

The data calendar remains full over the coming week, headlined by the PCE Delator, JOLTS Job Openings, ISM Services and the Employment Cost Index. Looking ahead, markets remain focused on inflation, employment data and signs of cooling economic activity. On the new issue front, ABS volumes slowed this week from the avalanche of supply post July 4th with five deals totaling $2.8 billion priced through the 27th and $168 billion year to date ($176.5 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance slowed with $14.7 billion priced through the 27th and $769.8 billion year to date ($848.8 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 robust.

Friday 7/28

PCE Deflator; Employment Cost Index

Monday 7/31

Dallas Fed Manufacturing Activity

Tuesday 8/1

JOLTS Job Openings; ISM Manufacturing; Dallas Fed Services Activity

Wednesday 8/2

ADP Employment Change

Thursday 8/3

Weekly Jobless Claims; ISM Services; Factory Orders

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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