Fixed Income Market Insights

June 22, 2023

Key takeaways

Bond yields were higher this week, with GT2s up 14 basis points and GT10s higher by 7 basis points and 2s/10s more inverted by 7 basis points (-100), driven by more hawkish comments by FOMC policymakers regarding future rate hikes during 2023. On the data front, the University of Michigan Consumer Sentiment Index came in stronger than expected at 63.9 in June, the highest level since February, driven by resolution of the debt ceiling standoff and easing inflation expectations. Sales of existing homes during May came in fractionally higher than expected to an annualized rate of 4.30 million homes, extending a rebound from this January's pandemic era low (4.0 million/lowest since 2010), but still well below pre-pandemic averages given low affordability via higher mortgage rates and elevated prices. Initial unemployment claims remained elevated during the week ended June 17th at 264,000, the highest level since October 2021, indicative of continued loosening of chronically tight labor market conditions given the recent uptrend in layoff announcements and cooling demand for temporary workers.

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

Powell Repeats & Lower Tax Receipts

During Federal Reserve Chairman Powell's semi-annual testimony to Congress this week, the nation's top banker reiterated the FOMC's collective view that more rate hikes are likely this year to further temper stubbornly elevated inflationary pressures. Indeed, the Chairman stated during prepared remarks that "inflation pressures continue to run high, and the process of getting inflation back down to 2% has a long way to go" and that "nearly all FOMC participants expect that it will be appropriate to raise interest rates somewhat further by the end of the year," echoing comments made last week when Powell and Company decided to refrain from raising the Federal Funds rate for the first meeting in 15 months. And it is this disconnect that many market participants characterize as mixed messaging- If inflation is still running at a pace not consistent with a discernable path towards 2%, then why did the FOMC unanimously vote to pause last week? Towards this end, the Chairman reiterated during this week's testimony that "It will take time for the full effects of monetary restraint to be realized, especially on inflation," and that "we judged it prudent to hold the target rate steady to allow the Committee to assess additional information and it's implications for the monetary policy."

Market Snapshot

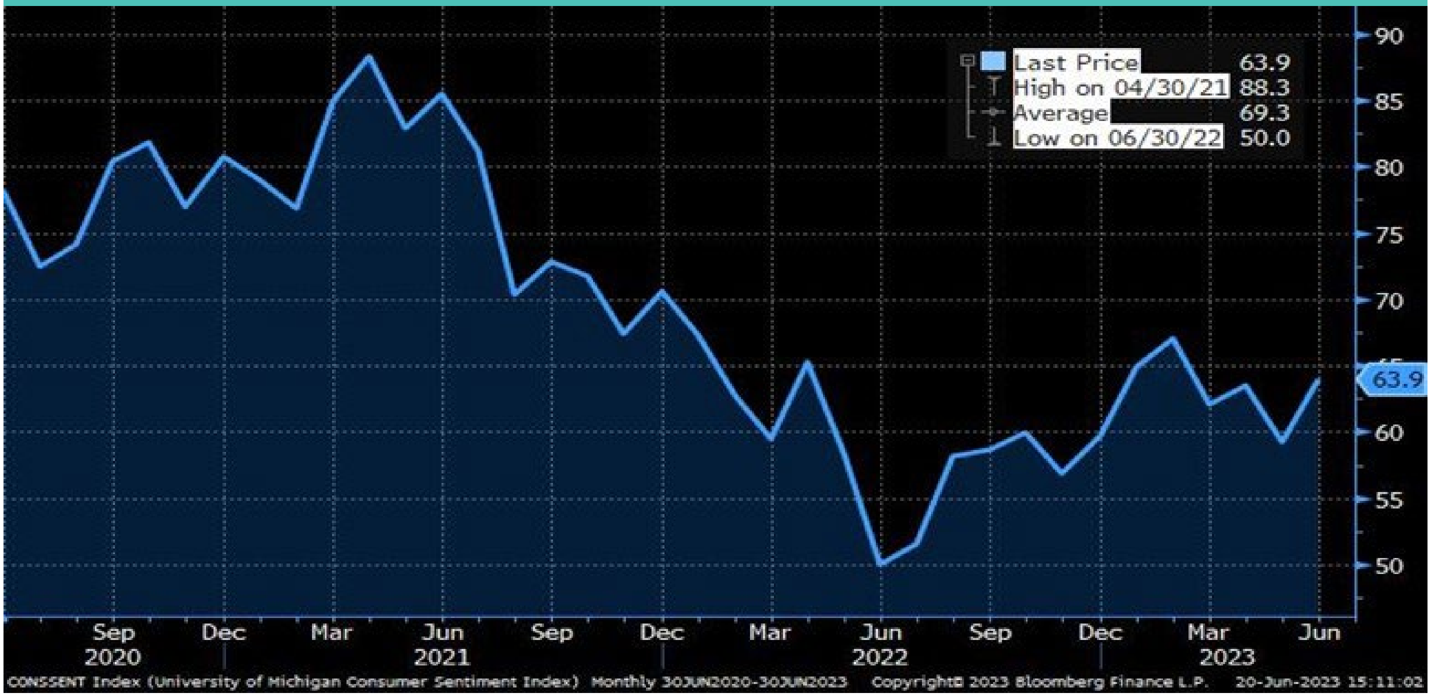
	This week 6/22/23	Last week 6/15/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.54%	5.51%	3	0.54%	16.14%
SOFR	5.05%	5.05%	0	0.00%	17.44%
2-year US Treasury	4.79%	4.65%	14	3.01%	8.13%
5-year US Treasury	4.03%	3.92%	11	2.81%	0.50%
10-yr US Treasury	3.79%	3.72%	7	1.88%	-2.32%
2s-10s UST Spread	-100.00	-93.00	-7.00	7.53%	81.82%
DJIA	33,958	34,413	-455.00	-1.32%	2.45%
S&P 500	4,372	4,434	-62.00	-1.40%	13.85%
Spot Gold	1,925	1,971	-46.00	-2.33%	5.42%
WTI (Oil) Current Contract	69.55	70.62	-1.07	-1.52%	-13.34%
1-year Brokered CD	5.30%	5.30%	0	0.00%	15.22%
5-year Brokered CD	4.50%	4.50%	0	0.00%	12.50%
5-year Bullet US Agency	4.10%	3.97%	13	3.27%	0.49%
5-year/NC1yr Callable US Agcy	5.55%	5.50%	5	0.91%	2.78%
CDX IG Spread Index	71.52	70.29	1.23	1.75%	-12.80%
CDX High Yield Index Spread	101.86	102.45	-0.59	-0.58%	1.23%
15-yr UMBS	5.06%	4.90%	16	3.27%	8.58%
30-yr UMBS	5.47%	5.34%	13	2.43%	2.63%

Source: Bloomberg data as of 2:30pm ET 6/22/2023 and 3:15pm ET 6/15/2023

As it relates to the next FOMC meeting on July 26th, this additional economic information is limited to one read for each of the key releases covering Non-Farm Payrolls, PCE Deflator and CPI, data likely to show continued moderation in inflation and slower job creation, hardly catalysts for the resumption of increasingly unpopular rate hikes given this month's pause. That said, Federal Funds futures currently imply a 70% chance of a 25-basis point rate hike in July, followed by a rate cut of the same magnitude by January 2024, a departure from the FOMC's latest forecast of 50-basis of additional rate hikes for the balance of this year. While not explicitly part of the 'additional information' that policymakers will consider when deciding on near term rate hikes, some troubling data regarding state tax receipts has emerged and may portend more economic duress that could ultimately impact the future path of interest rates during 2024 and beyond. According to state filings, personal income tax collections plunged for New York, New Jersey and California last month, with year-over-year receipts sliding 45%, 55% and 35% respectively. While this may be, in part, explained by tax deadline extensions and other timing factors, the reality is economic growth has been below trend for five quarters (.9% GDP 2022; 1.1% GDP Q123), a landscape we expect to endure as credit conditions tighten further and the cumulative effects of FOMC tightening take hold, which should slow hiring and drive layoffs higher in the quarters to come. Should this scenario materialize, expect the FOMC to relax their 'higher for longer' stance regarding short term interest rates and a shorter timeline to rate cuts during 2024.

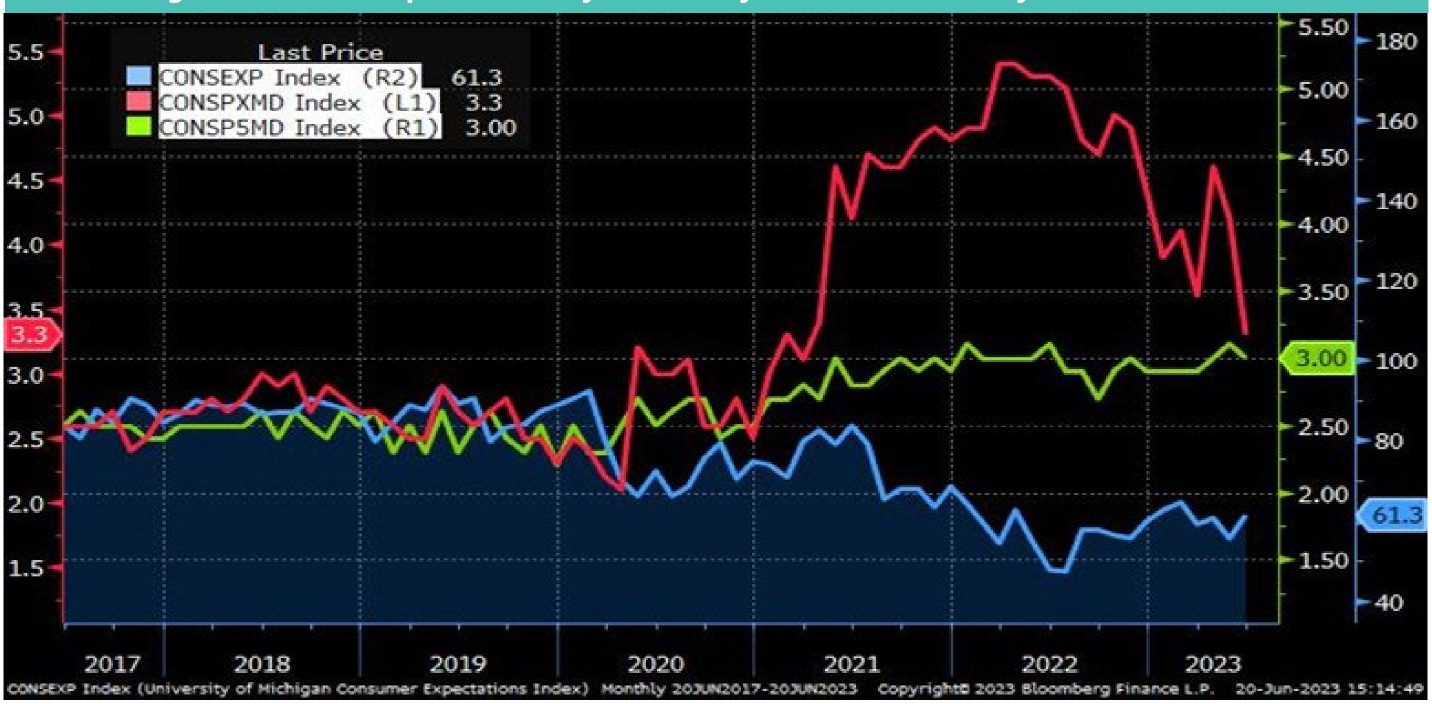
Still quiet on the fiscal front post the debt ceiling deal. To recap, the President signed the debt ceiling bill into law two weeks ago, known as the "Fiscal Responsibility Act of 2023," sidestepping a potential U.S. debt default and subsequent rating agency downgrades. Additionally, the President vetoed a bipartisan bill that would have eliminated the Executive Order regarding student loan forgiveness, which aims to cancel up to $20,000 per borrower and boasts a price tag of at least $400 billion (with some scoring upwards of $1 trillion), with a Supreme Court decision regarding the legality of the Executive order expected this month. Stay tuned!

U of Michigan Consumer Sentiment – Monthly – 3 Years



Source: Bloomberg as of 6/22/2023

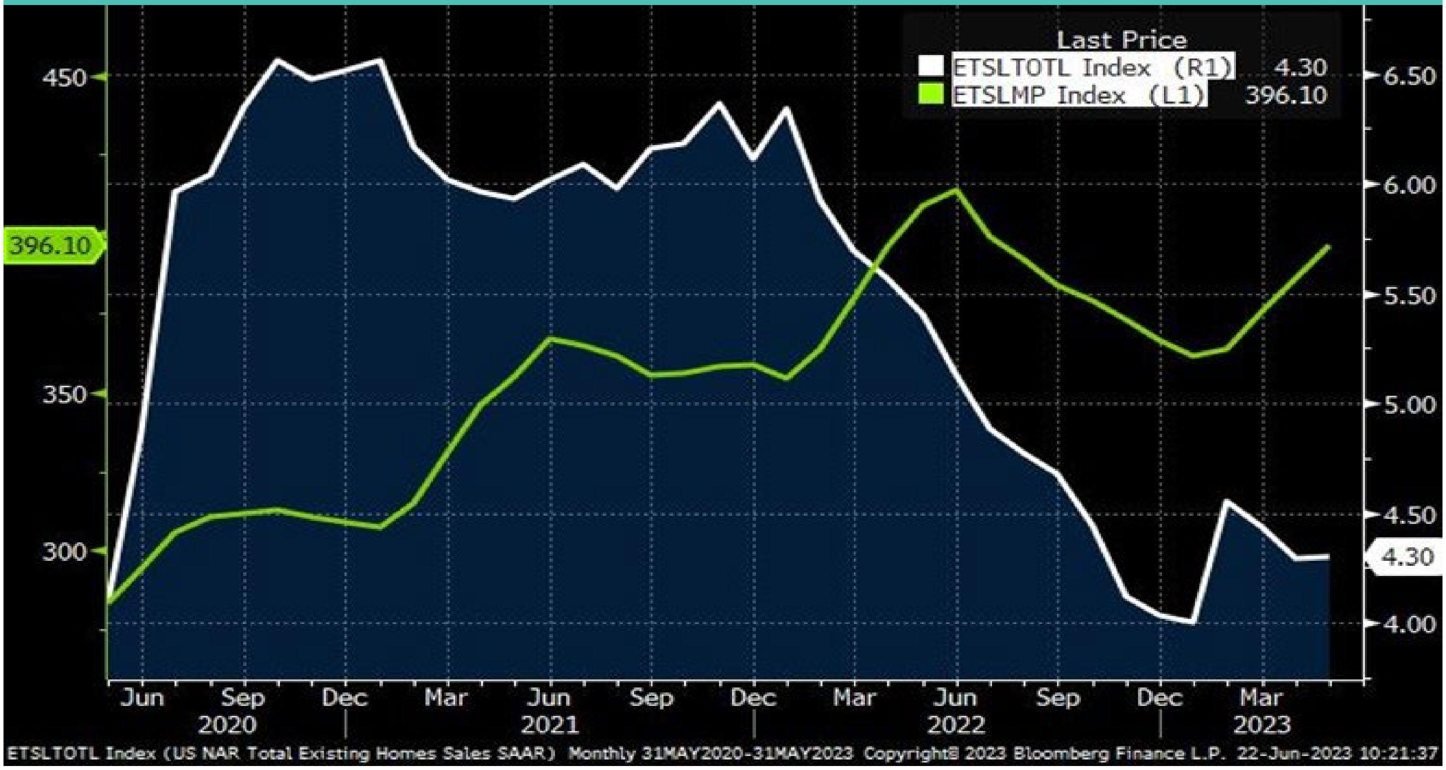
U of Michigan Consumer Expectations, 1yr and 5-10yr Inflation– Monthly – 3 Years



Source: Bloomberg as of 6/22/2023

The University of Michigan Consumer Sentiment Index came in stronger than expected at 63.9 in June (60.0 est.; 59.2 May), the highest level since February, driven by resolution of the debt ceiling standoff and easing inflation expectations. Notwithstanding this improvement, nearly 42% of consumers attributed their negative views regarding personal finances to inflation (41% May; 36% in Jan.), shy of the all-time high during the 2008 financial crisis (49%), and a mere 16% expect their incomes to rise more than inflation, a slight improvement over last June's 13% cycle low. Additionally, a mere 27% of consumers expect good economic times over the next year (July 2022 cycle low: 13%) as higher interest rates, inflation and disapproval of the government's economic policies (46%; second highest since last July) continue to dampen consumer optimism regarding their near-term financial well-being. A deeper dive into the survey revealed that both components of headline sentiment were higher, with current conditions up to 68.0 (64.9 May; 68.4 Jan) and expectations jumped to 61.3 (55.4 May; 62.7 Jan), the highest level since February. On the price front, year-ahead inflationary expectations receded for the second consecutive month to 3.2%, the lowest level since March 2021, driven largely by lower gasoline prices (2.6% 2019 Average; cycle high 5.4% Mar. 2022) and longer-term expectations were little changed at 3.0% (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 "Sentiment is now 28% above the historic low from a year ago and may be resuming its upward trajectory since then," and that "As it stands, though, sentiment remains low by historical standards as income expectations softened." All in all, inflation, higher interest rates and low confidence regarding government policies continue to weigh on consumer optimism, conditions that threaten to weaken consumer spending in the months to come as the cumulative effects of 500 basis points of FOMC tightening fully make their way through the economy.

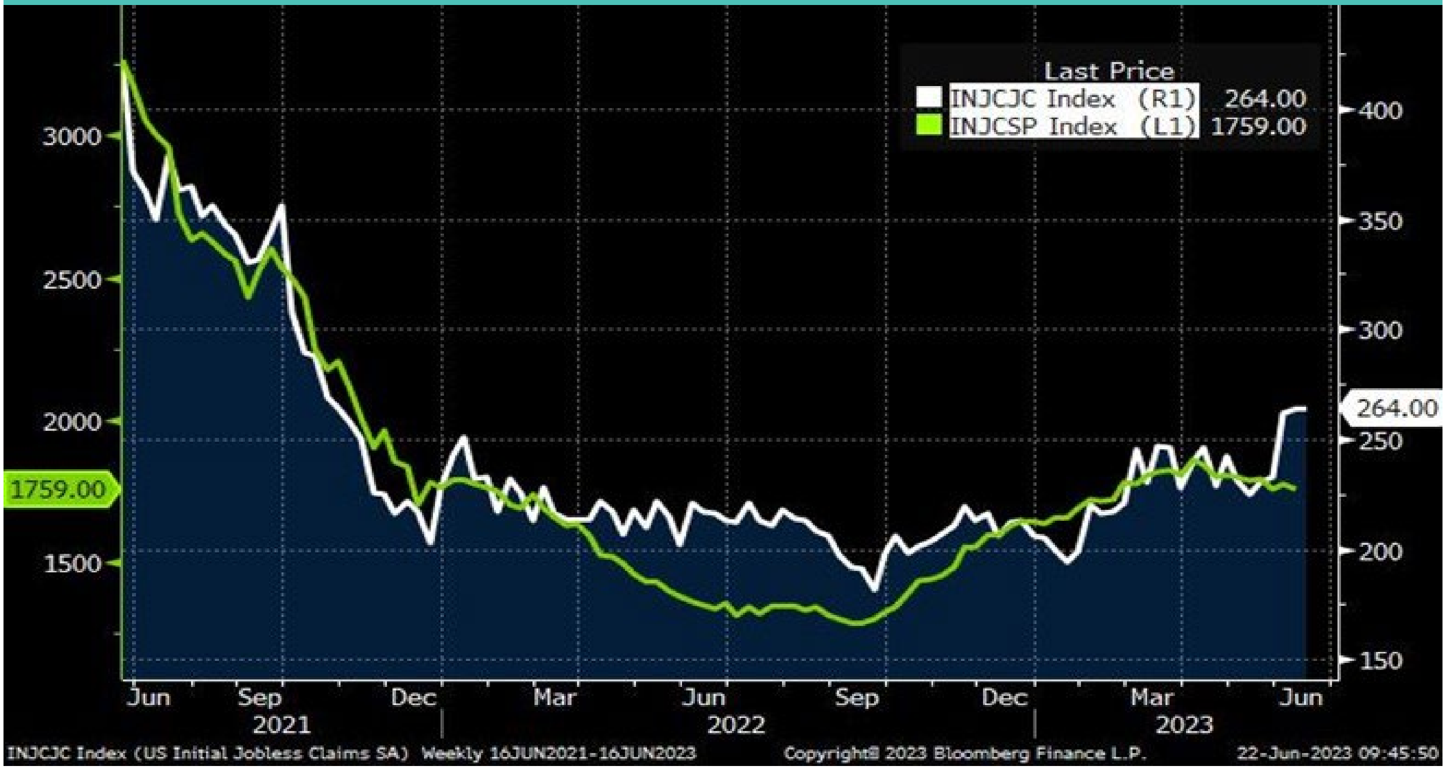
U.S. Existing Home Sales (Annualized) & Median Home Sales Price – Monthly – 3 Years



Source: Bloomberg as of 6/22/2023

Sales of existing homes during May came in fractionally higher than expected to an annualized rate of 4.30 million homes (4.25 est.), extending a rebound from this January's pandemic era low (4.0 million/lowest since 2010), but still well below pre-pandemic averages given low affordability via higher mortgage rates and elevated 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 more than 6% lower May 2022 inventory levels (1.15 million), the lowest inventory level for any May since 1999. Notwithstanding last year's increase in supply from January 2022's cycle low (850,000), housing inventories are still historically low (1.92 million peak in 2019) as higher mortgage rates and elevated prices have stymied mobility. The magnitude of this tighter supply is revealed in the months of supply and days on the market metrics for May, which came in at 3.0 months (record low 1.8 months) and 18 days (record low 14 days) respectively, both very low by historical standards. As a consequence, existing home prices have risen sharply and maintained most of these pandemic era gains with median selling prices coming in at $396,100 last month ($385,900 Apr.), a decline from last June's all-time high of $413,800 and down -3.1% during the last year, the largest year-over-year decline since 2011, but still historically high. Looking at the text of the report, the survey's Chief Economist stated that "Relatively steady rates have led to several consecutive months of consistent home sales," and that "existing-home sales activity is down sizably due to the current supply being roughly half the level of 2019." Indeed, while rising 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 $1,995 during May, up $28 from April and off a mere $58 from August 2022's all-time high of $2,053. While elevated prices and higher mortgage rates will likely weaken home sales further, we expect demand for housing to remain robust and prices to remain elevated in the near term given historically low inventories and higher likelihood of mortgage rate relief as the cumulative effects of 500 basis points of monetary policy take hold later this year.

Initial Jobless & Continuing Claims – Monthly – 2 Years



Source: Bloomberg as of 6/22/2023

Initial unemployment claims remained elevated during the week ended June 17th at 264,000 (259k est./264k last), the highest level since October 2021, indicative of continued loosening of chronically tight labor market conditions given the recent uptrend in layoff announcements and cooling demand for temporary workers. To be sure, claims have trended higher since March given the jump in WARN notices during the first quarter and may portend a broader economic slowdown, triggering more layoffs and slower hiring. To review, the Worker Adjustment and Retraining Notification (WARN) Act of 1988 requires companies with more than 100 full-time employees to file with state labor departments and notify workers of layoffs with a 60-day lead if they plan to lay off at least 50 people at a single site, and to workers who have their hours cut by half or more in any six-month period. Additionally, the four-week moving average of initial claims, which smooths out outsized observations in the data, jumped to 255,750, the highest level since November 2021 and well in excess of pre-pandemic averages observed during 2019. Indeed, some further signs of labor market cooling appear to be brewing given continuing unemployment claims, which came in at 1.759 million (1.645 million on Dec 30th) and include people who have already received unemployment benefits for a week, just shy of 2023 highs but still near pre-pandemic averages as employers struggle to fill the 10.1 million open positions estimated by the latest JOLTS survey. All in all, another weak report suggestive that the jump in layoff announcements may be starting to convert into outright job cuts, notwithstanding the persistence of labor market tightness seen post the darkest days of the pandemic.

The Week Ahead

The data calendar remains light over the coming week, headlined by S&P Services PMI, Consumer Confidence and Weekly Jobless Claims. Looking ahead, markets remain focused on inflation, employment data and further signs of slowing economic activity. On the new issue front, ABS volumes picked up during this holiday shortened week, with 7 deals totaling $7.1 billion priced through the 21st and $138 billion year to date ($151.7 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance remained light, with $10.2 billion priced through the 21st and $681.5 billion year to date ($744 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 improved post SVB/SBNY/FRBK bank failures and the new deal landscape remains favorable for a wider array of ABS and corporate issuers as investor demand remains strong.

Friday 6/23

S&P Services/Manufacturing PMI

Monday 6/26

Dallas Fed Manufacturing Activity

Tuesday 6/27

Durable Goods Orders; New Home Sales; Consumer Confidence; CoreLogic CS HPI

Wednesday 6/28

MBA Mortgage Applications

Thursday 6/29

GDP (1st Quarter/Third Look); 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.

InspereX