# Fixed Income Market Insights

January 13, 2023

## Key takeaways

Bond yields were lower this week, with GT2s down 2 basis points and GT10s lower by 5 basis points and 2s/10s more inverted by 3 basis points (-72), as a third consecutive month of benign CPI data fueled optimism that the FOMC will soon pause rate hikes. On the data front, the NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, fell to 89.8 in December, the second lowest level since 2013, as high inflation, labor shortages and deteriorating business expectations continue to weigh on sentiment. Headline CPI fell -.1% in December, the first drop since May 2020, and were up 6.5% during the last year, as declines in core goods prices were largely offset by durable strength in food, shelter and other core services. The University of Michigan Consumer Sentiment Index came in stronger than expected to 64.6 in January, a nine-month high, as another month of energy price relief, easing financial conditions and a five-decade low in unemployment have bolstered consumer optimism above June's all-time low of 50.

## 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.

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# Third Time's A Charm?

This week's Consumer Price Index (CPI) data revealed a third, consecutive month of moderating prices as the cumulative effects of 425 basis points of monetary policy tightening have adjusted the trajectory of inflation to what appears to be a discernable path towards the FOMC's 2% stated target, a requisite condition to hasten the end of the most aggressive monetary policy tightening in over 40 years. While inflation aggregates still remain elevated, with little relief observed in shelter, food and wages thus far, the transition away from more costly goods to services spending is well underway and has served to slow recent run-rates in Core CPI (Headline less food and energy), with a three-month annualized rate of 3.1% as of December 2022 (versus 6.0% in Sept. 2022), along with a six-month annualized rate of 4.55% (versus 6.9% in Sept. 2022) on the same basis. While this is welcome news for the FOMC and investors alike, there are surely risks of reacceleration in the months ahead, particularly in energy and medical care costs, which have driven the bulk of cooling in inflation aggregates over the past three months. Additionally, chronically tight labor markets remain a problem for the Federal Reserve and employers, as compensation costs (wages +) have been much slower to moderate and, given the five-decade low in the unemployment rate (3.5%; Dec.) and elevated JOLTS job openings (10.5 million; Nov.), will likely take an extended period of time to achieve a more favorable, downward trajectory, the main driver of the FOMC's assertion that the Federal Funds rate will be maintained at its terminal level (near 5%) for the balance of 2023.

**Market Snapshot**

| | This week 1/13/23 | Last week 1/06/23 | Basis Points Change | Weekly % Change | YTD % Change |
|---|---|---|---|---|---|
| 3-month USD Libor | 4.83% | 4.81% | 2 | 0.42% | 1.26% |
| SOFR | 4.30% | 4.31% | -1 | -0.23% | 0.00% |
| 2-year US Treasury | 4.23% | 4.26% | -3 | -0.70% | -4.51% |
| 5-year US Treasury | 3.61% | 3.71% | -10 | -2.70% | -9.98% |
| 10-yr US Treasury | 3.51% | 3.56% | -5 | -1.40% | -9.54% |
| 2s-10s UST Spread | -72.00 | -70.00 | -2.00 | 2.86% | 30.91% |
| DJIA | 34,207 | 33,608 | 599.00 | 1.78% | 3.20% |
| S&P 500 | 3,987 | 3,894 | 93.00 | 2.39% | 3.83% |
| Spot Gold | 1,924 | 1,874 | 50.00 | 2.67% | 5.37% |
| WTI (Oil) Current Contract | 79.71 | 73.90 | 5.81 | 7.86% | -0.69% |
| 1-year Brokered CD | 4.70% | 4.60% | 10 | 2.17% | 2.17% |
| 5-year Brokered CD | 4.05% | 3.90% | 15 | 3.85% | 1.25% |
| 5-year Bullet US Agency | 3.69% | 3.82% | -13 | -3.40% | -9.56% |
| 5-year/NC1yr Callable US Agcy. | 5.05% | 5.15% | -10 | -1.94% | -6.48% |
| CDX IG Spread Index | 70.90 | 74.75 | -3.85 | -5.15% | -13.56% |
| CDX High Yield Index Spread | 102.94 | 101.94 | 1.00 | 0.98% | 2.31% |
| 15-yr UMBS | 4.11% | 4.32% | -21 | -4.86% | -11.80% |
| 30-yr UMBS | 4.81% | 4.94% | -13 | -2.63% | -9.76% |

Source: Bloomberg data as of 2:15pm ET 1/13/2023 and 1:30pm ET 1/6/2023

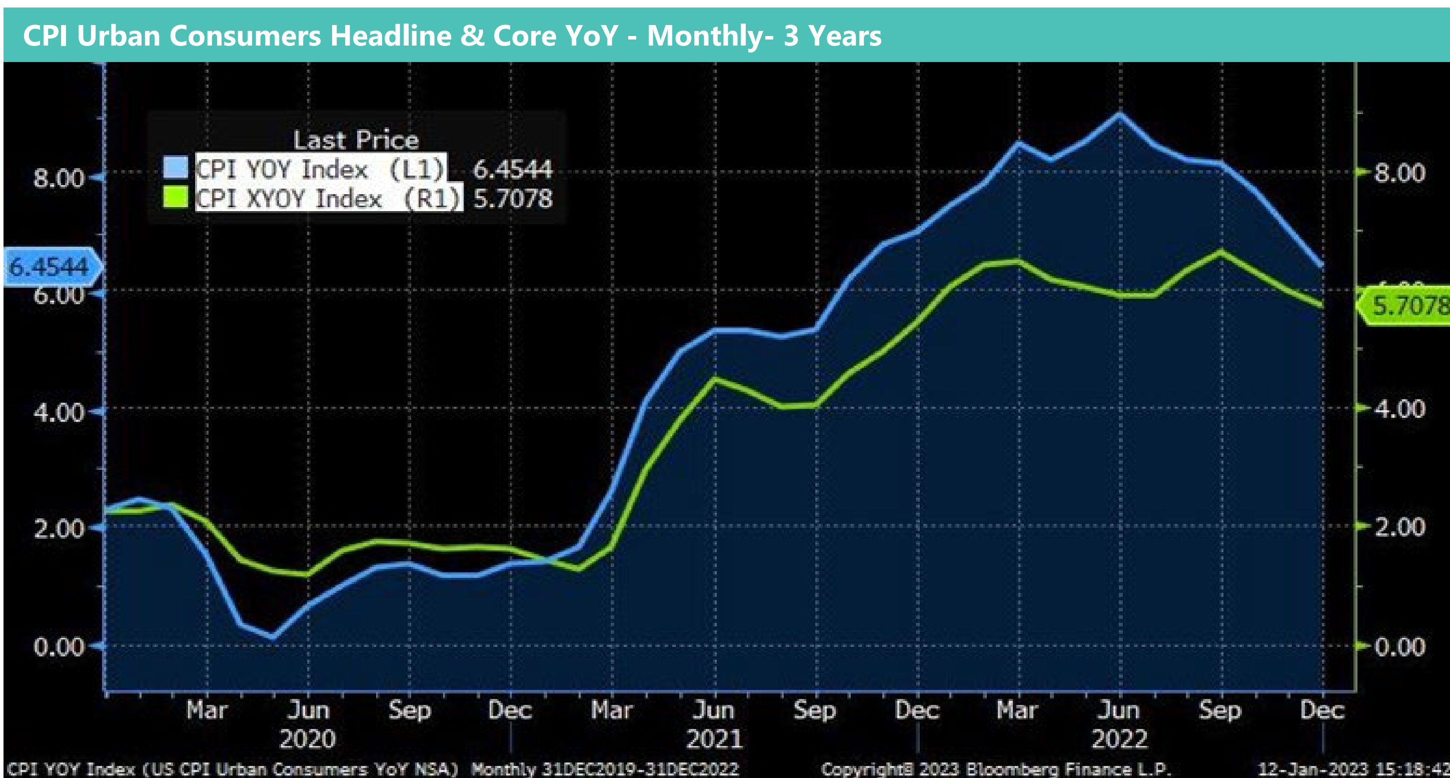
Additionally, chronically tight labor markets remain a problem for the Federal Reserve and employers, as compensation costs (wages +) have been much slower to moderate and, given the five-decade low in the unemployment rate (3.5%; Dec.) and elevated JOLTS job openings (10.5 million; Nov.), will likely take an extended period of time to achieve a more favorable, downward trajectory, the main driver of the FOMC's assertion that the Federal Funds rate will be maintained at its terminal level (near 5%) for the balance of 2023. Indeed, last week's Non-Farm Payroll data revealed that average hourly earnings were up 4.6% during 2022, an improvement from last year's peak, year-over-year read of 5.6% (March), but little changed from 2021's 4.9% tally. On the flip side, some good news regarding potential moderation in shelter costs have materialized over the past few months, with national median prices for existing homes falling for five consecutive months ($371,000 Nov.; $414,000 June, All-Time High) and spot rents, or what landlords are charging for new leases, down .8% during December. Given the lagged effect of legacy lease rollovers, shelter costs as measured by the CPI were actually up .8% in December's (+7.5% for 2022, All-Time High), a main contributor to higher observed inflation metrics for all of 2022, and one likely to wane as 2023 progresses and higher-priced, legacy leases roll off. While the next few months of inflation data will ultimately drive the FOMC's decision to end the current tightening cycle, a growing number of investors and policymakers appear to be signaling that December's, third consecutive month of benign inflation data may have been a charm.

All quiet on the fiscal front as the House of Representatives remained in session and began the task of selecting committee members to launch the new legislative year. Among several legislative imperatives, negotiation of the debt ceiling will be front and center when both houses of congress return during the week of January 24th. Stay tuned!

**NFIB Small Business Optimism – Monthly – 2 Years**

Source: Bloomberg as of 1/13/2023

The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, fell by more than 2 points to 89.8 in December (91.5 est.), the second lowest level since 2013, as high inflation, labor shortages and deteriorating business expectations continue to weigh on sentiment. On the inflation front, 32% of respondents reported that inflation was their most significant business problem, just shy of last July's cycle high 37% print (highest since 1979), underscoring the durability of inflationary pressures afflicting small businesses. Additionally, a near record high of 41% of small businesses said they had unfilled job openings (51% record high; May 2022) and 44% stated they have increased compensation over the last three months to attract new workers. As with other elevated input costs, higher labor expenses are being passed along to customers with 43% of the small businesses surveyed stating that they anticipate higher selling prices, a moderation from last March's all time high of 66% (1974 inception) and the lowest share since May 2021, but still historically high. 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 slid eight points to -51% last month (versus -38% pandemic low), an improvement versus June's -61%, but still historically weak. Indeed, the survey stated that "Overall, small business owners are not optimistic about 2023 as sales and business conditions are expected to deteriorate," and "Owners are managing several economic uncertainties and persistent inflation and they continue to make business and operational changes to compensate." All in all, continued weakness in small business optimism mirrors consumer sentiment data and underscores mounting economic pessimism, eroding confidence in policymakers and elevated wage inflation expectations.



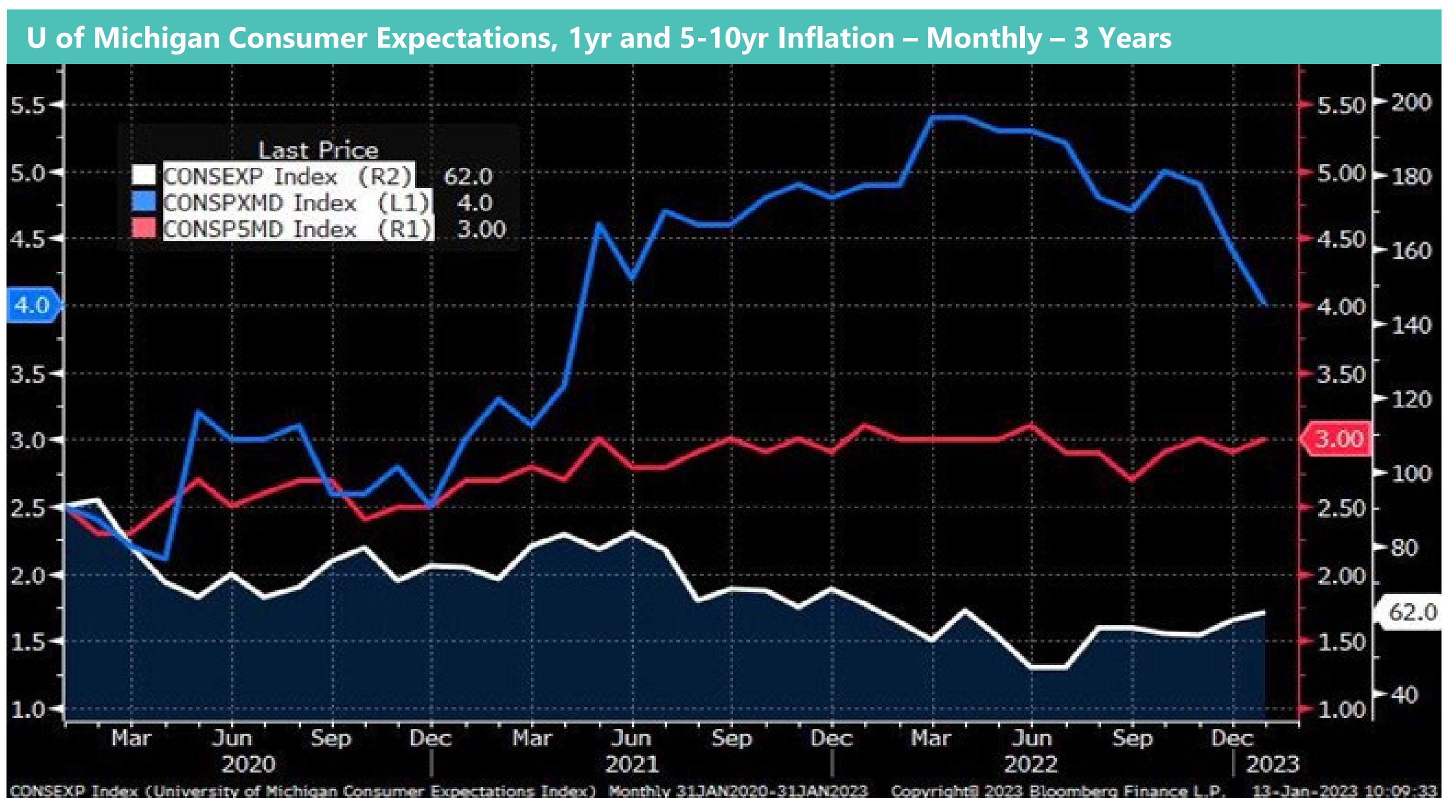

Source: Bloomberg as of 1/13/2023

Headline CPI fell -.1% (-.1% est.) in December, the first drop since May 2020, and were up 6.5% during the last year (+6.5% survey), as declines in core goods prices were largely offset by durable strength in food, shelter and other core services. Core CPI (less food and energy) was up .3% (+.3% est.) and 5.7% (+5.7% est.) on the same basis, another leg lower from September's year-over-year cycle high (6.6%; highest since 1982), but still historically high, again underscoring the persistent and broad-based nature of inflationary pressures across both services and selected goods. Indeed, the breadth of price gains remains troublesome, with nearly 53% of index components up by more than 4% on an annualized basis, down from nearly 60% in November, but more than double the pre-pandemic run rate. From a contribution standpoint, energy prices moved lower for the second consecutive month, with gasoline down -9.4% in December (worth -.37% Headline), used cars fell -2.5% (worth -.10% Headline) and services prices reaccelerated, up .6% (worth +.37% Headline) and 7.5% from a year ago, a new cycle high (versus 7.4% last September) and the largest annual advance in more than 30 years. Looking at headline CPI, prices were mixed, with the largest gains seen in shelter (+.8%), apparel (+.5%), food/beverage (+.3%), and recreation (+.2%), which were offset by declines in energy (-4.5%), airline fares (-3.1%), transportation (-2.5%), and commodities (-1.1%) as discretionary goods spending continues to moderate and shift 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 December (+.8%; +7.5% year over year), another record high, annual advance. Given that inflation expectations are closely tied to food, energy and shelter costs, the durability of price gains in 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 hawkish stance in the months to come. All in all, while this third, consecutive benign CPI will be welcome news for the FOMC, 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 February 1st.

## U of Michigan Consumer Sentiment – Monthly – 3 Years

Source: Bloomberg as of 1/13/2023

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




Source: Bloomberg as of 1/13/2023

The University of Michigan Consumer Sentiment Index came in stronger than expected to 64.6 in January (60.7 est.; 59.7 Dec.), a nine-month high, as another month of energy price relief, easing financial conditions and a five decade low in unemployment have bolstered consumer optimism above June's all-time low of 50. Notwithstanding the improvement, nearly 36% 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 historically high, and a mere 17% expect their incomes to rise more than inflation, a slight improvement from June's 13% cycle low. Additionally, a mere 24% 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 soften consumer attitudes about their near-term financial health. A deeper dive into the survey revealed that the improvement in headline sentiment was broad-based, with current conditions sharply higher (68.6 vs. 59.4 Dec.) and expectations up to 62 (59.9 Dec.; 68.3 Dec 2021), both at highest levels since April 2022, but still historically weak. On the price front, near-term inflationary expectations fell for the third consecutive month to the lowest level since April 2021, due largely to falling energy prices and some relief at the grocery store, but still remain historically high over the near (1yr. 4.0%; 4.4% Nov.; cycle high 5.4% March 2022) and longer terms (5+ yrs. 3.0%, 2.9% Dec.; 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 "Uncertainty over both inflation expectations measures remains high, and changes in global factors in the months ahead may generate a reversal in recent improvements," and that "Two-thirds of consumers expect an economic downturn in the year ahead, reflecting how low sentiment remains despite recent improvements. That said, given current historic lows in unemployment and strength in expected incomes, a gradual slowdown in spending appears more likely than a cliff-like drop." All in all, while recent moderation in inflation data is welcome news for the FOMC, elevated prices and higher interest rates continue to weigh on consumer optimism, conditions that are likely to persist in the near term and threaten the durability of consumer spending seen this year, particularly when the cumulative effects of FOMC tightening set in.

# The Week Ahead

The data calendar slows next week given Monday's market holiday, headlined by the Producer Price Index (PPI), Retail Sales and Industrial Production. Looking ahead, markets remain focused on inflation, jobs data and further signs of economic weakness. On the new issue front, three ABS deals totaling $3.96 billion were priced this week to kick off the new year ($23.3 billion for Jan. 2022; $276.7 billion for 2022) and IG corporate issuance remained robust with $37.9 billion in deals priced this week through the 12th ($152.5 billion for Jan. 2022; $1.26 trillion for 2022). While new issue supply slowed during 2022 given FOMC rate hikes and elevated volatility, the market is still supportive for selected ABS and corporate issuers as investor demand remains strong.

### Monday 1/16

Market Holiday – MLK Day

### Tuesday 1/17

Empire Manufacturing

### Wednesday 1/18

PPI; Retail Sales; Industrial Production

### Thursday 1/19

Weekly Jobless Claims; Housing Starts

### Friday 1/20

Existing Home Sales

## 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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