Fixed Income Market Insights

June 1, 2023

Key takeaways

Bond yields were lower this week, with GT2s down 19 basis points and GT10s lower by 21 basis points respectively and 2s/10s more inverted by 2 basis points (-73), as weaker consumer confidence easing of debt ceiling concerns pushed yields lower. On the data front, headline PCE prices rebounded in April and were up +.4%, the largest monthly advance since January, as flat food costs were offset by rebounding energy and other goods prices and persistent advances in housing and other services. Consumer confidence was again muted during May at 102.3, the lowest level since November 2022, driven by continued cooling in labor market conditions and mounting pessimism regarding near term business prospects. The S&P CoreLogic Case-Shiller 20-city home price index unexpectedly rose +.45% in March (-1.15% YOY), breaking the streak of eight consecutive monthly declines and the first annual retreat since May 2012, as the combination of low affordability and higher mortgage rates have softened prices from last year's all-time highs. The number of available jobs unexpectedly rose to 10.1 million in April, the first increase in four months and still indicative of durable labor markets tightness driven by chronic labor shortages and still robust demand.

We suggest

We continue to prefer playing rate defense given elevated 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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Dry Powder?

In the wake of the SVB/SBNY/FRBK failures, investors have been hoarding cash at a record pace given mounting concerns about the financial stability of regional/community banks and the pursuit of higher yielding, short term investments away from traditional bank deposits. Indeed, money market mutual fund assets have soared since the early March failures of SVB/SBNY, with balances accumulating at the fastest pace since the darkest days of the pandemic during 2020, to an all-time high of $5.39 trillion as of May 24th. While the inverted yield curve and highest, short-term interest rates since 2007 have surely contributed to this historic run-up, mounting headwinds, including withering consumer confidence and rock-bottom business sentiment, have also driven investors into safe-haven assets as economic expectations weaken. Typically, this type of liquidity build has been a leading indicator of 'risk-off' sentiment, where riskier assets like equities and high-yield corporate debt tend to underperform with investors favoring more conservative alternatives.

Market Snapshot

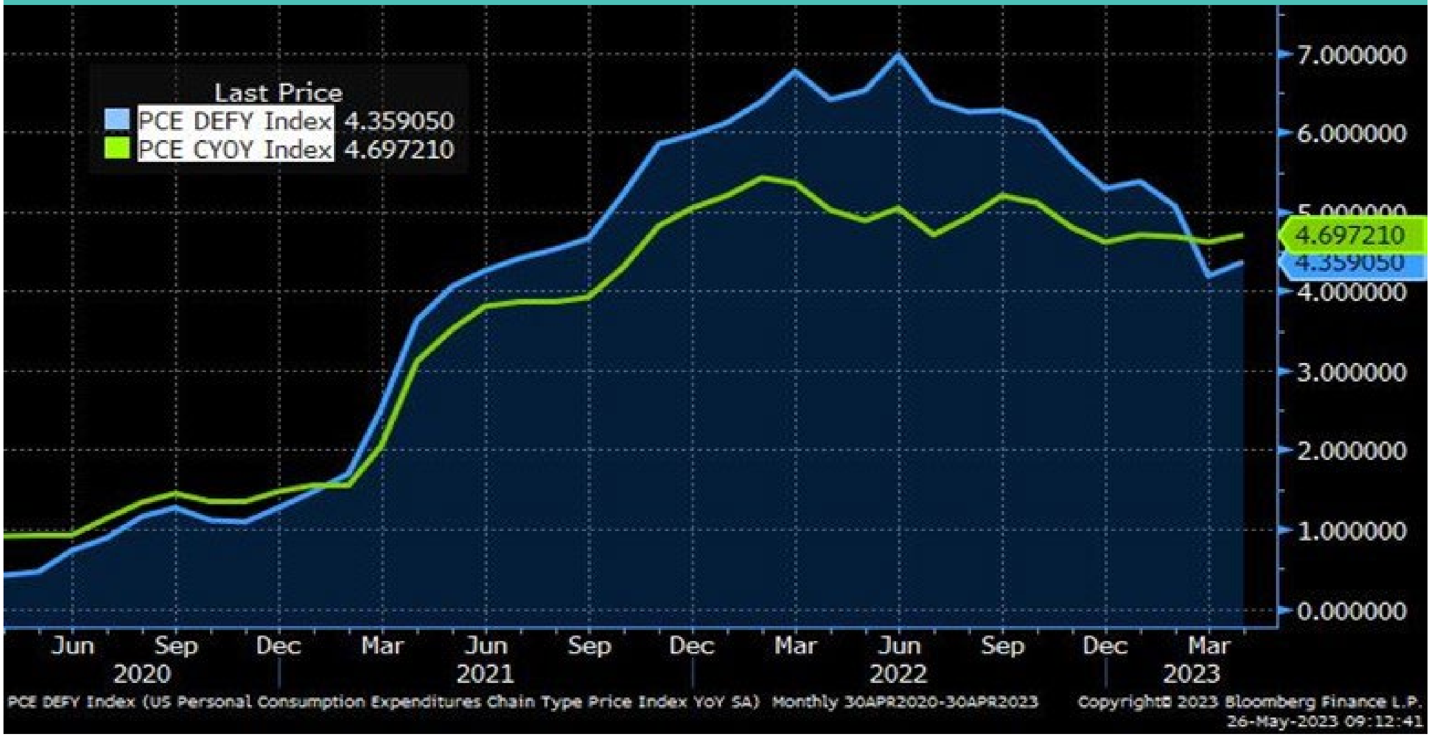
	This week 6/1/23	Last week 5/25/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.52%	5.46%	6	1.10%	15.72%
SOFR	5.08%	5.06%	2	0.40%	18.14%
2-year US Treasury	4.34%	4.53%	-19	-4.26%	-2.05%
5-year US Treasury	3.70%	3.91%	-21	-5.37%	-7.73%
10-yr US Treasury	3.61%	3.82%	-21	-5.50%	-6.96%
2s-10s UST Spread	-73.00	-71.00	-2.00	2.82%	32.73%
DJIA	33,098	32,765	333.00	1.02%	-0.15%
S&P 500	4,231	4,151	80.00	1.93%	10.18%
Spot Gold	1,996	1,962	34.00	1.73%	9.31%
WTI (Oil) Current Contract	70.09	71.83	-1.74	-2.42%	-12.67%
1-year Brokered CD	5.25%	5.25%	0	0.00%	14.13%
5-year Brokered CD	4.50%	4.50%	0	0.00%	12.50%
5-year Bullet US Agency	3.80%	3.98%	-18	-4.52%	-6.86%
5-year/NC1yr Callable US Agcy.	5.25%	5.45%	-20	-3.67%	-2.78%
CDX IG Spread Index	73.43	77.27	-3.84	-4.97%	-10.47%
CDX High Yield Index Spread	101.42	100.61	0.81	0.81%	0.80%
15-yr UMBS	4.87%	5.26%	-39	-7.41%	4.51%
30-yr UMBS	5.34%	5.69%	-35	-6.15%	0.19%

Source: Bloomberg data as of 3:00pm ET 6/1/2023 and 5:00pm ET 5/25/2023

Of course, the recent pandemic and most aggressive Federal Reserve tightening cycle in a generation have upended some traditional investment norms and relationships, for now. Indeed, all three major stock indices (DJIA, S&P 500 and NASDAQ) have traded higher since the SVB/SBNY bank failures, with the S&P 500 and NASDAQ surging 6.72% and 15.14% since March 1st, while investment grade and high yield corporate debt have also fared well from a spread perspective, performance that could hardly be described aptly as 'risk-off.' That said, the likelihood of some form of stepped-up credit contraction, monetary tightening lags, drumbeat of big-box retailers warning about sales declines and business sentiment at the lowest level since January 2013 (NFIB Small Business Optimism Index: 89 April) may challenge recent performance of 'risk-on' assets and markets may revert back to more traditional behavior when faced with this magnitude of economic headwinds. Additionally and according to Ned Davis Research, money market assets represent approximately 13% of the U.S. stock market capitalization, versus nearly 47% in February 2009 post-Great Financial Crisis, and nearly 25% in February 2003 after the dot-com bubble, suggesting that more dry-powder build could be in the offing during the second half of 2023, and likely at the expense of riskier assets. Stay tuned!

The House passed a compromise version of debt-limit legislation agreed to by Speaker of the House McCarthy and the President on a bipartisan basis (314-117) Wednesday evening, moving the bill to the Senate for consideration as the estimated default x-date nears. As of publication, looks like the Senate could vote on the bill as early as this afternoon, with amendments likely coming from both sides of the aisle. While the amendments process can be tedious and has torpedoed bills in the past, this seems unlikely given the gravity of the issue and lack of time remaining prior to the U.S. government running out of money, with Senators from both parties claiming the necessary votes are there given the current framework of the House bill.

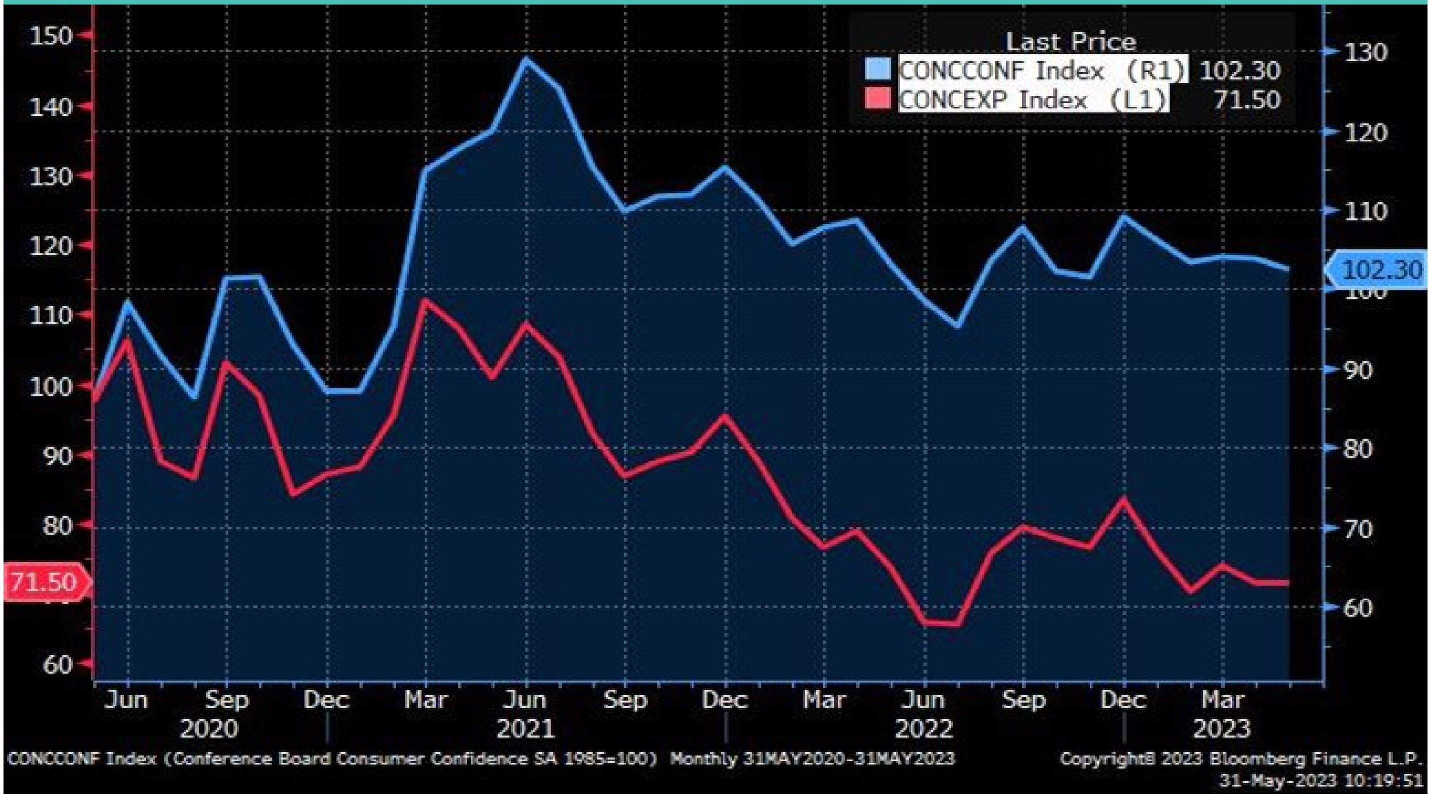
PCE Deflator YoY% & CORE PCE Deflator YoY% – Monthly – 3 years



Source: Bloomberg as of 6/1/2023

Headline PCE prices rebounded in April and were up +.4% (+.3% est./+.1% Mar.), the largest monthly advance since January, as flat food costs were offset by rebounding energy and other goods prices and persistent advances in housing and other services. Indeed, last month's rebound in prices was broad-based, reigniting concerns that the first quarter's deceleration was an anomaly, with goods prices up +.2% and services higher by +.4% during the month, and +2.1% and +5.5% on a year-over-year basis, as PCE Supercore (Services ex. housing and energy) advanced +.4%, the fastest pace since January. In the aggregate, headline PCE prices were up 4.4% during the past year, the smallest annual advance since July 2021, but a reacceleration from March and still a stubbornly slow decline from last June's 7% cycle high, which was the largest annual increase since December 1981. Additionally, the breadth of price gains remains troubling, with 49.4% of components rising at a 5% clip or faster last month (50.6% Mar.), with just 10.6% components rising at or below the FOMC's 2% target. This closely followed inflation gauge, known as the 'PCE Deflator,' has soared since the first quarter of 2021 as surging food and energy prices and elevated rents and other services costs have pushed prices progressively higher. The Core PCE Deflator (excluding food and energy) also rebounded during April, up +.4% for the month (+.3% Mar.) and higher by 4.7% over the past year, a small deceleration versus September's annual increase (5.2%) and evidence that broad-based inflation remains stubbornly high and sticky. Indeed, Core PCE price index advances reaccelerated from the start of the year, running 4.8%, 5.0% and 4.5% (Apr-Feb) 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 supportive of the current 'higher for longer' short term interest rate stance by the FOMC.

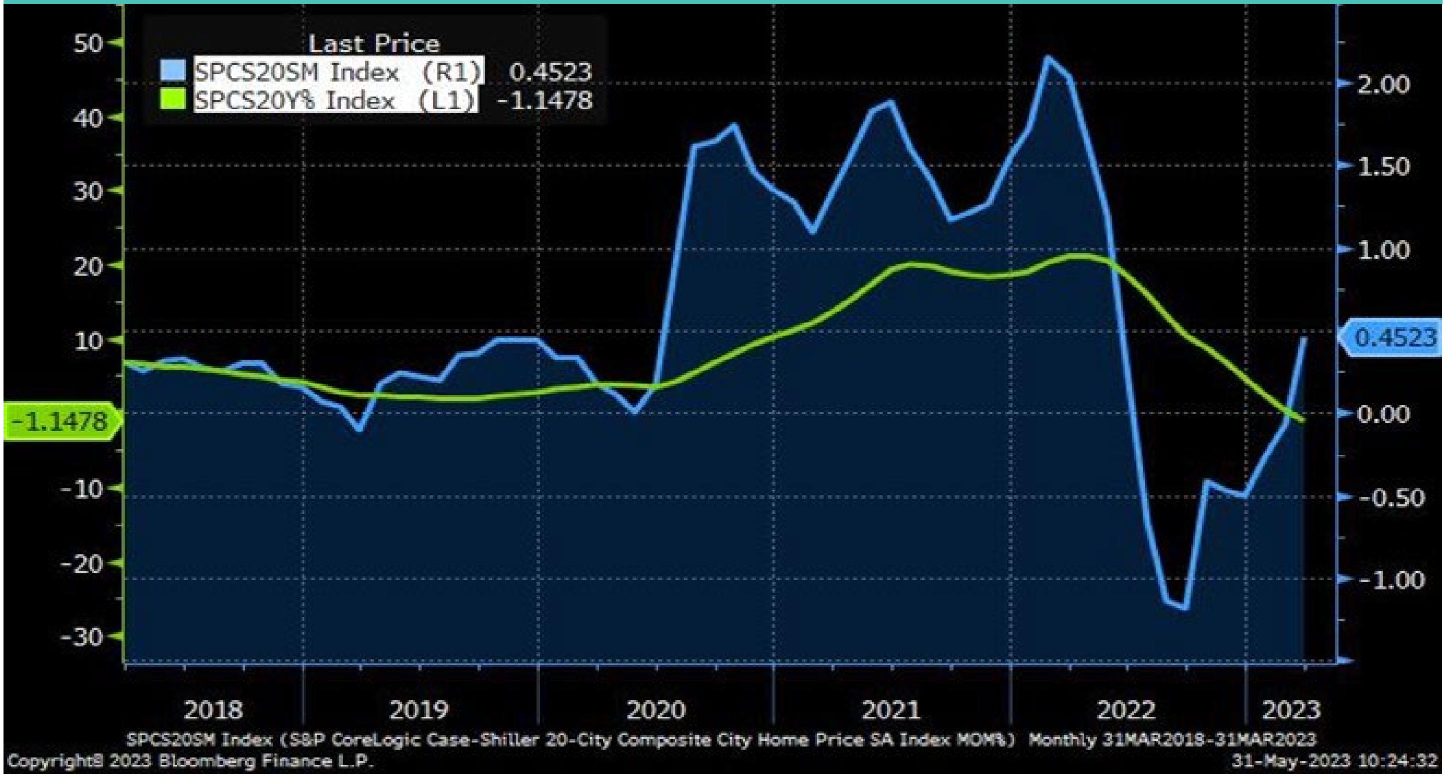
Consumer Confidence & Expectations – Monthly – 3 Years



Source: Bloomberg as of 6/1/2023

Consumer confidence was again muted during May at 102.3 (vs. 99 est./103.7 Apr.), the lowest level since November 2022, driven by continued cooling in labor market conditions and mounting pessimism regarding near term business prospects. Leading this month's decline was the current conditions component, which fell to 148.6 (151.8 Apr.), led by fewer respondents stating that jobs are plentiful (43.5% vs. 47.5% Apr.), the lowest level in two years and below 2019 run rates. Adding to this month's decline was the expectations component, a measure of consumers' six-month outlook, which fell to 71.5 (71.7 Apr./74 Mar.), the second lowest level since last July and below the recessionary reading (80) for the eleventh time over the past year as fewer respondents expect business conditions to improve (12.9% vs. 14.1% Apr.), the lowest level since 2011, and a lower share see more jobs being added (13.6% vs. 14.3% Apr.). Looking at the text of the report, the senior director of the survey stated that "Consumer confidence declined in May as consumers' view of current conditions became somewhat less upbeat while their expectations remained gloomy," and that "Their assessment of current employment conditions saw the most significant deterioration. While consumer confidence has fallen across all age and income categories over the past three months, May's decline reflects a particularly notable worsening in the outlook among consumers over 55 years of age." Indeed, labor market conditions loosened more than expected last month as cooling demand for workers suggests further progress towards curing the supply-demand imbalance, with May's Labor Index metric, which measures the labor differential of jobs plentiful less hard to get, coming in at 31.0% (36.9% Apr.), the lowest level since April 2021. All in all, a weak report led by cooling demand for labor, suggesting further softness in consumer spending as higher interest rates, low personal savings rates and soaring consumer debt are likely to weaken confidence further in the coming months.

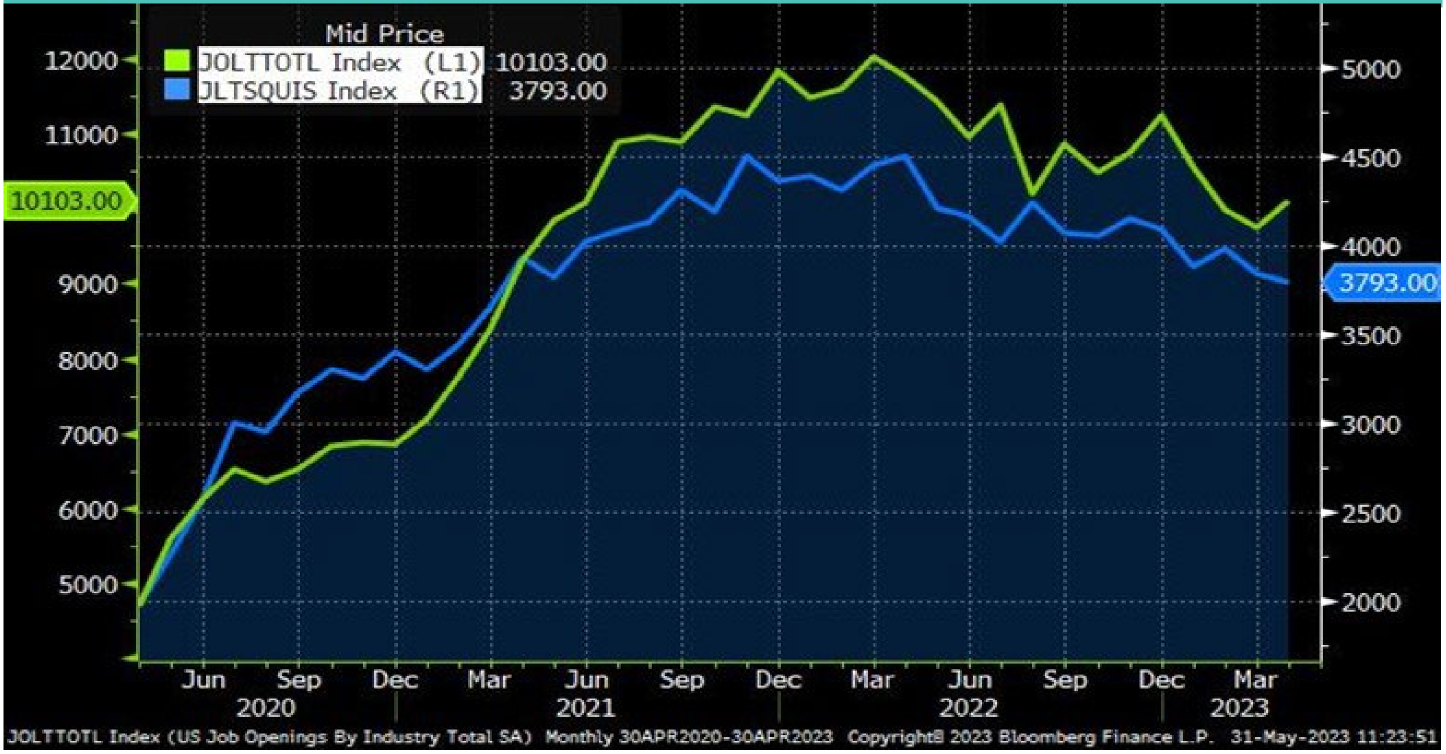
S&P CL Case-Shiller 20 City Comp Home Price Index MOM/YOY% Change – Monthly – 5 Years



Source: Bloomberg as of 6/1/2023

The S&P CoreLogic Case-Shiller 20-city home price index unexpectedly rose +.45% in March (0.0% est./-1.15% YOY), breaking the streak of eight consecutive monthly declines and the first annual retreat since May 2012, as the combination of low affordability and higher mortgage rates have softened prices from last year's all-time highs. While this moderation was inevitable given the meteoric rise in prices from mid-2020, housing market technicals continue to be supportive as supply remains lighter in many areas (2.6 months in Apr./record low 1.8), listings continue to sell quickly (22 days on market in Mar./record low 14) and the rental market remains on firm footing. Regarding inventories, March's existing home sales data revealed that there were just 1.04 million previously owned homes for sale, down nearly 20% since last Summer (cycle low 850,000, Jan. 2022), which should provide a cushion to more meaningful depreciation in coming quarters. In total, 10 of the 20 cities continued to show annual price gains, albeit well-off of their cycle highs last year, with Miami (+7.7%), Tampa (+4.9%) and Charlotte (+4.7%) posting the largest annual gains, with San Diego (-5.4%), San Francisco (-11.2%) and Seattle (-12.4%) rounding out the bottom three. While price appreciation has surely slowed as affordability continues to wane and mortgage rates remain high, demand is still strong in many areas and migration away from larger cities should support elevated home prices for much of the country in the near term. On a national basis, the housing price index rose +.66% for the year ended March, well below March's 20.8% all-time record high (1988 index inception) and the smallest annual gain since May 2012. All in all, market participants expected lower home prices given the sharp rise in mortgage rates over the past year and the sheer magnitude of price appreciation during the pandemic, with these factors and potential credit contraction from recent bank failures now likely to dictate how far prices will fall this year

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



Source: Bloomberg as of 6/1/2023

The number of available jobs unexpectedly rose to 10.1 million in April (9.40 est./9.75 Mar.), the first increase in four months and still indicative of durable labor markets tightness driven by chronic labor shortages and still robust demand. By industry, job openings increased in retail trade/transportation (+329,000), healthcare services (+185,000) and construction (+68,000), with declines in leisure & hospitality (-86,000), government (-71,000) and manufacturing (-26,000), as employers continue to report difficulty recruiting and retaining enough workers to keep up with strong 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 hindered 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; 2.3% Dec. 2019), shy of last March's all-time high (3%) but still elevated, as higher compensation, new employee incentives and the magnitude of job vacancies continue to drive higher employee turnover. Further evidence of job market tightness can be seen in the layoffs and discharge rate, which ticked down to 1.0% during April (record low .9% December 2021) and the 1.8x 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 indicative of tight labor markets. To be sure, durable labor shortages have forced companies to raise compensation to recruit and retain workers, with little relief expected during the first half of 2023. While labor market imbalances should recede given FOMC rate hikes and softening demand, we believe the JOLTS data will remain high as the pandemic and elevated, state-level direct economic assistance drove structural changes to the labor force that have hampered the return to pre-pandemic levels of participation. While demand for labor appears to be cooling given the cumulative decline of over 1.1 million job vacancies during the first four months of this year, open positions and the job openings rate (6.1% Apr.; 7.4% peak Mar. 2022) remain historically high and will likely support robust wage growth in the coming months as labor supply and demand imbalances endure.

The Week Ahead

The data calendar remains light over the next week, headlined by Non-Farm Payrolls, ISM Services and Initial Jobless Claims. Looking ahead, markets remain focused on inflation, employment data and a potential pause in the FOMC's current tightening cycle. On the new issue front, ABS volumes surged during May and came in at the highest monthly level of 2023, with 42 deals totaling $29.5 billion priced and $118.3 billion year to date ($133.2 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance also finished May strong, with $149.5 billion priced and $610 billion year to date ($680.9 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 robust.

Friday 6/2

Non-Farm Payrolls

Monday 6/5

ISM Services; Factory Orders

Tuesday 6/6

No Data

Wednesday 6/7

Consumer Credit; MBA Mortgage Applications

Thursday 6/8

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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