Fixed Income Market Insights

January 27, 2023

Key takeaways

Bond yields were fractionally higher this week, with GT2s up 3 basis points and GT10s higher by 5 basis points and 2s/10s more inverted by 2 basis points (-68), as the reaction to stronger headline GDP and Durable Goods orders was tempered by underlying metrics trending towards slower consumption in the months to come. On the data front, Real GDP was up for a second consecutive quarter and grew at a 2.9% annualized rate during the fourth quarter, where a jump in the pace of inventory expansion and narrowing of the trade gap offset another sharp decline in residential fixed investment and slower consumer spending growth. U.S. durable goods orders were much stronger than expected in December, driven exclusively by a surge in the volatile commercial aircraft order component, reversing November's steep decline, which offset broad-based weakness across much of the capital goods sub-sector. Headline PCE prices were up .1% for the second consecutive month in December as lower goods prices were more than offset by higher prices for food, rents and other services.

We suggest

We continue to prefer playing rate defense given relatively low market rates, 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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Fed Action and M2 Contraction

As those regular readers of this publication will know, we have long lamented the meteoric rise in money supply and the excess inflation created by extraneous amounts of fiscal stimulus heaped upon a post-pandemic economy already on the mend. Indeed and during the pandemic years of 2020 and 2021, a key measure of money supply known as M2, which is comprised of currency and coins in circulation, checking and saving accounts, money market accounts, certificates of deposit as well as other liquid deposits, ballooned by over 40%, or approximately $6 trillion. Naturally, this triggered a buying frenzy by both the employed and unemployed that far exceeded the capacity of an already diminished supply-chain, as producers and logistics companies alike struggled with raw material and labor shortages, pressuring goods prices sharply higher through the first half of 2022. After the FOMC's inexplicable delay in tightening monetary policy based upon their 'transitory' theories regarding the fastest inflation in over 40 years, Powell and company started raising rates last March and ultimately heaped on 425 basis points of rate hikes last year, which has swung the money supply pendulum decidedly into contractionary territory.

Market Snapshot

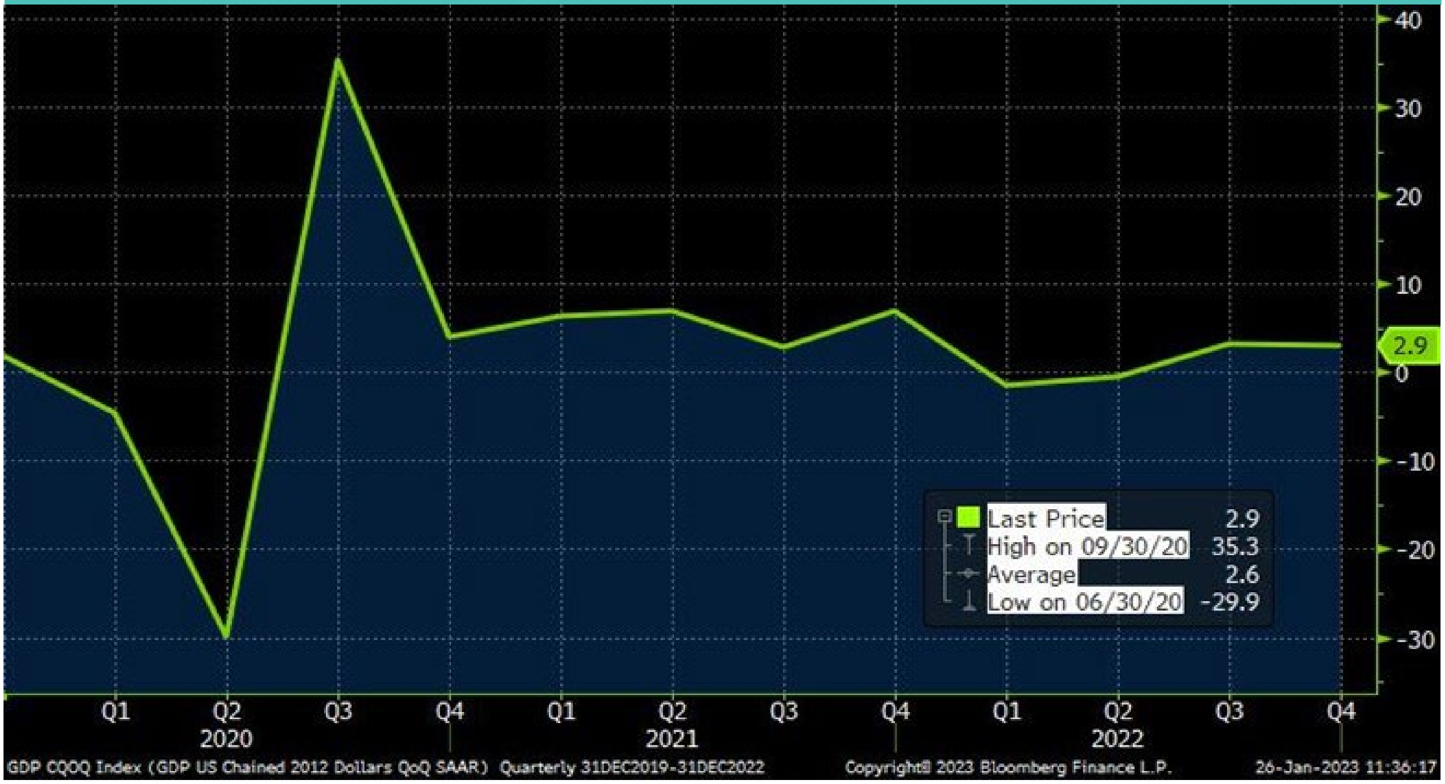
	This week 1/27/23	Last week 1/20/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	4.80%	4.82%	-2	-0.41%	0.63%
SOFR	4.30%	4.31%	-1	-0.23%	0.00%
2-year US Treasury	4.21%	4.17%	4	0.96%	-4.97%
5-year US Treasury	3.62%	3.56%	6	1.69%	-9.73%
10-yr US Treasury	3.52%	3.48%	4	1.15%	-9.28%
2s-10s UST Spread	-69.00	-70.00	1.00	-1.43%	25.45%
DJIA	34,119	33,348	771.00	2.31%	2.93%
S&P 500	4,090	3,958	132.00	3.34%	6.51%
Spot Gold	1,946	1,931	15.00	0.78%	6.57%
WTI (Oil) Current Contract	79.46	81.31	-1.85	-2.28%	-1.00%
1-year Brokered CD	4.70%	4.70%	0	0.00%	2.17%
5-year Brokered CD	3.80%	3.90%	-10	-2.56%	-5.00%
5-year Bullet US Agency	3.71%	3.66%	5	1.37%	-9.07%
5-year/NC1yr Callable US Agcy.	5.05%	5.02%	3	0.60%	-6.48%
CDX IG Spread Index	71.32	74.64	-3.32	-4.45%	-13.05%
CDX High Yield Index Spread	102.77	102.02	0.75	0.74%	2.14%
15-yr UMBS	4.06%	4.11%	-5	-1.22%	-12.88%
30-yr UMBS	4.81%	4.85%	-4	-0.82%	-9.76%

Source: Bloomberg data as of 3:15pm ET 1/27/2023 and 3:00pm ET 1/20/2023

As higher interest rates have increased finance charges, a growing amount of personal savings has been expended by either paying elevated financing rates or, in some cases, by outright cash purchases of larger-ticket items, further draining system-wide cash and near-cash balances. Indeed, M2 actually contracted during the year ended December 2022, the first contraction since the 1960's, which has already started to moderate prices for both goods and services, with clear signs of disinflation in the former, as retailers have discounted prices on a wide array of products to clear excess inventories during the fourth quarter of last year. While a mountain of excess savings still remains to kick off 2023, current burn rates suggest that this will be expended by the fourth quarter, which will likely dampen personal consumption further and elevate the risks of a harder economic landing later this year. That said, job creation has remained resilient, with jobs openings abundant and a near 50-year low unemployment rate (3.5%), and inflation for many goods and some services has cooled considerably from the pandemic peak, both elements necessary to achieve the economic equivalent of nirvana- a soft landing. More to follow!

All quiet on the fiscal front as both houses of Congress returned from recess earlier this week. Among several legislative imperatives, negotiation of the debt ceiling will be front and center in the weeks to come. Stay tuned!

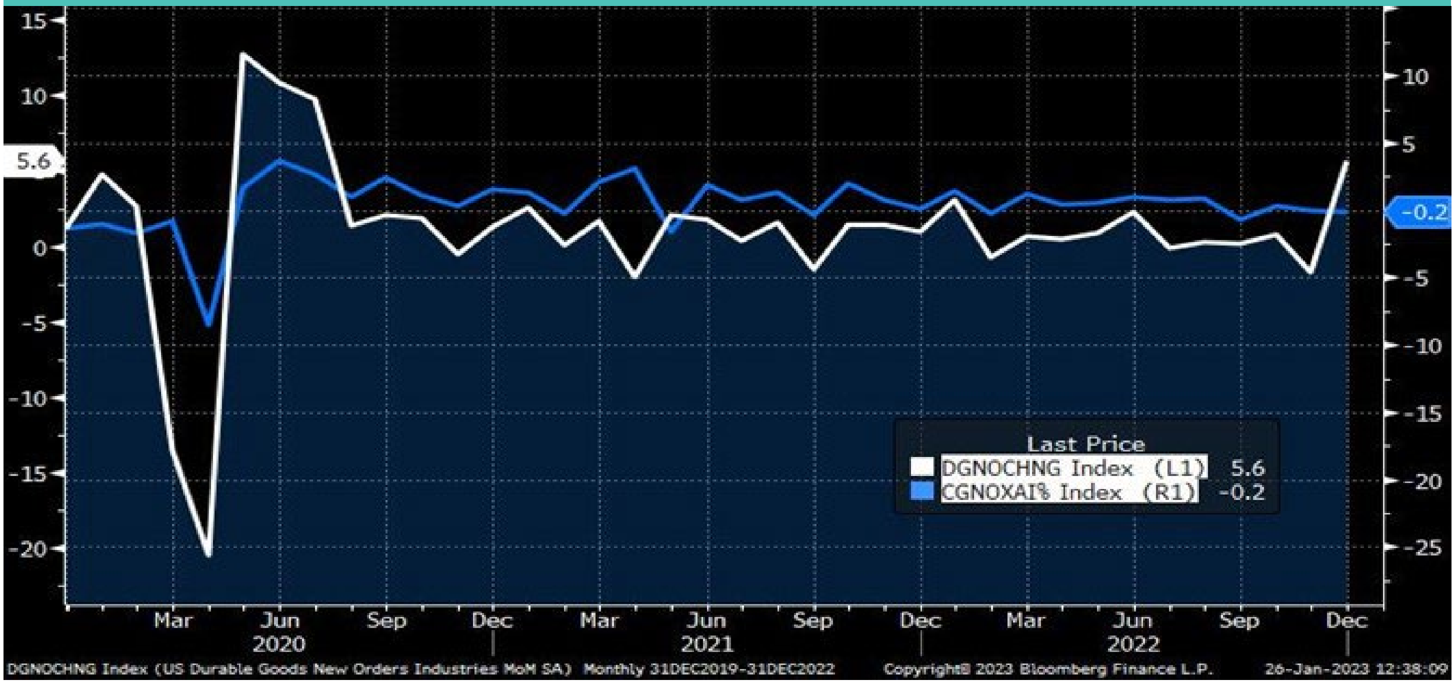
US Real GDP & GDP Price Index Annualized QoQ Change – Quarterly – 2 years



Source: Bloomberg as of 1/27/2023

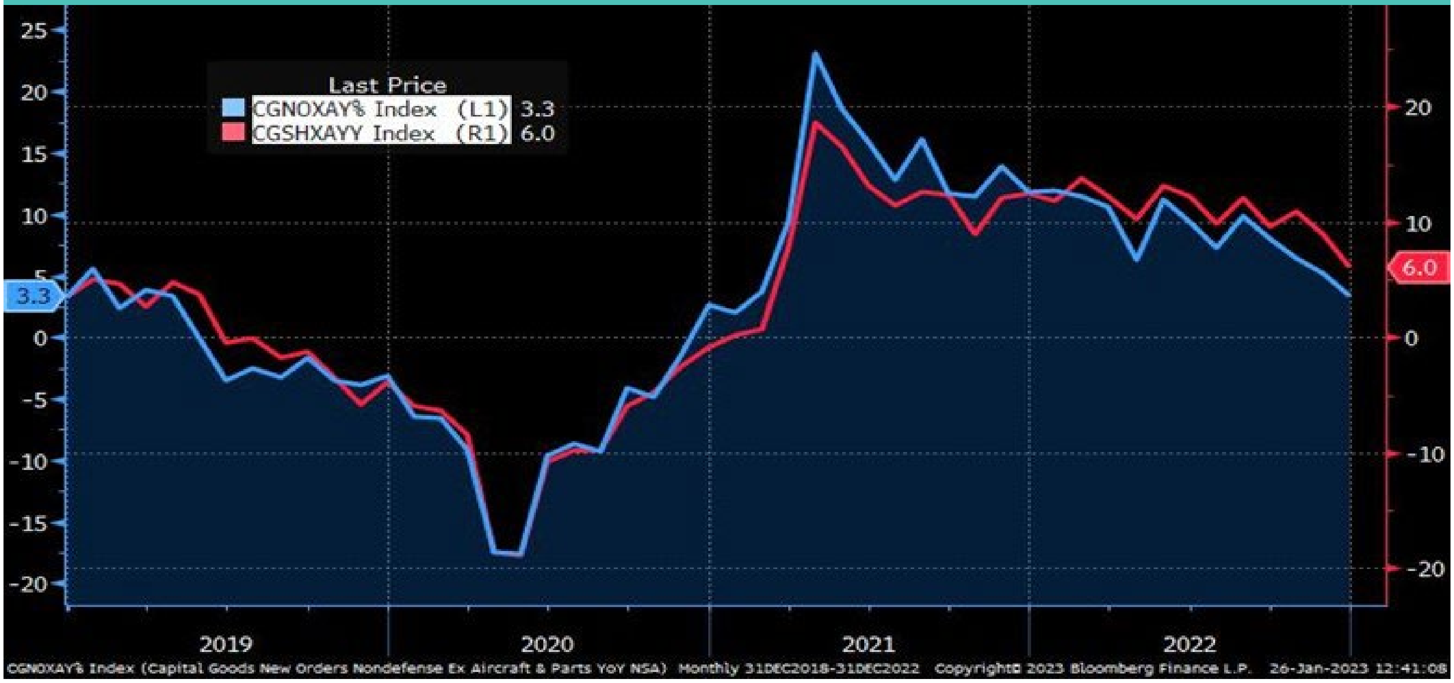
Real GDP was up for a second consecutive quarter and grew at a 2.9% annualized rate during the fourth quarter (+.2.6% est.; +3.2% Q3), where a jump in the pace of inventory expansion (+1.5% of top line) and narrowing of the trade gap (+.6% to top line) offset another sharp decline in residential fixed investment and slower consumer spending growth. On the consumption side, consumer spending slowed to +2.1% during the quarter (+2.3% Q3), confirming the recent trend of rotation away from goods and into services, which came in at +1.1% and +2.6% respectively. Surely more ominous was the anemic advance 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 grew a mere +.2% during the quarter (+1.1% Q3/+.5% Q2), the lowest level since the second quarter of 2020. Additionally, inflation-adjusted residential and business fixed investment (equipment) dropped -26.7% and -3.7% respectively as rising interest rates and elevated prices continue to erode purchasing power. On the inflation front, yesterday's report revealed another, stubbornly high 3.9% annualized increase in the Core PCE deflator (+4.7% Q3 & Q2), a condition expected by most consumers and businesses to persist in the near term. All in all, while a second consecutive quarterly rebound in GDP was welcome news, the headline number masked the trend of underlying weakness in residential and business investment and softer final sales to private domestic buyers, which posted the second-lowest reading of the post-pandemic recovery period, as the negative impact of higher interest rates and elevated inflation continue to weigh on consumers and businesses.

U.S. Durable Goods & Core Capital Goods Non-Defense Ex Air New Orders MOM % – Monthly – 3 Years



Source: Bloomberg as of 1/27/2023

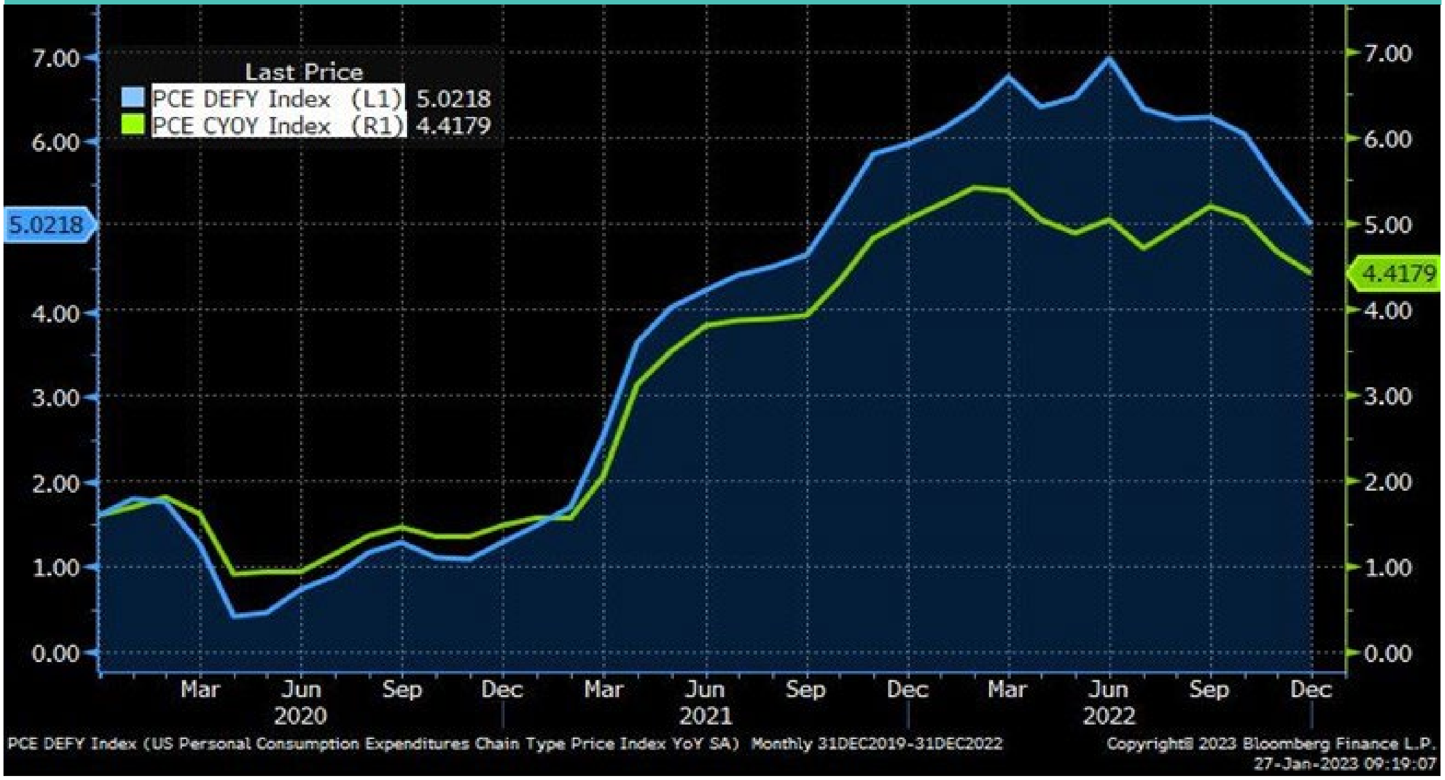
Core Capital Goods Orders & Shipments Non-Defense Ex Air YOY % – Monthly – 4 Years



Source: Bloomberg as of 1/27/2023

U.S. durable goods orders were much stronger than expected in December, with the headline up +5.6% (+2.5% est), driven exclusively by a surge in the volatile commercial aircraft order component, reversing November's steep decline, which offset broad-based weakness across much of the capital goods sub-sector. While demand for equipment and other fixed business investment (excluding aircraft and military hardware) remained resilient for much of 2022 as companies push to increase production and invest in labor-saving technologies, new orders slowed dramatically during the fourth quarter. This metric, known as core capital goods orders, dropped -.2% in December, which rendered three-month and year-over-year growth rates to .3% and 5.4%, a sharp slowdown from the 3.2% and 7.9% run rates during the third quarter. All in all, last month's data revealed a meaningful slowdown in larger-ticket spending (ex-aircraft) during the last 3 months of last year, a moderation well-underway given FOMC rate hikes and heightened risk of recession, both of which may dampen new order momentum in the months to come.

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



Source: Bloomberg as of 1/27/2023

Headline PCE prices were up .1% for the second consecutive month in December (0% survey) as lower goods prices were more than offset by higher prices for food, rents and other services. Indeed, the recent trend of goods disinflation and stronger services prices continued last month, with goods prices down -.7% and services up +.5% in December, and +4.6% and +5.2% for all of 2022. Notwithstanding the last few months of moderation, headline PCE prices were still up 5.0% during the past year, a slow descent from this 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 moved sharply higher since the first quarter of 2021 as higher food and energy prices, elevated rents and persistent labor and materials shortages have slowed production alongside of still robust demand, further pushing prices higher. The Core PCE Deflator (excluding food and energy) reaccelerated in December, up .3% for the month and higher by 4.4% over the past year, a minor deceleration versus September's annual increase (5.2%) and clear evidence that today's broad-based inflation remains stubbornly high and increasingly sticky. That said, Core PCE price index advances have started to moderate, running 3.9%, 4.4% and 4.9% (Dec-Oct) on a three-month annualized basis, surely welcome news for the FOMC and data that supports another step-down in the sizing of the Fed's next rate hike, with an eye towards a pause during the first quarter of this year. All in all, another benign inflation report that supports slowing the pace of monetary policy tightening and all but cements a 25-basis point rate hike by the FOMC at the February 1st meeting.

The Week Ahead

The data calendar remains full next week, headlined by the FOMC Rate Decision, Non-Farm Payrolls, JOLTS Job Openings and ISM Services. Looking ahead, markets remain focused on inflation, jobs data and further signs of softer economic activity. On the new issue front, ABS volumes remained robust during the last week of January with nine deals totaling $5.08 billion priced through the 26th and $19.1 billion year to date ($23.3 billion for Jan. 2022; $276.7 billion for 2022) and IG corporate issuance was again robust with $26 billion in deals priced through the 26th and $136.2 billion year to date ($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, market conditions have improved significantly since the start of the year and the new deal landscape is again attractive for a wider breadth of ABS and corporate issuers as investor demand remains robust.

Monday 1/30
Dallas Fed Manufacturing Activity

Tuesday 1/31
Consumer Confidence; Employment Cost Index; S&P CoreLogic U.S. HPI

Wednesday 2/1
FOMC Rate Decision; JOLTS Job Openings; ISM Manufacturing

Thursday 2/2
Factory Orders; Weekly Jobless Claims

Friday 2/3
Non-Farm Payrolls; ISM Services

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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