Fixed Income Market Insights

January 20, 2023

Key takeaways

Bond yields were again lower this week, with GT2s down 6 basis points and GT10s lower by 3 basis points and 2s/10s less inverted by 3 basis points (-70), as weaker retail sales and benign PPI data fueled speculation of a deeper contraction in consumer spending during the first half of the year. On the data front, headline PPI came in weaker than expected during December with prices down -.5% (+6.2% last 12 months), the most since April 2020, driven by sharply lower energy, a partial reversal of last month's outsized gains in food and larger than expected moderation in services costs. Headline retail sales contracted for the second consecutive month in December (-1.1%), the largest drop since December 2021, driven by broad-based declines across the goods sector and reflective of slower volumes and deeper discounting to clear excess inventory as demand cools back towards pre-pandemic levels.

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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Has Retail Sailed?

This week's economic data was headlined by Producer Price Index (PPI) and Retail Sales releases for December, which revealed further disinflation in goods prices and demonstrably weaker consumer spending during the fourth quarter of 2022. On the inflation front, PPI data underscored the trend away from spending on goods in favor of services, with prices for the former sliding 1.6% last month, the second largest monthly decline of 2022 (-1.8% July), driven by another month of lower energy costs, an unexpected drop in food prices and further moderation in services outlays. Regarding retail sales, last year ended with a whimper, with headline consumer purchases declining in the last two months of the 4th quarter, typically holiday-related bounce territory for retailers, as the cumulative effects of higher interest rates, elevated inflation and surging credit card debt weighed on spending patterns across a wider swath of the economy that had been seen for most of 2022. Indeed, holiday sales during the last two months of the year (excluding autos, gas and restaurants) rose by a mere 5.3% versus the same period in 2021, short of the National Retail Federation's forecast of 6% to 8% growth. Perhaps more daunting, the sales data are not adjusted for inflation, which ran hotter than receipts for many types of goods and services, indicating that volumes are also starting to wane.

Market Snapshot

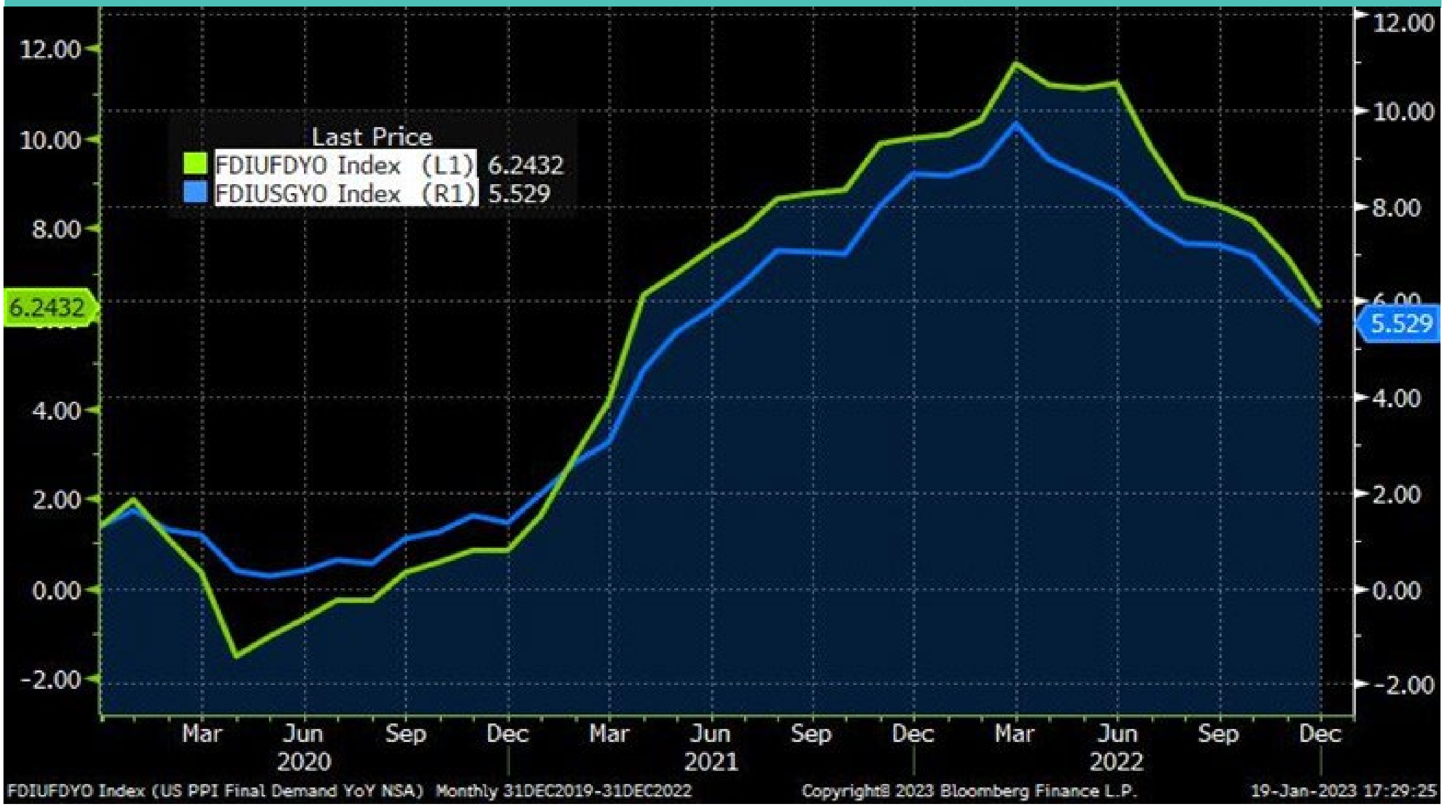
	This week 1/20/23	Last week 1/13/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	4.82%	4.83%	-1	-0.21%	1.05%
SOFR	4.31%	4.30%	1	0.23%	0.23%
2-year US Treasury	4.17%	4.23%	-6	-1.42%	-5.87%
5-year US Treasury	3.56%	3.61%	-5	-1.39%	-11.22%
10-yr US Treasury	3.48%	3.51%	-3	-0.85%	-10.31%
2s-10s UST Spread	-70.00	-72.00	2.00	-2.78%	27.27%
DJIA	33,348	34,207	-859.00	-2.51%	0.61%
S&P 500	3,958	3,987	-29.00	-0.73%	3.07%
Spot Gold	1,931	1,924	7.00	0.36%	5.75%
WTI (Oil) Current Contract	81.31	79.71	1.60	2.01%	1.31%
1-year Brokered CD	4.70%	4.70%	0	0.00%	2.17%
5-year Brokered CD	3.90%	4.05%	-15	-3.70%	-2.50%
5-year Bullet US Agency	3.66%	3.69%	-3	-0.81%	-10.29%
5-year/NC1yr Callable US Agcy.	5.02%	5.05%	-3	-0.59%	-7.04%
CDX IG Spread Index	74.64	70.90	3.74	5.28%	-9.00%
CDX High Yield Index Spread	102.02	102.94	-0.92	-0.89%	1.39%
15-yr UMBS	4.11%	4.11%	0	0.00%	-11.80%
30-yr UMBS	4.85%	4.81%	4	0.83%	-9.01%

Source: Bloomberg data as of 3:00pm ET 1/20/2023 and 2:15pm ET 1/13/2023

Additionally, Industrial Production data released this week also finished off the fourth quarter with broad-based weakness, with three consecutive months of contraction, including a 1.3% decline in factory output in December, rendering the slowest quarter for manufacturing since the early days of the pandemic. All in all, the fourth quarter data revealed that both consumption and investment (business and residential) have started to sputter, with the latter well underway given the more immediate impact on larger ticket purchases of 425 basis points of monetary policy tightening by the Federal Reserve during 2022. While pandemic-related, excess savings ($1+ trillion est.) helped consumers continue spending last year and should buffer a meaningful downturn in the near term, most expect these funds to largely wind down as we approach the fourth quarter of this year, further elevating the risks of a more protracted, consumption-led economic downturn that could very well tip the economy into recession during the second half of 2023. To be sure, first quarter employment and spending data will shed more light on the real health of the consumer sector during 2023, which should be supported by tight labor markets and higher nominal wages, both conditions that make it premature to postulate that the proverbial economic ship has already sailed.

All quiet on the fiscal front as both houses of Congress were again in recess. 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!

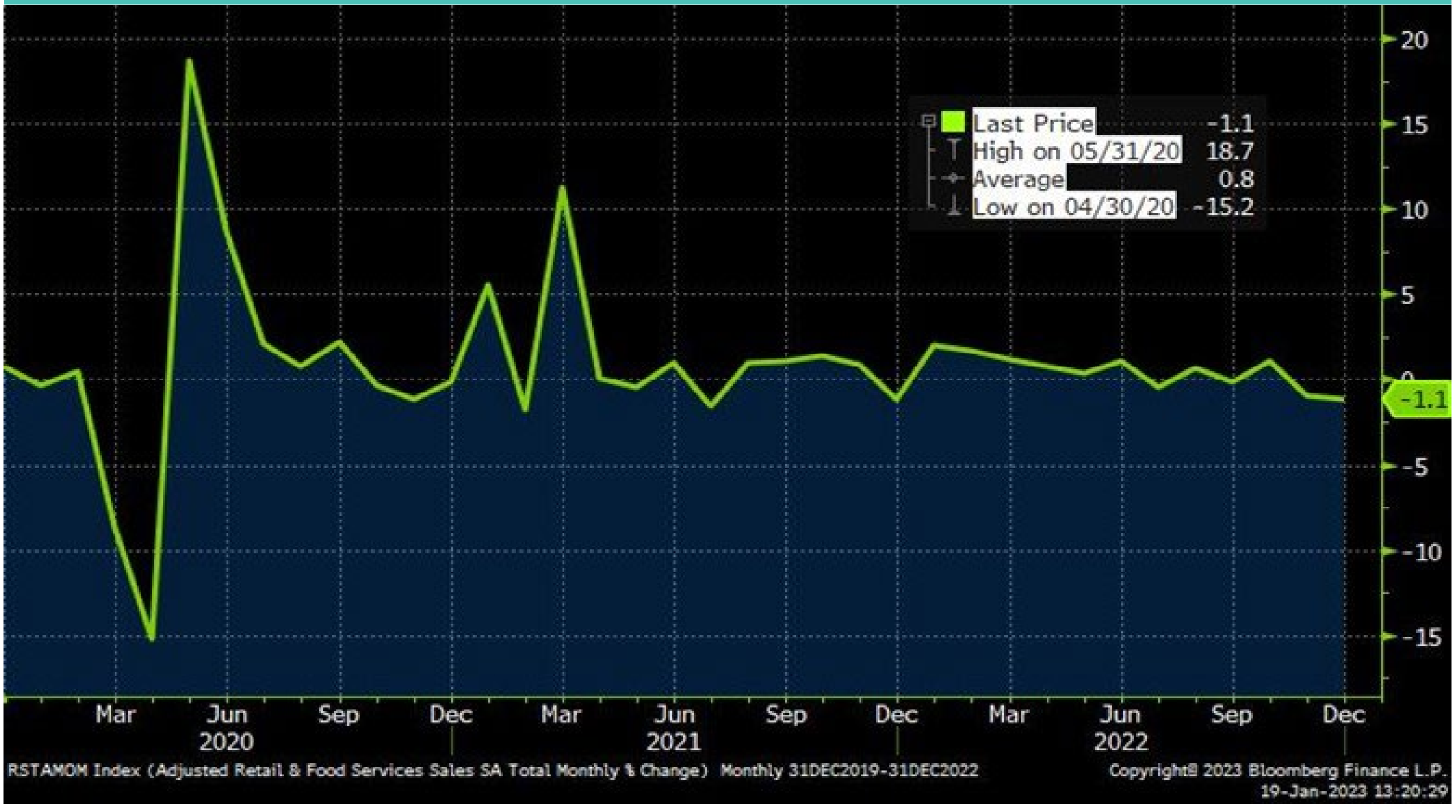
PPI Final Demand – Headline & Core YoY – Monthly – 3 years



Source: Bloomberg as of 1/20/2023

Headline PPI came in weaker than expected during December with prices down -.5% (-.1% est.; +6.2% last 12 months), the most since April 2020, driven by sharply lower energy, a partial reversal of last month's outsized gains in food and larger than expected moderation in services costs. In the aggregate, both goods and services prices were mixed, with goods plummeting by -1.6% (+8.0% year over year) and services up a tepid +.1% (+5.0% year over year) last month, the slowest monthly gain in eight months, further evidence of a durable shift towards services and faster cooling of goods prices. Core PPI (less food and energy) came in as expected with prices up .1% last month (+.1 est.; +4.6% last 12 months), well off March's 9.7% cycle high, but still indicative elevated inflationary pressures away from food and energy. As with much of the past year and a half, the durability of these cost increases has enabled businesses to raise prices, which have been passed along to consumers and served to keep inflation expectations elevated above the FOMC's stated target of 2%. As reported in the NFIB Small Business Optimism index this week, more than 43% (all-time high of 66 in March 2022) of small businesses surveyed stated that they raised selling prices last month and a near record 44% of respondents said they raised compensation to attract and retain employees, both likely to add to pricing pressures in the months to come. That said, loosening supply chain bottlenecks and slower goods demand have dampened the cost of processed goods for intermediate demand, reflecting prices earlier in the production pipeline, which fell -2.8% in December (+4.7% year over year), the sixth consecutive monthly decline, driven by a -10.9% drop in processed energy prices, which accounted for over 80% of last month's decrease. Notwithstanding softer goods prices and some pipeline pressure relief, underlying inflationary pressures remain elevated, particularly in food and wages, given the ongoing conflict in Ukraine and durable labor shortages in the U.S. All in all, a weaker report that reflects continued goods disinflation and further moderation of services prices, all welcome news for the FOMC that all but cements a 25 basis point increase in the Federal Funds rate at the February 1st meeting.

Retail Sales Advance MoM – Monthly – 3 Years



Source: Bloomberg as of 1/20/2023

Headline retail sales contracted for the second consecutive month in December (-1.1% vs. -.09% est.), the largest drop since December 2021, driven by broad-based declines across the goods sector and reflective of slower volumes and deeper discounting to clear excess inventory as demand cools back towards pre-pandemic levels. In total, 10 of 13 categories posted declines last month, led by lower receipts for gasoline stations (-4.6%), furniture (-2.5%), eating/drinking outlets (+1.6%), motor vehicles/parts (-1.2%), electronics (-1.1%), non-store retailers (-1.1%), food and beverage (-.9%), and general merchandise (-.8%). To be sure, sales volumes have slowed and breadth of gains have narrowed given rate hikes and higher prices, with fourth quarter headline retail sales up just .5% on an annualized basis, demonstrably lower than the third quarter's 3.1% pace. Additionally, control-group sales, which exclude food services, auto dealers, building-material stores and gasoline stations and feed directly into GDP calculations, fell -.7% in December and were up 1.9% on an annualized basis during the fourth quarter of last year, a meaningful pullback from the 7.4% advance during the third quarter. While labor market strength and excess liquidity via pandemic stimulus have propelled consumer spending, with retail sales up 9.2% for 2022 (second highest annual tally since 1993), surging credit card balances and near-record low savings rates have increased the risks of a deeper contraction in consumption in the months to come, particularly given the likelihood of more rate hikes during the first quarter and the cumulative effects of last year's monetary policy tightening. All in all, a weak report that will get the attention of the FOMC, but not get in the way of a 25-basis point rate hike at the February 1st meeting.

The Week Ahead

The data calendar heats up next week, headlined by the PCE Deflator, GDP (4th Quarter) and Durable Goods Orders. Looking ahead, markets remain focused on inflation, jobs data and further signs of slower economic activity. On the new issue front, ABS volumes ramped up during the third week of January with eight deals totaling $8.41 billion priced through the 19th and $12.4 billion year to date ($23.3 billion for Jan. 2022; $276.7 billion for 2022) and IG corporate issuance slowed from last week's blistering pace with $16.1 billion in deals priced through the 19th and $110.2 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 1/23

Leading Index

Tuesday 1/24

S&P Global Manufacturing & Services

Wednesday 1/25

MBA Mortgage Applications

Thursday 1/26

GDP (4th Quarter Advance); Durable Goods Orders; New Home Sales; Weekly Jobless Claims

Friday 1/27

PCE Deflator

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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