Fixed Income Market Insights

August 10, 2023

Key takeaways

Bond yields moved lower this week, with GT2s down 7 basis points and GT10s lower by 10 basis points respectively, and 2s/10s more inverted by 3 basis points (-73), driven by another month of benign CPI data and some signs of cooling in the jobs market. On the data front, Headline Non-Farm Payrolls again came in weaker than expected with 187,000 new jobs added in July, the slowest two-month advance since January 2021, as another month of moderating growth in private payrolls (services), negative revisions and a decline in hours worked may portend further weakness in job creation in the months to come. The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, was fractionally higher at 91.9 during July, the highest level since November 2022, but still hovering near pandemic-era lows as chronically elevated inflation, higher interest rates and diminished business expectations continue to weigh on sentiment. Headline CPI rose a tepid +.2% for the second consecutive month during July and up 3.2% over the past year, the second smallest annual gain since March 2021, as another drop in core goods prices was offset by an increase in energy and another month of slower advances in services and food/beverage prices.

We suggest

We continue to prefer playing defense given elevated inflationary expectations and the likelihood of higher short-term rates in the quarters to come. We favor barbell strategies in securitized products, anchored by short, higher current cash flow assets and longer, high quality bonds.

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As the Consumer Turns

As investors and other market participants grapple with handicapping the likelihood and timing of the most anticipated recession in decades, some troubling data regarding the ultimate financial well-being of consumers and small business continue to mount and may portend further deterioration in consumption and investment during the second half of 2023. Indeed, we highlighted surging delinquency rates for auto loans two weeks ago, a good leading indicator of future consumer credit performance, where late payments for both Prime and Subprime borrowers jumped to 12 year and all-time highs respectively during May, surely worsened by the highest financing rates seen since the run-up to the Great Financial Crisis (GFC) during 2007. Another form of consumer and small business debt, commonly referred to as 'Marketplace Loans' (MPL), have also started to show signs of stress with the share of borrowers late on their payments now at the highest level since late 2015. Marketplace lending, which gained prominence post the GFC when traditional bank lenders retreated, connects both borrowers and investors directly, predominately via online platforms, and feature fast approval times, shorter loan maturities and generally higher financing rates relative to other types of traditional funding.

Market Snapshot

	This week 8/10/23	Last week 8/3/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.63%	5.63%	0	0.00%	18.03%
SOFR	5.30%	5.30%	0	0.00%	23.26%
2-year US Treasury	4.82%	4.89%	-7	-1.43%	8.80%
5-year US Treasury	4.20%	4.29%	-9	-2.10%	4.74%
10-yr US Treasury	4.09%	4.19%	-10	-2.39%	5.41%
2s-10s UST Spread	-73.00	-70.00	-3.00	4.29%	32.73%
DJIA	35,252	35,248	4.00	0.01%	6.35%
S&P 500	4,478	4,510	-32.00	-0.71%	16.61%
Spot Gold	1,947	1,970	-23.00	-1.17%	6.63%
WTI (Oil) Current Contract	82.96	81.55	1.41	1.73%	3.36%
1-year Brokered CD	5.25%	5.25%	0	0.00%	14.13%
5-year Brokered CD	4.45%	4.50%	-5	-1.11%	11.25%
5-year Bullet US Agency	4.32%	4.40%	-8	-1.82%	5.88%
5-year/NC1yr Callable US Agcy	5.65%	5.72%	-7	-1.22%	4.63%
CDX IG Spread Index	66.66	67.09	-0.43	-0.64%	-18.73%
CDX High Yield Index Spread	102.72	102.74	-0.02	-0.02%	2.09%
15-yr UMBS	5.33%	5.44%	-11	-2.02%	14.38%
30-yr UMBS	5.78%	5.91%	-13	-2.20%	8.44%

Source: Bloomberg data as of 3:00pm ET 8/10/2023 and 2:30pm ET 8/3/2023

While there tends to be credit tiering amongst MPL issuers, ranging from borrowers with Subprime to Super-prime credit scores, a common thread has been the sharp rise in cumulative net losses (CNL) for more recently dispersed loans, particularly those originated in 2021 and 2022. Indeed, CNL for asset-backed securities (ABS) backed by MPL issued during 2022 have soared, in some cases nearly doubling versus loans disbursed in 2021, as the weight of higher interest rates, steamy inflation and depleted savings have pushed more borrowers into delinquency and ultimately default. Accordingly, credit rating agencies have started to either place on 'negative watch' or downgrade the riskier ABS classes in selected 2022 securitizations backed by MPL, with the risk of principal loss near the highest levels observed since the sector's inception post the GFC. Notwithstanding the resilience seen in the job market and, by extension, the economy, we believe that the weight of 525 basis points in FOMC rate hikes, still elevated inflation, record-high credit card debt and financing charges ($1.03 trillion/20.5%), tighter credit conditions and the depletion of pandemic-era excess savings will push delinquencies and defaults higher during the second half of this year, likely triggering deeper reduction in consumption and investment as we enter 2024. Judging by credit spread performance for ABS and corporate bonds this year, currently at or near 2023 tights, investors appear to be relying on the FOMC to cut the Federal Funds rate early in 2024 to bail out debtors, along with a little bit of hope.

All quiet on the fiscal front as Congress remains in summer recess until September 5th. Away from that, the Biden administration continues to promote plans to cancel $39 billion of certain federal student loan debt for more than 800,000 borrowers that have been paying down still outstanding loans for more than 20 years, citing the Higher Education Act of 1965 as enabling legislation. As expected, the first lawsuit challenging the legality of this latest forgiveness plan was filed last week by the New Civil Liberties Alliance (NCLA), underpinned by the argument that the proposed plan violates the Constitution's Appropriations Clause, which affords Congress the sole authority to cancel debt owed to the U.S. Treasury. Stay tuned!

US Non-Farm Payrolls MoM Net Change – Monthly – 2 years

NFP Total
Mining, Logging & Construction
Manufacturing
Services (Lower Paying)
Services (Higher Paying)
Government

800
600
400
187.0000
20.0000

Sep 2021 Dec Mar Jun 2022 Sep Dec Mar 2023 Jun

NFP TCH Index (US Employees on Nonfarm Payrolls Total MoM Net Change SA) NFP Monthly Change Monthly 31JUL2021-31JUL2023
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Source: Bloomberg as of 8/10/2023

Unemployment Rate and Average Hourly Earnings % YOY Change – Monthly – 2 years

Last Price
AHE YOY% Index 4.4
USURTOT Index 3.5

6.0
5.5
5.0
4.5
4.4
4.0
3.5

Sep 2021 Dec Mar Jun 2022 Sep Dec Mar 2023 Jun

AHE YOY% Index (US Average Hourly Earnings All Employees Total Private Yearly Percent Change SA) Monthly 31JUL2021-31JUL2023
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Source: Bloomberg as of 8/10/2023

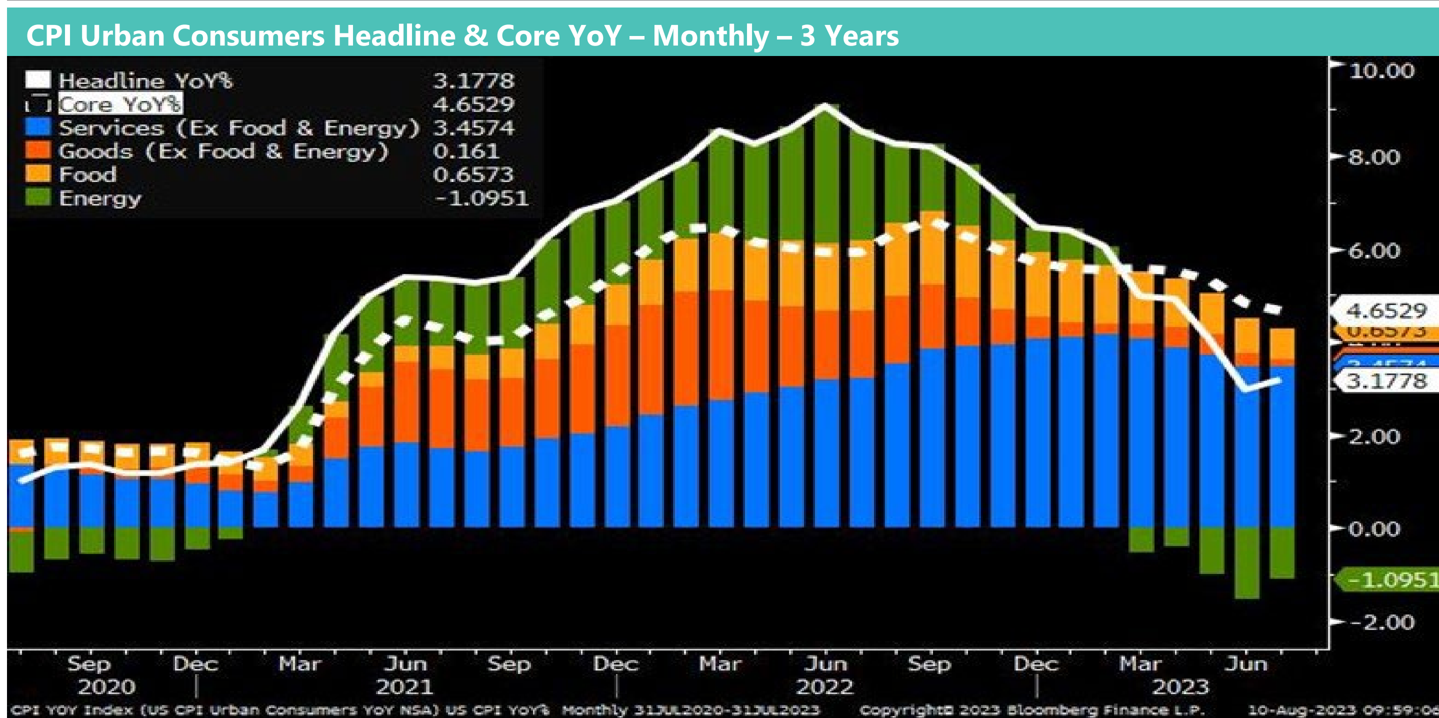
Headline Non-Farm Payrolls again came in weaker than expected with 187,000 new jobs added in July (200,000 est./185,000 Jun.), the slowest two month advance since January 2021, as another month of moderating growth in private payrolls (services), negative revisions and a decline in hours worked may portend further weakness in job creation in the months to come. Taken together with revisions that subtracted 49,000 jobs in the prior two months, job creation has slowed, though still healthy with average monthly gains of 218,000 over the last three months, a deceleration from the first quarter's 312,000 pace (vs. 284,000 Q4 2022). Looking by industry revealed broad based gains, albeit at a slower pace, led by advances in healthcare (+87k), financial activities (+19k), construction (+19k), leisure/hospitality (+17k) and government (+15k), which were partially offset by declines in temporary help (-22k) and non-durable goods (-10k). Beyond the softer headline number, the other big takeaways were the drop in the unemployment rate (3.5%/3.6% Jun.) and the uptick in average hourly earnings (+.4%/+.3% est. 4.4% YOY/4.2% est.), conditions that may pave the way for another rate hike this year given the durable tightness of labor markets and sustainability of elevated, nominal wage gains post pandemic. Regarding the labor market, last week's JOLTS job openings (9.6 million), the number of available positions per unemployed worker (1.6x) and quits rate (2.4% or 3.8 million jobs) remain historically high, suggesting that wage inflation will remain durable in the near term. Additionally, labor participation remains nearly a percentage point lower than the 2019, pre-pandemic high as elevated retirement rates, skill mismatches and increased entrepreneurship have stunted efforts to fill millions of job openings. This lower participation has driven down the unemployment rate, which fell to 3.5% last month, just above April's cycle low of 3.4% (lowest since 1969) and a key driver of higher average hourly earnings (4.4% YOY), both conditions expected to persist in the coming months. All in all, a weaker report that revealed another month of slower job that, when taken with downward revisions and lighter hours worked, may presage further cooling in the labor market and, ultimately, some relief from still elevated nominal wage growth.

NFIB Small Business Optimism – Monthly – 2 Years

Source: Bloomberg as of 8/10/2023

The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, was fractionally higher at 91.9 during July (91.3 est.; 91.0 Jun.), the highest level since November 2022, but still hovering near pandemic-era lows (89.5 June 2022) as chronically elevated inflation, higher interest rates and diminished business expectations continue to weigh on sentiment. On the inflation front, 21% of respondents reported that inflation was their most significant business problem, an improvement from 24% during June and shy of last July's cycle high 37% print (highest since 1979), but still historically high and reflective of the durable nature of inflationary pressures impacting small businesses. Additionally, labor quality exceeded inflation as the largest business problem at 23%, again reflective of elevated labor market friction as companies push to find qualified candidates for millions of open positions. Indeed, a full 42% of small businesses said they had unfilled job openings (51% record high; May 2022) and 38% stated they have increased compensation over the last three months to add new workers as chronically tight labor markets continue to compound wage pressures. As with other elevated input costs, higher labor expenses are being passed along to customers with 25% of the small businesses surveyed stating that they anticipate higher selling prices, a drop from March 2022's all-time high of 66% (1974 inception) and the lowest share since January 2021, but still historically high. The combination of still elevated inflation and chronic labor shortages have dampened optimism, with businesses expecting better economic conditions over the next six months running at -30% last month, a 10-point improvement versus June (-40) and better since last June's -61% cycle low, but still historically pessimistic. Indeed, the NFIB chief economist stated that "With small business owners' views about future sales growth and business conditions dismal, owners want to hire and make money now from solid consumer spending," and "Inflation has eased slightly on Main Street, but difficulty hiring remains a top business concern." In summary, the durable weakness in small business optimism aligns with consumer sentiment data and underscores anemic economic expectations, mounting concerns regarding a larger credit contraction on the heels of last quarter's bank failures and still elevated inflation expectations.

CPI Urban Consumers Headline & Core YoY – Monthly – 3 Years



Source: Bloomberg as of 8/10/2023

Headline CPI rose a tepid +.2% (+.2% est.) for the second consecutive month during July and up 3.2% over the past year (+3.3% est.), the second smallest annual gain since March 2021, as another drop in core goods prices (autos) was offset by an increase in energy and another month of slower advances in services and food/beverage prices. Core CPI (less food and energy) was again up +.2% (+.2% est.) in July, matching the smallest monthly advance since August 2021, and 4.7% (+4.7% est./+4.8% Jun.) over the past 12 months, a moderation from September's year-over-year cycle high (6.6%; highest since 1982), but historically high and still indicative of sustained inflationary pressures across both services and selected goods. While receding, the breadth of price gains remains elevated with 35% of index components up by more than 4% on an annualized basis in July, down from 40% in June (56.4/59.5 May/Apr.) and still well in excess of pre-pandemic run rates. From a contribution standpoint, core goods were down -.3% in June, the second consecutive decline and the lowest read since March 2022, again driven by falling used car prices, along with services up +.3% and 5.7% from a year ago, shy of January's cycle high (7.6%), driven by a +.4% gain in shelter (worth 90% of Headline advance). Drilling down into headline CPI components, prices were mixed, with the largest gains seen in rent of primary residence (+.4%), energy commodities (+.3%) and food (+.2%), which were partially offset by lower airfares (-8.1%), used cars (-1.3%) and medical care (-.2%). Additionally, real estate prices remain high, with values at or close to record levels in many parts of the country, driving another increase in owner's equivalent rent during July (+.5%; +7.7% year over year), just shy of May's record high, 8% annual gain. While still troublesome, the silver lining of recent deceleration in rents, a lagging indicator given the gradual process of lower spot leasing contract rates bleeding into price data, should trigger further shelter disinflation in the months to come. Given that inflation expectations are highly correlated to food, energy and shelter costs, the durable nature of elevated prices across these aggregates has unmoored near-term, consumer expectations away from the FOMC's 2% target, a key consideration for policymakers and supportive of the FOMC's 'higher for longer' stance regarding short term interest rates. All in all, another benign report where core prices advanced at the FOMC's 2% (annualized) target rate for the second consecutive month, a disinflationary impulse that is likely to persist in the near term, a condition that will likely hasten the end of the most aggressive monetary policy tightening in over 40 years

The Week Ahead

The data calendar remains full over the coming week, headlined by the PPI, UM Consumer Sentiment, Retail Sales and Weekly Jobless Claims. Looking ahead, markets remain focused on inflation, employment data and signs of cooling economic activity. On the new issue front, ABS volumes ramped up during the second week of August with twelve deals totaling $9 billion priced through the 9th and $182.6 billion year to date ($196.9 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance remained robust with $26.9 billion priced through the 9th and $831.3 billion year to date ($941.6 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 normalized post first quarter bank failures and the new deal landscape remains favorable for a wider array of ABS and corporate issuers as investor demand remains robust.

Friday 8/11

PPI; UM Consumer Sentiment

Monday 8/14

No Releases

Tuesday 8/15

Retail Sales; Empire Manufacturing

Wednesday 8/16

Industrial Production; Housing Starts; FOMC Meeting Minutes (July 26th)

Thursday 8/17

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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