Fixed Income Market Insights

July 6, 2023

Key takeaways

Bond yields were sharply higher this week, with GT2s up 14 basis points and GT10s higher by 20 basis points respectively and 2s/10s less inverted by 6 basis points (-96), as strength in durable goods orders and rebounding services have elevated the likelihood of multiple FOMC rate hikes prior to year-end. On the data front, headline PCE prices slowed in May and were up +.1%, matching the slowest monthly advance since July 2022, as another tepid advance in food, lower energy and other goods prices were again offset by advances in housing and other services. The number of available jobs came in fractionally lower than expected at 9.8 million in May, a partial reversal of April's sharp rise, but still reflective of chronic labor markets tightness driven by durable worker shortages and still robust demand. The ISM Services PMI index came in much stronger than expected at 53.9 during June, the highest level since February, as a rebound in new orders, employment and business activity dampened concerns that chronic strength in services may be waning given the burden of higher prices, elevated interest rates and tighter credit conditions.

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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InsepereX

A Model of Innovation

With the darkest days of the pandemic behind us, government and private industry continue to grapple with the fallout from public policies and workplace rules that furloughed a large swath of employees, stunted academic aptitude, and exposed the nation's dependence on overseas manufacturing long exported away from the United States. While COVID-19 surely brought this production gap in goods ranging from microchips to pharmaceuticals center stage, selected countries around the globe have been faster to respond to this decades-long shift in manufacturing to the lowest cost producers, many of whom reside in Asia. While the progress at home has been slow, a few states have acted early and invested in technical training initiatives that often include highly subsidized or free vocational school education to bridge what many expect to be a growing divide between the supply and demand for labor to fuel a potential manufacturing renaissance in the United States. Case in Point: Tennessee. In 2014, the Volunteer state became first in the nation to offer tuition-free community or technical college for every graduating high school senior via the "Tennessee Promise" program, with the "Tennessee Reconnect" initiative for adults added shortly thereafter.

Market Snapshot

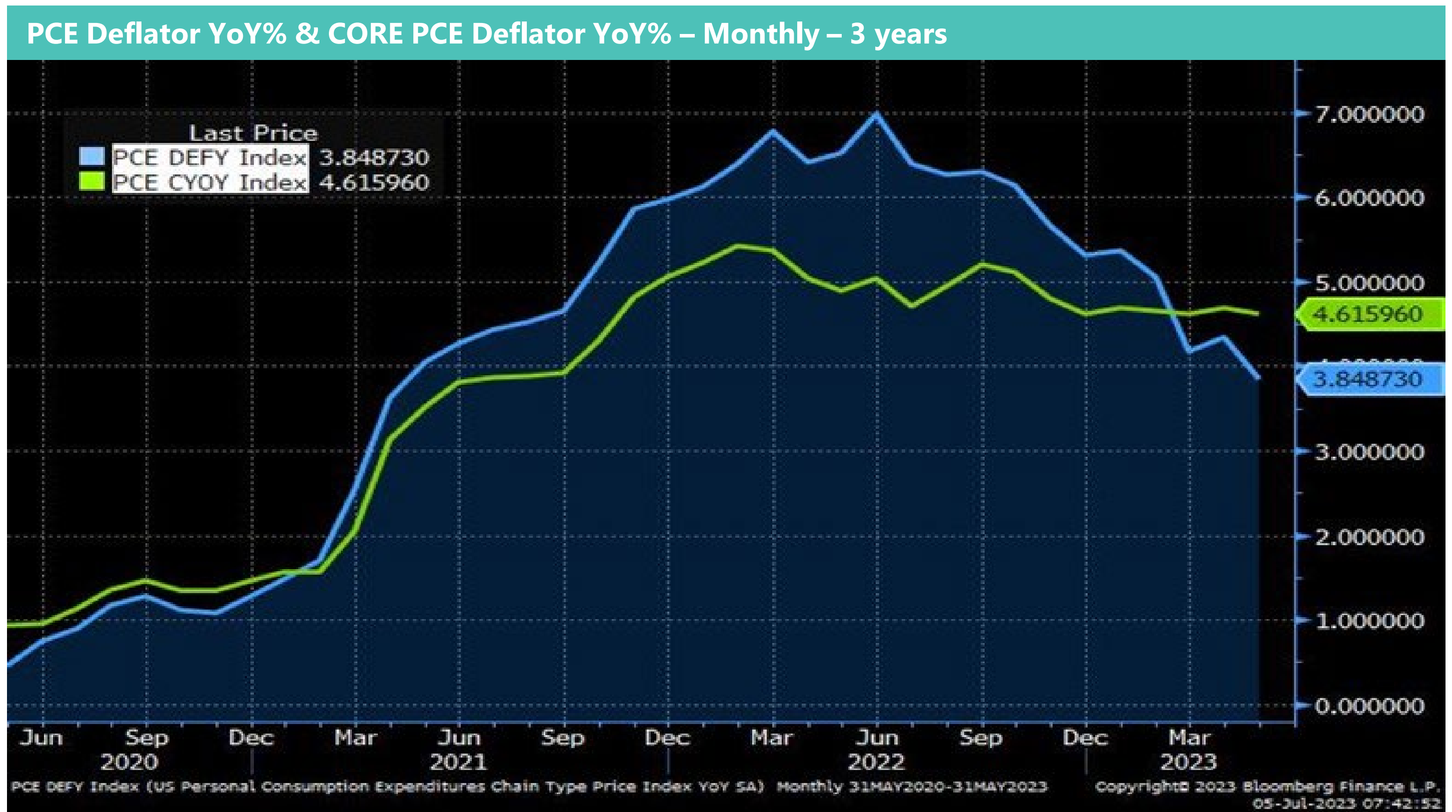
	This week 7/6/23	Last week 6/29/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.54%	5.54%	0	0.00%	16.14%
SOFR	5.06%	5.06%	0	0.00%	17.67%
2-year US Treasury	5.00%	4.86%	14	2.88%	12.87%
5-year US Treasury	4.36%	4.13%	23	5.57%	8.73%
10-yr US Treasury	4.04%	3.84%	20	5.21%	4.12%
2s-10s UST Spread	-96.00	-102.00	6.00	-5.88%	74.55%
DJIA	33,930	34,122	-192.00	-0.56%	2.36%
S&P 500	4,412	4,396	16.00	0.36%	14.90%
Spot Gold	1,918	1,916	2.00	0.10%	5.04%
WTI (Oil) Current Contract	71.89	69.80	2.09	2.99%	-10.43%
1-year Brokered CD	5.30%	5.30%	0	0.00%	15.22%
5-year Brokered CD	4.60%	4.55%	5	1.10%	15.00%
5-year Bullet US Agency	4.43%	4.21%	22	5.23%	8.58%
5-year/NC1yr Callable US Agcy	5.85%	5.65%	20	3.54%	8.33%
CDX IG Spread Index	70.90	69.19	1.71	2.47%	-13.56%
CDX High Yield Index Spread	101.78	102.16	-0.38	-0.37%	1.15%
15-yr UMBS	5.39%	5.18%	21	4.05%	15.67%
30-yr UMBS	5.87%	5.60%	27	4.82%	10.13%

Source: Bloomberg data as of 3:00pm ET 7/6/2023 and 5:00pm ET 6/29/2023

These programs were created to fill a growing skills gap and build a pool of available labor to lure employers to the state, with the then-Governor stating that "ultimately, the states who were going to win were going to be the states that had the better-trained workforce." While the programs enjoyed early success in the form of lower dropout rates and higher college enrollment, perhaps the largest payoffs have started to take shape in post-pandemic Tennessee, which is poised to cash in on one of the largest, post-war manufacturing booms in the fields of electronic vehicle (EV) and battery cell manufacturing. Additionally, the state's policymakers, educators and industry leaders have forged a unique partnership to foster education and innovation, with auto manufacturers Nissan and Volkswagen committing substantial sums of money to meld academics and real-world experience together, adding to an already growing pool of qualified and technically trained workers. In a partnership with the Tennessee College of Applied Technology system (TCAT), Nissan helped open a campus near one of its manufacturing plants, contributing funding and company trainers to scale up technical instruction and real-world experience for prospective workers upon completion. In the case of Volkswagen, which has been manufacturing in Tennessee for over a decade, these types of public/private partnerships are nothing new and have been a mainstay in their home country of Germany, where manufacturing remains a much larger contributor to the nation's economic output versus the United States. Indeed, manufacturing contribution to GDP and employment are much higher in Germany versus the United States, with the former running 19% and 18% and the latter running at 12% and 8% respectively. In Tennessee, Volkswagen helped build digital fabrication studios in schools, offer classes at their Mechatronics Academy, and launched an apprenticeship program with Chattanooga State Community College that melds classroom and first-hand experience at their plant. In the end, states that embrace these types of public/private industry partnerships and promote policies that encourage outside investment will be far better equipped to build a more sustainable economic engine that will secure progressively higher paying jobs for its increasingly skilled population. Given the durability of labor shortages, staggering tuition inflation and student loan forgiveness debacle, the Volunteer state's approach to higher education and public/private partnerships should serve as a model for the rest of the country, with a windfall of durable economic prosperity likely for those states that follow Tennessee's lead.

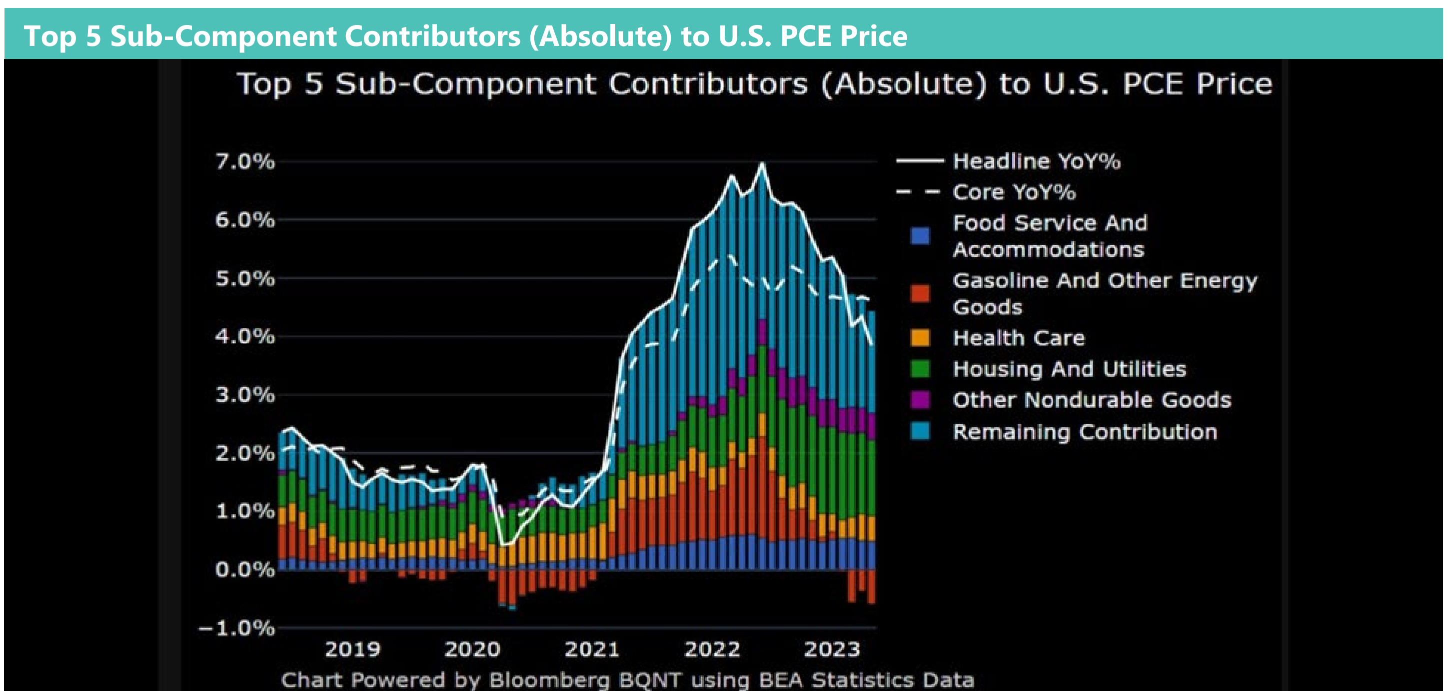
All quiet on the fiscal front post the debt ceiling deal as congress remains in summer recess. To review, the President signed the debt ceiling bill into law last month, known as the "Fiscal Responsibility Act of 2023," averting a U.S. Government debt default and rating agency downgrades. Away from that and as expected, the Supreme Court struck down the Biden administration's Executive Order regarding student loan forgiveness, which attempted to cancel up to $20,000 per borrower and boasted a price tag of at least $400 billion (with some scoring upwards of $1 trillion). Notwithstanding the defeat, the administration appears to be working on another end-around the Court and Congress to lower payments for some that possess student loan debt. Stay tuned!

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



Source: Bloomberg as of 7/6/2023

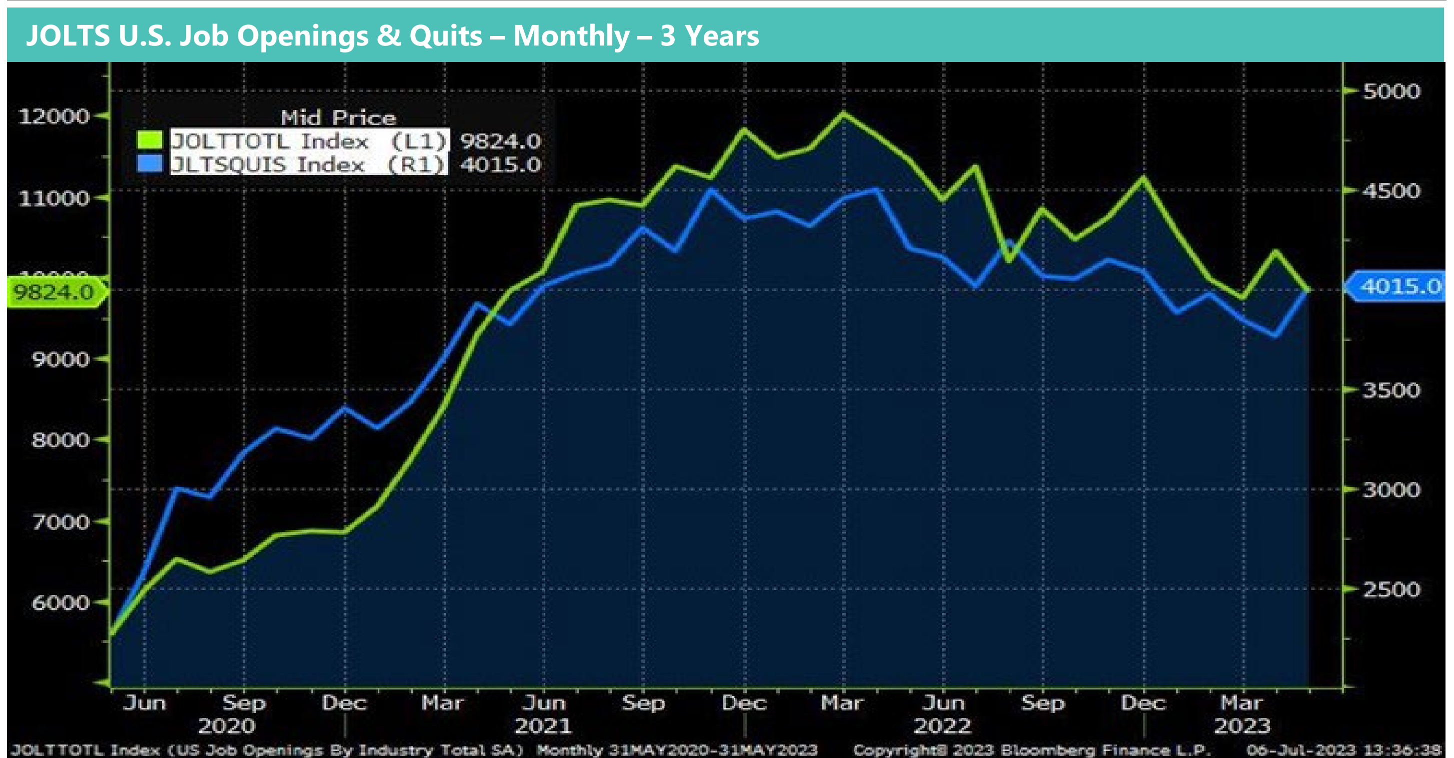
Top 5 Sub-Component Contributors (Absolute) to U.S. PCE Price



Source: Bloomberg as of 7/6/2023

Headline PCE prices slowed in May and were up +.1% (+.1% est./+.4% Apr.), matching the slowest monthly advance since July 2022, as another tepid advance in food, lower energy and other goods prices were again offset by advances in housing and other services. Indeed, May's softer gains have mitigated concerns that April's reacceleration in prices would be sustained, with goods prices down -.1% and services higher by +.3% during the month, and +1.1% and +5.3% on a year-over-year basis, as PCE Supercore (Services ex. housing and energy) advanced +.2%, the slowest pace since last July. In the aggregate, headline PCE prices were up 3.8% during the past year, the smallest annual advance since April 2021, but still a stubbornly slow descent from last 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 soared since the first quarter of 2021 as higher 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 slowed during May, up +.3% for the month (+.4% Apr.) and higher by 4.6% over the past year, a small deceleration versus last September's annual increase (5.2%) and evidence that broad-based inflation remains stubbornly high and durable. Indeed, Core PCE price index advances have changed little since the end of last year, running 4.4%, 4.7% and 4.9% (May-Mar) 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 still supportive of the current 'higher for longer' interest rate stance by the FOMC.

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



Source: Bloomberg as of 7/6/2023

The number of available jobs came in fractionally lower than expected at 9.8 million in May (9.9 est./10.3 Apr.), a partial reversal of April's sharp rise, but still reflective of chronic labor markets tightness driven by durable worker shortages and still robust demand. By industry, job openings decreased in healthcare services (-285,000), finance/insurance (-139,000), retail trade (-125,000), leisure & hospitality (-108,0000) and manufacturing (-64,000), with increases in government (+103,000), professional/business services (+94,000), transportation (+41,000) and construction (+19,000) as employers continue to report difficulty hiring and retaining enough workers to keep up with robust demand for services and selected goods. To be sure, the labor participation rate remains roughly 1% lower than its 2019, pre-pandemic peak as higher retirement rates, skill mismatches and mixed participation have stymied employer efforts to add new workers. Additionally, the quits rate, which measures voluntary job separations per month as a percent of total employment, ticked up to 2.6% (4 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 sheer magnitude of job vacancies continue to drive elevated employee turnover. Additional evidence of job market tightness can be seen in the layoffs and discharge rate, which was unchanged at 1.0% during May (record low .9% December 2021) and the 1.6x 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 reflective of snug labor markets. Indeed, chronic labor shortages have forced companies to raise compensation to recruit and keep workers, with little relief expected in the months to come. While labor market imbalances should improve given FOMC rate hikes and slower consumption, we believe the JOLTS data will remain high in the near term as the pandemic and elevated, state-level direct economic assistance triggered structural changes to the labor force that have slowed the return to pre-pandemic levels of participation. While demand for labor appears to be cooling given the cumulative decline of over 1.4 million job vacancies during the first five months of this year, open positions and the job openings rate (5.9% May; 7.4% peak Mar. 2022) remain historically high and are likely to support solid wage growth in the near term as labor supply and demand imbalances endure.

Source: Bloomberg as of 7/6/2023

The ISM Services PMI index came in much stronger than expected at 53.9 during June (est. 51.2/50.3 May), the highest level since February, as a rebound in new orders, employment and business activity dampened concerns that chronic strength in services may be waning given the burden of higher prices, elevated interest rates and tighter credit conditions. A deeper dive into the survey revealed relatively broad-based gains across industries (15 of 18 reporting growth), with new orders up nearly 3 points (55.5/52.9 May), employment higher by 4 points (53.1/49.2 May), and delivery times lower (47.6/53.9 Sep.), the third lowest level since June 2009 and reflective of much improved supply chain logistics. Furthermore, the data also revealed that prices paid by service providers fell for the seventh time in eight months during June (54.1/68.1 Dec.), the lowest level since March 2020 and more in-line with historical averages. Looking at the text of the report, the Chairman of the survey committee stated that "There has been an uptick in the rate of growth for the services sector. This is due mostly to the increase in business activity, new orders and employment," and that "The majority of respondents indicate that business conditions remain stable; however, they are cautious relative to inflation and the future economic outlook." All in all, a demonstrably stronger report suggesting that demand for services remains robust despite the effects of FOMC rate hikes, chronically high inflation and tightening credit conditions.

The Week Ahead

The data calendar ramps up over the coming week, headlined by Non-Farm Payrolls, CPI, PPI and NFIB Small Business Optimism. Looking ahead, markets remain focused on inflation, employment data and further signs of slowing economic activity. On the new issue front, ABS volumes slowed this week given the July 4th holiday, with no deals priced through the 5th and $147.6 billion year to date ($157.1 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance remained light, with $5.8 billion priced through the 5th and $706.8 billion year to date ($758.9 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 first quarter bank failures and the new deal landscape remains favorable for a wider array of ABS and corporate issuers as investor demand remains solid.

Friday 7/7
Non-Farm Payrolls

Monday 7/10
Consumer Credit

Tuesday 7/11
NFIB Small Business Optimism

Wednesday 7/12
CPI; MBA Mortgage Applications

Thursday 7/13
PPI; 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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