Fixed Income Market Insights

June 29, 2023

Key takeaways

Bond yields were again higher this week, with GT2s up 7 basis points and GT10s higher by 5 basis points respectively and 2s/10s more inverted by 2 basis points (-102), driven by a larger than expected upward revision to 1st Quarter GDP and more hawkish speak by Federal Reserve Chairman Powell. On the data front, Consumer confidence rebounded during June and came in at 109.7, the highest level since January 2022, led by a recovery in labor market expectations and easing pessimism regarding near term business prospects. The S&P CoreLogic Case-Shiller 20-city home price index rose +.91% in April (-1.70% YOY), the second consecutive monthly gain and largest annual retreat since April 2012, as the combination of low affordability and higher mortgage rates have softened prices from last year's all-time highs. Initial unemployment claims eased during the holiday-shortened week ended June 24th to 239,000 (265k last), but still reflective of some loosening of chronically tight labor market conditions given the uptick in layoff announcements and cooling demand for temporary workers.

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.

Author

David Petrosinelli, CFA
Managing Director
Senior Trader

InspereX

Gilded Age for Private Credit

In the wake of the most aggressive monetary policy tightening in forty years, the largest bank failures since the Great Financial Crisis (GFC) and elevated risks of a more pronounced economic downturn, credit conditions are likely to get tighter in the quarters to come as traditional bank lenders scale back funding and shore up balance sheets. Given higher market rates, lush fees and the credit contraction already underway, particularly at regional/community banks, a diverse group ranging from private equity to traditional, big-box money management firms to sovereign wealth funds are rushing in to capitalize on Wall Street's hottest opportunity- Private Credit. With lending growth estimates in the trillions and targeted returns ranging from high single digits to high teens, it's no wonder that the private credit sector has seen a deluge of new entrants over the past year. The private credit sector, which traces its origins back to lending to private equity businesses decades ago, grew rapidly when traditional banks retreated from lending post the GFC and has nearly tripled in size since 2015 to an estimated $1.5 trillion, with some forecasting a potential market size upwards of $50 trillion.

Market Snapshot

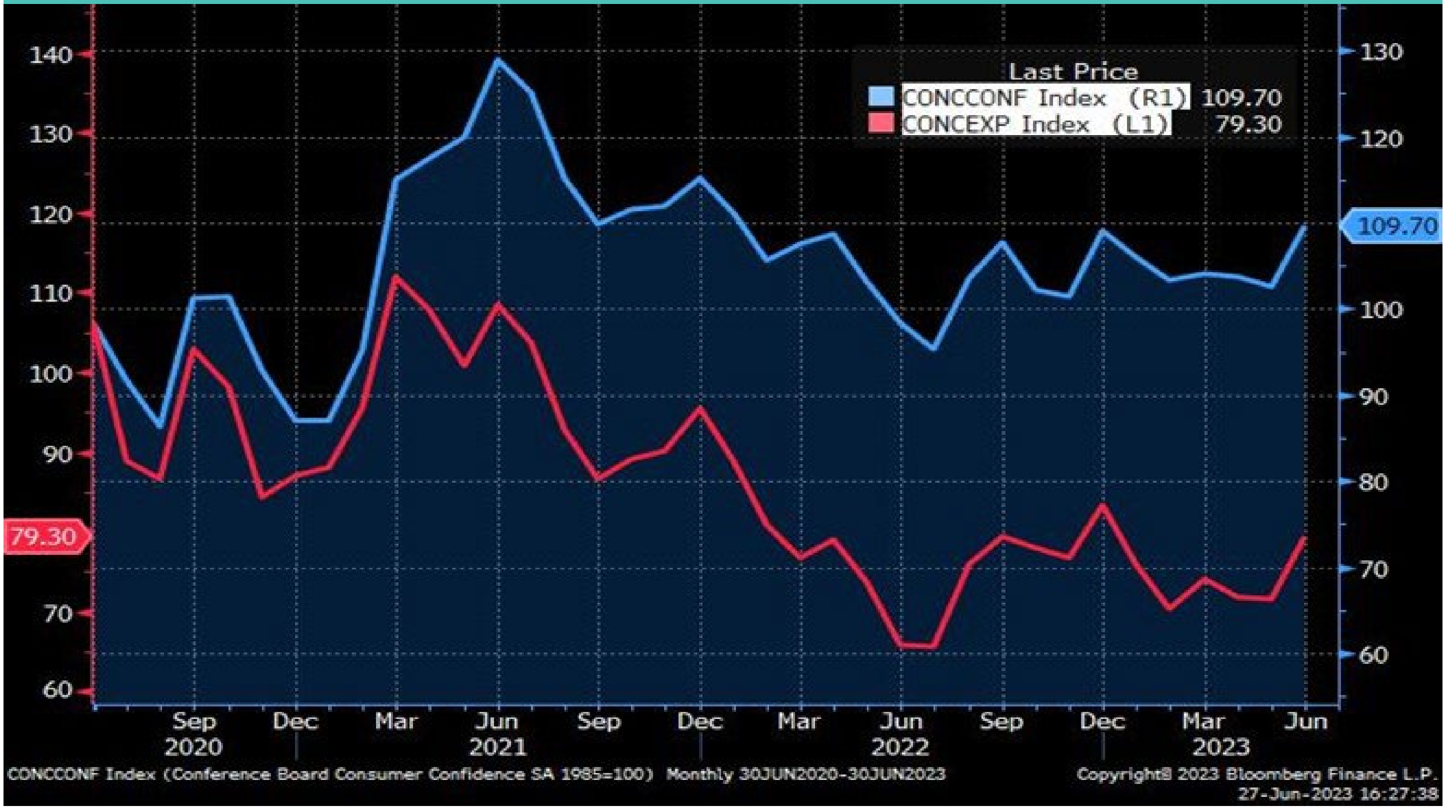
	This week 6/29/23	Last week 6/22/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.54%	5.54%	0	0.00%	16.14%
SOFR	5.06%	5.05%	1	0.20%	17.67%
2-year US Treasury	4.86%	4.79%	7	1.46%	9.71%
5-year US Treasury	4.13%	4.03%	10	2.48%	2.99%
10-yr US Treasury	3.84%	3.79%	5	1.32%	-1.03%
2s-10s UST Spread	-102.00	-100.00	-2.00	2.00%	85.45%
DJIA	34,122	33,958	164.00	0.48%	2.94%
S&P 500	4,396	4,372	24.00	0.55%	14.48%
Spot Gold	1,916	1,925	-9.00	-0.47%	4.93%
WTI (Oil) Current Contract	69.80	69.55	0.25	0.36%	-13.03%
1-year Brokered CD	5.30%	5.30%	0	0.00%	15.22%
5-year Brokered CD	4.55%	4.50%	5	1.11%	13.75%
5-year Bullet US Agency	4.21%	4.10%	11	2.68%	3.19%
5-year/NC1yr Callable US Agcy.	5.65%	5.55%	10	1.80%	4.63%
CDX IG Spread Index	69.19	71.52	-2.33	-3.26%	-15.64%
CDX High Yield Index Spread	102.16	101.86	0.30	0.29%	1.53%
15-yr UMBS	5.18%	5.06%	12	2.37%	11.16%
30-yr UMBS	5.60%	5.47%	13	2.38%	5.07%

Source: Bloomberg data as of 5:00pm ET 6/29/2023 and 2:30pm ET 6/22/2023

In today's parlance, the private credit market has expanded to include everything from traditional direct lending to small and mid-market businesses, funding for leveraged buyouts, asset-backed financing and a growing presence in real estate debt. Regarding real estate, many of the growing number of private credit sponsors see increasingly attractive opportunities in the commercial real estate (CRE) market, specifically lending mezzanine and senior debt to reposition underperforming and distressed properties. As we have discussed at length, the rapid advance of interest rates, pandemic-driven demand destruction for office space and migration away from key office space and retail markets (San Francisco, Los Angeles, New York and Chicago) have roiled markets, and the timing couldn't be worse given the avalanche of CRE debt maturing over the next few years. Indeed, of the nearly $5 trillion of CRE loans in the United States, more than $1.4 trillion are due by the end of 2025, with the fallout already underway this year, and not just for smaller borrowers. Towards that end, even large CRE sponsors like Brookfield and Westfield have opted to throw in the towel and transfer office and shopping center properties back to lenders as falling occupancy, sky-high refinance rates and "challenging operating conditions" (translation: crime) have driven debt burdens higher than the market value of those affected properties. Perhaps more telling, given that 50% of the $5 trillion in CRE loans reside on bank balance sheets and smaller banks (up to $250 billion in assets) are responsible for nearly 70% of this lending, the opportunity for private credit sponsors to take market share in direct CRE lending is, in a word, massive. While further credit contraction from traditional lenders is expected given commercial and CRE loan concentration at smaller banks, along with the write-downs and losses likely to follow over the coming quarters, private credit sponsors are gearing up for what many are calling the "Guided Age" of non-bank lending to fill the funding void across a growing variety of asset types.

Still quiet on the fiscal front post the debt ceiling deal. To recap, the President signed the debt ceiling bill into law three weeks ago, known as the "Fiscal Responsibility Act of 2023," averting a U.S. Government debt default and rating agency downgrades. Additionally, the President vetoed a bipartisan bill that would have eliminated the Executive Order regarding student loan forgiveness, which aims to cancel up to $20,000 per borrower and boasts a price tag of at least $400 billion (with some scoring upwards of $1 trillion), with a Supreme Court decision regarding the legality of the Executive order expected prior to their summer recess, which starts July 1st. Stay tuned!

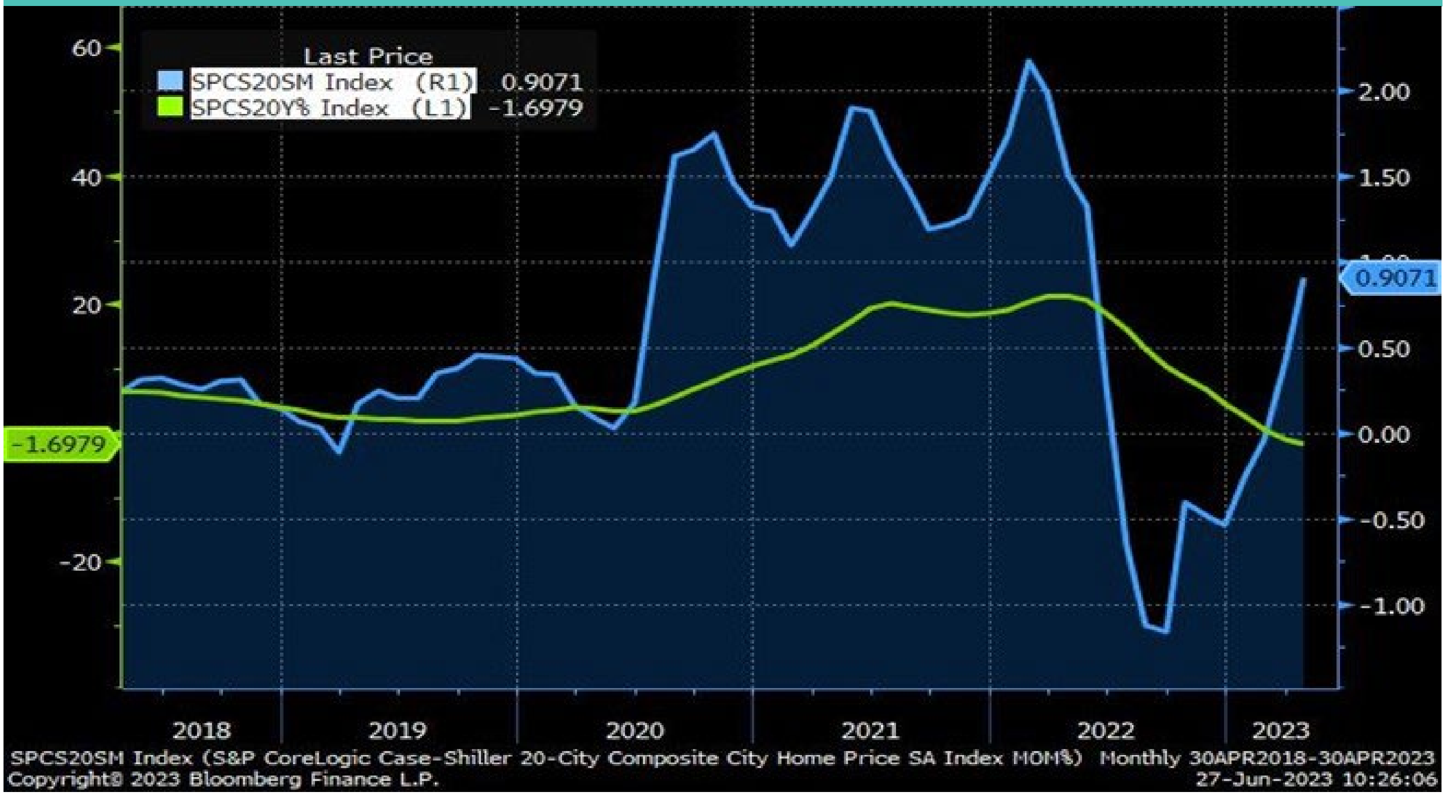
Consumer Confidence & Expectations – Monthly – 3 Years



Source: Bloomberg as of 6/29/2023

Consumer confidence rebounded during June and came in at 109.7 (104 est./102.5 May), the highest level since January 2022, led by a recovery in labor market expectations and easing pessimism regarding near term business prospects. Leading this month's advance was the current conditions component, which rose to 155.3 (148.9 May/147.4 Dec.), driven by more respondents stating that jobs are plentiful (46.8% vs. 43.3% May), and a larger share of consumers stating that current business conditions are good (23.7% vs. 19.7% May). Adding to this month's advance was the expectations component, a measure of consumers' six-month outlook, which jumped to 79.3 (71.5 May/83.4 Dec.), the highest level since last December, but again below the recessionary reading (80) for the fifteenth time over the past sixteen months, as fewer respondents expect business conditions to worsen (17.7% vs. 21.4% May) and a lower share see fewer jobs being added (16.0% vs. 21.1% May). Looking at the text of the report, the senior director of the survey stated that "Greater confidence was most evident among consumers under age 35, and consumers earning incomes over $35,000. Nonetheless, the expectations gauge continued to signal consumers anticipating a recession at some point over the next 6 to 12 months," and that "vacation plans within the next six months continued to flag, led largely by declines in plans to travel domestically. This is an important indicator of desires to spend on services ahead, which may be a signal that post-pandemic 'revenge spending' on travel may have peaked and is likely to slow over the rest of this year." On the jobs front, labor market conditions appear to have tightened this month, partially reversing May's outsized loosening, but still indicative of cooling demand for workers versus the first quarter as June's Labor Index metric, which measures the labor differential of jobs plentiful less hard to get, came in at 34.4% (30.7% May/39.9% June 2022). While a stronger than expected report led by more sanguine perceptions regarding labor and the economy, we expect further softness in consumer spending as higher interest rates, low personal savings rates and surging consumer debt are likely to weaken confidence in the months to come.

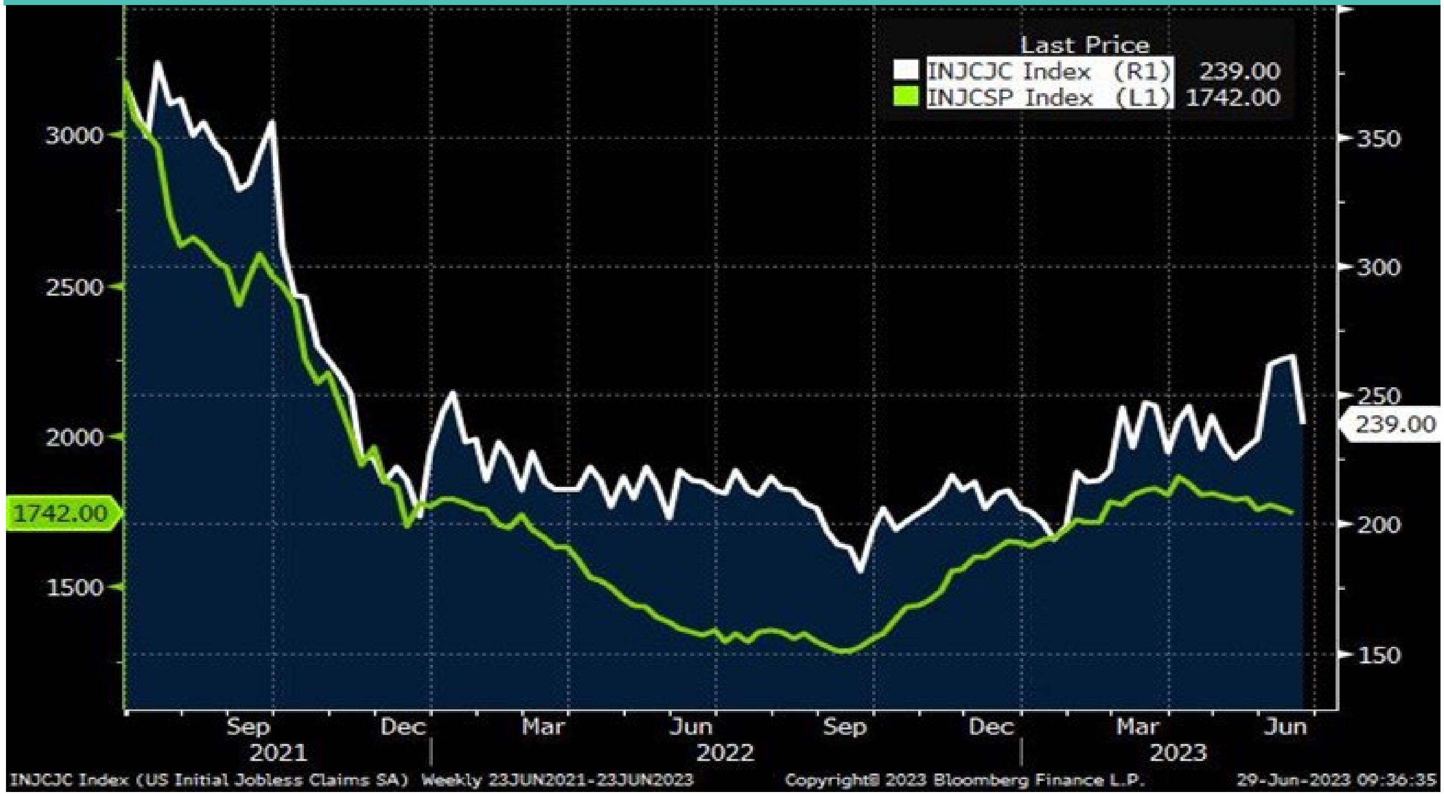
S&P CL Case-Shiller 20 City Comp Home Price Index MOM/YOY% Change – Monthly – 5 Years



Source: Bloomberg as of 6/29/2023

The S&P CoreLogic Case-Shiller 20-city home price index rose +.91% in April (+.40% est./-1.70% YOY), the second consecutive monthly gain and largest annual retreat since April 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 sharp rise in prices from mid-2020, housing market technicals continue to be favorable as supply remains light in many locales (3.0 months in May/record low 1.8), listings continue to sell quickly (18 days on market in May/record low 14) and the rental market remains on firm ground. Regarding inventories, May's existing home sales data revealed that there were just 1.08 million previously owned homes for sale, down nearly 20% since last Summer (cycle low 850,000, Jan. 2022), which should provide a buffer 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 (+5.2%), Chicago (+4.1%) and Atlanta (+3.5%) posting the largest annual gains, with Las Vegas (-6.6%), San Francisco (-11.1%) and Seattle (-12.4%) rounding out the bottom three. While price appreciation has slowed as affordability continues to languish and mortgage rates remain high, demand is still strong in many areas and migration away from larger cities will likely support elevated home prices for much of the country in the near term. On a national basis, the housing price index fell -.24% for the year ended April, a sharp reversal from last March's 20.8% all-time record high (1988 index inception) and the first annual decline since April 2012. All in all, market participants expected lower home prices given the steep 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 in the months to come.

Initial Jobless & Continuing Claims – Monthly – 2 Years



Source: Bloomberg as of 6/29/2023

Initial unemployment claims eased during the holiday-shortened week ended June 24th to 239,000 (265k est./265k last), but still reflective of some loosening of chronically tight labor market conditions given the uptick in layoff announcements and cooling demand for temporary workers. Indeed, claims have trended higher since March given the jump in WARN notices during the first quarter and may presage a broader economic slowdown, triggering more layoffs and slower job creation. To review, the Worker Adjustment and Retraining Notification (WARN) Act of 1988 requires companies with more than 100 full-time employees to file with state labor departments and notify workers of layoffs with a 60-day lead if they plan to lay off at least 50 people at a single site, and to workers who have their hours cut by half or more in any six-month period. Additionally, the four-week moving average of initial claims, which smooths out outsized observations in the data, edged higher to 257,500, the highest level since November 2021 and well in excess of pre-pandemic averages observed during 2019. To be sure, some further signs of labor market cooling appear to be forming with continuing unemployment claims, which came in at 1.742 million (1.645 million on Dec 30th) and include people who have already received unemployment benefits for a week, just shy of this year's highs but still near pre-pandemic averages as employers struggle to fill the 10 million open positions forecasted by the latest JOLTS survey. All in all, another report suggestive that the recent uptrend in layoff announcements may be starting to translate into outright job cuts, notwithstanding the durability of labor market snugness seen post the pandemic.

The Week Ahead

The data calendar lightens up over the coming, holiday-shortened week, headlined by the PCE Deflator, JOLTS Job Openings and ISM Services. Looking ahead, markets remain focused on inflation, employment data and further signs of weaker economic activity. On the new issue front, ABS volumes slowed this week, with 5 deals totaling $1.7 billion priced through the 28th and $146.6 billion year to date ($156.4 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance remained light, with $11.8 billion priced through the 28th and $698.6 billion year to date ($756.2 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 robust.

Friday 6/30

PCE Deflator

Monday 7/3

ISM Manufacturing; Wards Vehicle Sales

Tuesday 7/4

Market Holiday- 4th of July

Wednesday 7/5

Factory Orders; FOMC Meeting Minutes (June 14th)

Thursday 7/6

Weekly Jobless Claims; ISM Services; JOLTS Job Openings

About the author

David Petrosinelli, CFA
Managing Director
Senior Trader

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.