Fixed Income Market Insights

February 9, 2023

Key takeaways

Bond yields were sharply higher this week, with GT2s up 36 basis and GT10s higher by 21 basis points respectively and 2s/10s more inverted by 15 basis points (-86), driven by the Non-Farm Payroll blowout and Federal Reserve policymaker hawkish speak. On the data front, headline Non-Farm Payrolls came in much stronger than expected with 517,000 new jobs added in January, the largest monthly gain since last July, led by broad-based gains in services employment, including durable strength in leisure and hospitality, professional/business services and healthcare. The ISM Services PMI index came much stronger than expected during January, driven by sharp increases in business activity and new orders components, suggesting that fears of a comparable downturn in services akin to manufacturing may be premature. Initial unemployment claims were again subdued during the week ended February 4th, further evidence of chronically tight labor market conditions as laid off workers have quickly secured new employment and firings have been minimal given persistent worker shortages.

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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As the Curve Flattens

In what has become a familiar pattern during several, post-FOMC meeting new conferences over the past year, seemingly dovish comments delivered by Federal Reserve Chairman Powell have served to loosen financial conditions and threaten to dampen the effects of the most aggressive monetary policy tightening in over forty years. To combat this very real risk, a parade of Fed policymakers typically hit the media with commensurately hawkish overtones to temper what they perceive as unduly bullish behavior in both stocks and bonds, commonly referred to as 'clean-up on aisle five' by many investors and market participants. Last week's post-FOMC meeting routine was no different, with a number of policymakers reiterating that financial conditions should not be getting looser, that the Federal Reserve will continue to raise rates and has a ways to go before short-term rates are restrictive enough to get inflation on a clear path towards 2% and, most importantly, that the terminal Federal Funds rate will need to remain higher for a longer period of time than many investors expect.

Market Snapshot

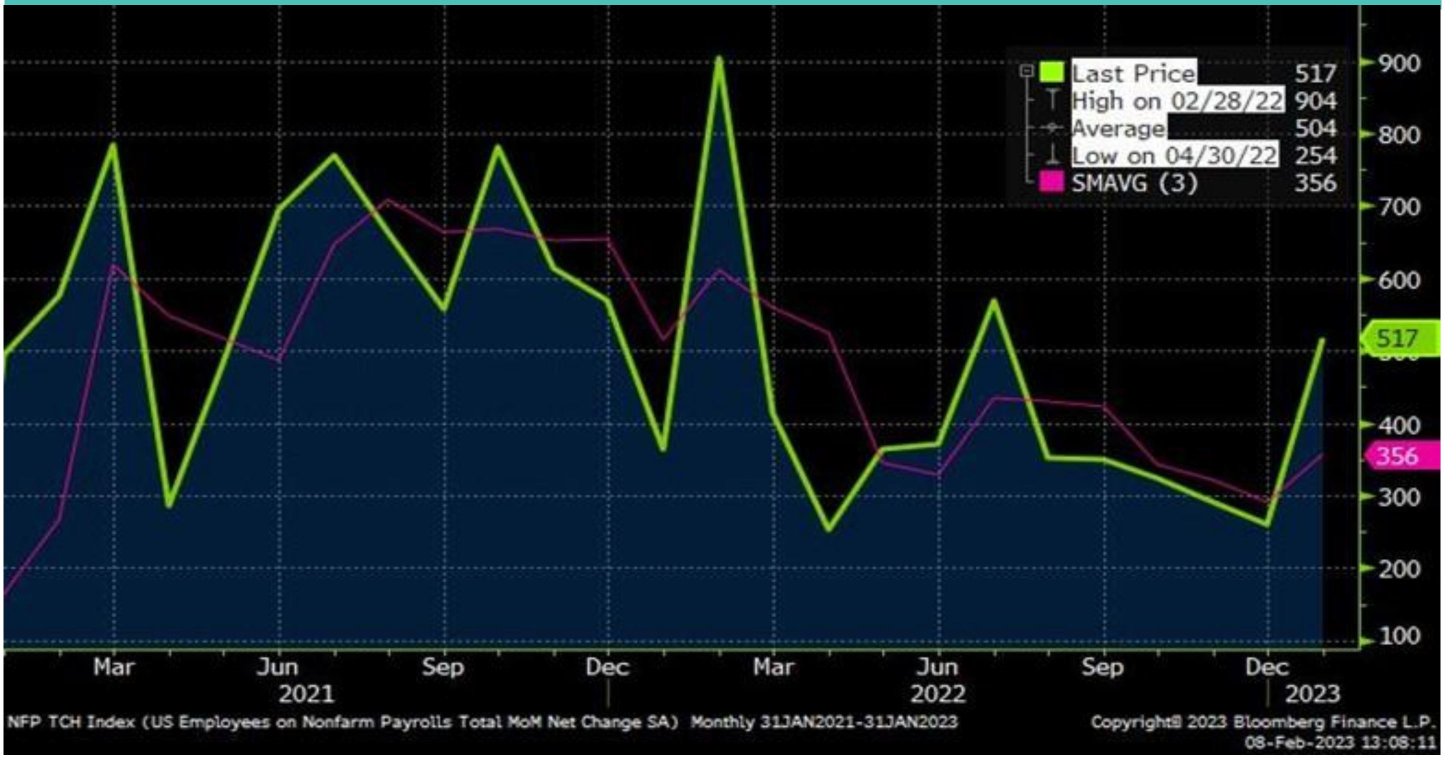
	This week 2/9/23	Last week 2/2/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	4.86%	4.79%	7	1.46%	1.89%
SOFR	4.55%	4.31%	24	5.57%	5.81%
2-year US Treasury	4.50%	4.11%	39	9.49%	1.58%
5-year US Treasury	3.87%	3.49%	38	10.89%	-3.49%
10-yr US Treasury	3.68%	3.40%	28	8.24%	-5.15%
2s-10s UST Spread	-82.00	-71.00	-11.00	15.49%	49.09%
DJIA	33,721	34,054	-333.00	-0.98%	1.73%
S&P 500	4,097	4,180	-83.00	-1.99%	6.69%
Spot Gold	1,874	1,930	-56.00	-2.90%	2.63%
WTI (Oil) Current Contract	77.75	75.84	1.91	2.52%	-3.13%
1-year Brokered CD	4.75%	4.70%	5	1.06%	3.26%
5-year Brokered CD	3.85%	3.80%	5	1.32%	-3.75%
5-year Bullet US Agency	3.94%	3.56%	38	10.67%	-3.43%
5-year/NC1yr Callable US Agcy	5.35%	4.95%	40	8.08%	-0.93%
CDX IG Spread Index	71.15	67.58	3.57	5.28%	-13.25%
CDX High Yield Index Spread	102.72	103.65	-0.93	-0.90%	2.09%
15-yr UMBS	4.44%	3.97%	47	11.84%	-4.72%
30-yr UMBS	5.11%	4.64%	47	10.13%	-4.13%

Source: Bloomberg data as of 3pm ET 2/9/2023 and 5pm ET 2/2/2023

While this latest clean-up was widely expected, last Friday's blockbuster Non-Farm Payroll data provided policymakers with even more cover to hammer home their hawkish messaging, with even more effectiveness versus past attempts given the larger impact on U.S. Treasury yields and Federal Funds futures levels. Regarding the former, the 2-year/10-year yield curve slope just hit this tightening cycle's deepest inversion, -86 basis points, the widest since the fourth quarter of 1981 and a sign that investors believe that additional rate hikes will tip the economy into recession at some point during the next year. While today's 2-year U.S. Treasury note yield (4.50%) is still lower than this cycle's high of 4.73% (November 7th), the generic 6-month Treasury rate, which correlates better with Federal Funds, did hit a cycle high today at 4.93%, the highest level since August 2007. Perhaps more importantly, Federal Funds futures implied yields also marched higher over the past week, with May 2023 through January 2024 tenors up 15 and 51 basis points respectively (5.15%/4.68% July/Jan), which now reflects 50 basis points of easing by early 2024, versus 75 basis points after market close last Thursday. While communication of FOMC policy pivots and appraisals of economic conditions is particularly difficult during periods of material policy adjustment, we believe that Chairman Powell has been most effective when he sticks to simple and consistent messages during the unscripted and often news-making Q&A session post FOMC rate decision announcement. More to follow!

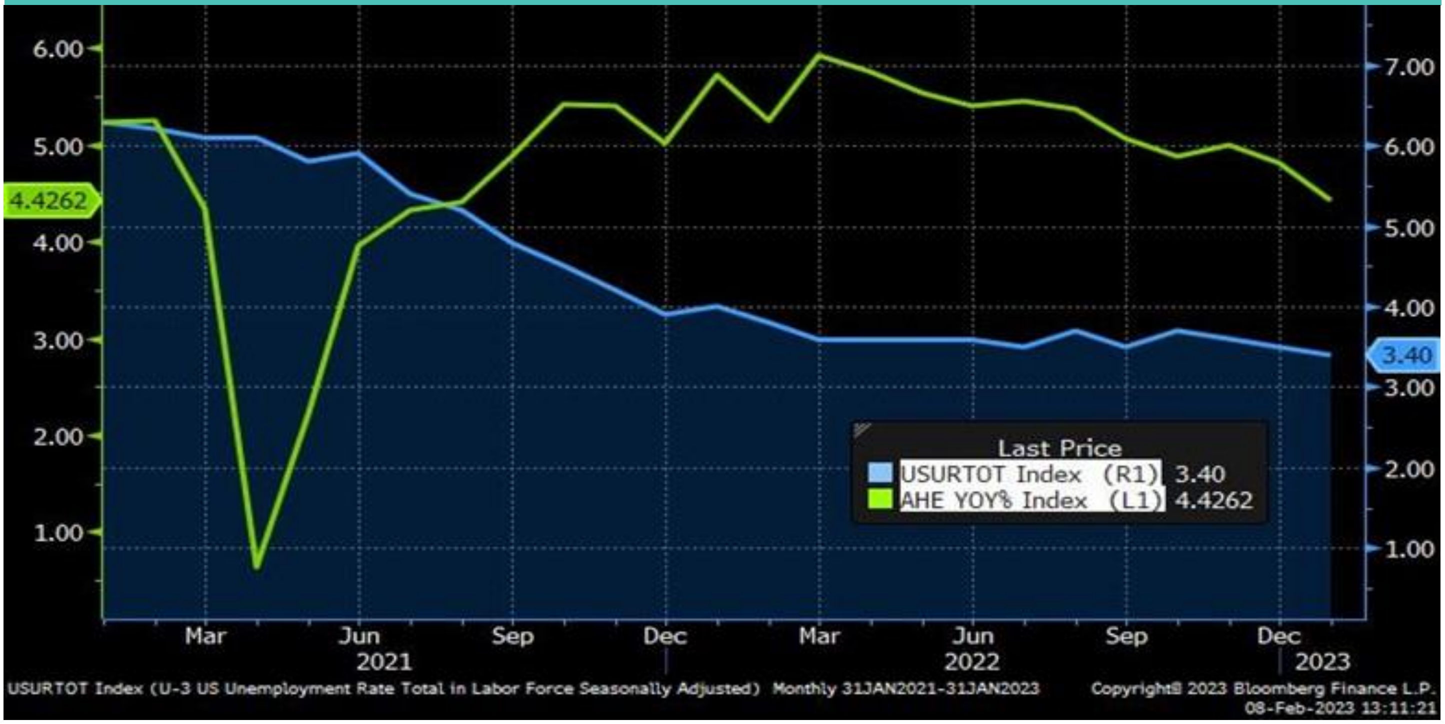
Still quiet on the fiscal front during the second full week of both houses of Congress being in session post the January recess. Among several legislative priorities, debate over the debt ceiling will be front and center in the weeks to come. Stay tuned!

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



Source: Bloomberg as of 2/9/2023

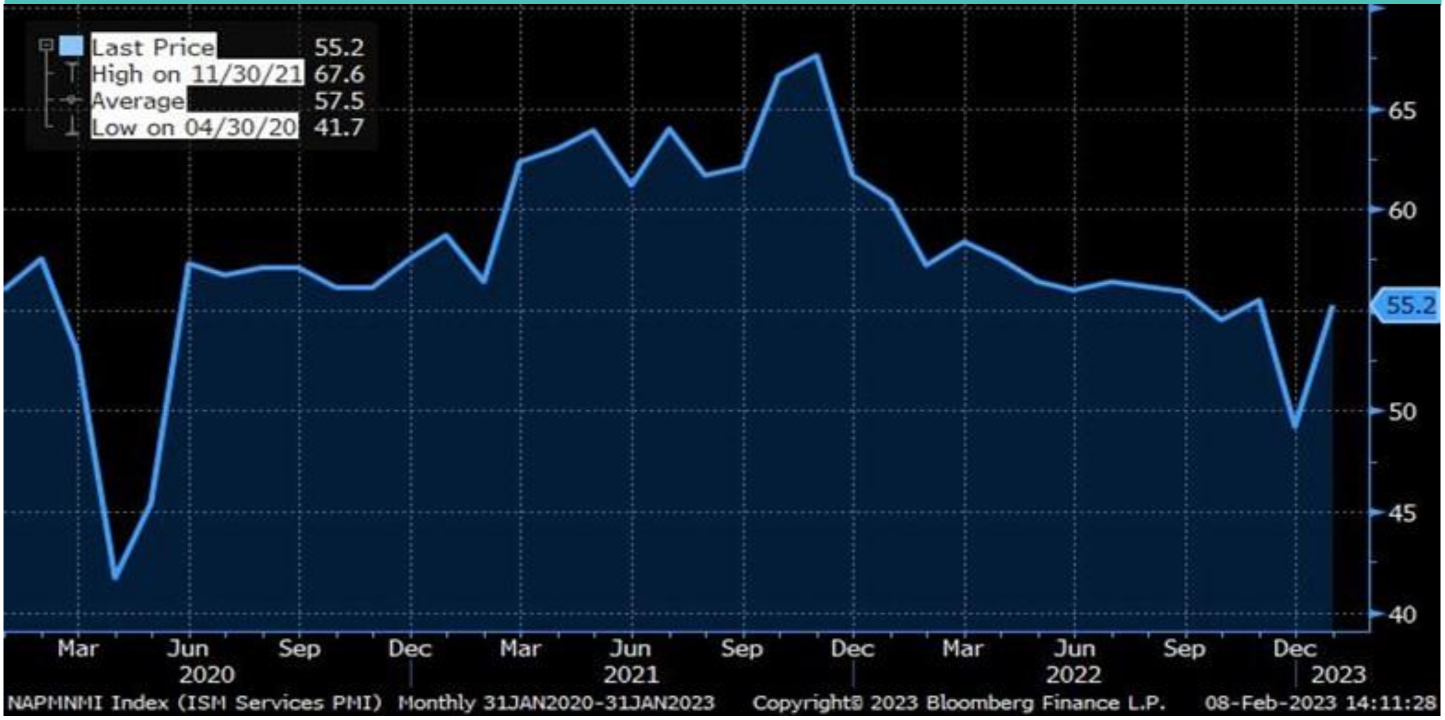
Unemployment Rate and Average Hourly Earnings % YOY Change – Monthly – 2 years



Source: Bloomberg as of 2/9/2023

Headline Non-Farm Payrolls came in much stronger than expected with 517,000 new jobs added in January (189,000 est.), the largest monthly gain since last July, led by broad-based gains in services employment, including durable strength in leisure and hospitality, professional/business services and healthcare. Taken together with revisions that added 71,000 jobs in the prior two months, job creation remains robust with average monthly gains of 356,000 during the last ninety days, an acceleration from the fourth quarter's 291,000 pace (vs. 423,000 Q3 2022). Looking by industry revealed broad based strength, led by leisure and hospitality (+128k), education/health (+105k), professional/business services (+82k), government (+74k), retail (+30k) and construction (+25k). Beyond the headline number, the big takeaways were the second consecutive uptick in labor participation (62.4% vs. 62.3% est.) and the moderation in average hourly earnings (+.3% vs. +.4% Dec./+4.4% YOY vs. 4.8% Dec.), surely welcome news for the FOMC and investors given the persistent tightness of labor markets and durability of elevated, nominal wage gains post pandemic. Indeed, this week's JOLTS job openings (11 million), the number of available positions per unemployed worker (1.92) and quits rate (2.7% or 4.1 million jobs) remain near all-time highs, suggesting that wage inflation will remain elevated in the months to come. Additionally, labor participation remains over a percentage point lower than the 2019, pre-pandemic high as elevated retirement rates, skill mismatches and increased entrepreneurship have hampered employer efforts to fill millions of job openings. This lower participation has driven down the unemployment rate to 3.4%, a new cycle low (lowest since 1969), and pressured average hourly earnings higher (4.4% YOY), both conditions expected to persist during the first half of 2023. All in all, a blockbuster employment report with some small silver linings regarding wage growth moderation and better labor participation, all supportive of another 25 basis point rate hike at the March 22nd meeting.

ISM Services PMI – Monthly – 3 years



Source: Bloomberg as of 2/9/2023

The ISM Services PMI index came much stronger than expected during January at 55.2 (est. 50.5/49.2), driven by sharp increases in business activity and new orders components, reversing December's soft patch (49.2), suggesting that fears of a comparable downturn in services akin to manufacturing may be premature. A deeper dive into the survey revealed that the business activity and new orders components of the index surged 7 and 15 points respectively, and delivery times held most of December's outsized improvement (50/48.5/53.8 Jan-Nov), the second lowest level in nearly seven years, all suggestive of resilient demand and improving supply chain logistics. Additionally, the data also revealed that prices paid by service providers slowed for the third consecutive month in January (67.8 vs. 69.8 six-month average), the lowest level since January 2021, but remain historically elevated. All in all, a strong report suggesting that demand for services remains quite resilient despite the cumulative effects of FOMC rate hikes and stubbornly high inflation, for now.

Initial Jobless & Continuing Claims – Monthly – 2 Years

Source: Bloomberg as of 2/9/2023

Initial unemployment claims were again subdued during the week ended February 4th at 196,000, further evidence of chronically tight labor market conditions as laid off workers have quickly secured new employment and firings have been minimal given persistent worker shortages. The four-week moving average of initial claims, which smooths out outsized observations in the data, has drifted lower for the ninth consecutive week, coming in at 189,250 (versus 230,250 on Dec 3rd) as job vacancies continue to be plentiful. That said, some initial signs of cooling appear to be brewing given the recent rise in continuing unemployment claims, which increased to 1.688 million (1.498 million on Nov 4th) and include people who have already received unemployment benefits for a week, but still historically low as employers push to absorb the 11+ million open positions estimated by the latest JOLTS survey. While total employment has finally exceeded pre-pandemic levels (+1.2 million jobs), labor participation continues to lag as elevated retirements, weaker female participation and skill mismatches have slowed employer efforts to attract and retain workers. All in all, the job market remains tight and the claims data support a slow path to restore better balance between the supply of and demand for labor, which all but cements a 25-basis point hike in the Federal Funds rate at the next FOMC meeting on March 22nd.

The Week Ahead

The data calendar heats up over the next week, headlined by the Consumer and Producer Price Indices (CPI & PPI), Retail Sales, UM Consumer Sentiment and NFIB Small Business Optimism. Looking ahead, markets remain focused on inflation, employment data and further signs of moderating economic activity. On the new issue front, ABS volumes ticked up during the second week of February with seven deals totaling $4.77 billion priced through the 8th and $27.4 billion year to date ($30.1 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance ramped up with $30.4 billion in deals priced through the 8th and $184.7 billion year to date ($178.2 billion over same period last year; $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 strong.

Friday 2/10
UM Consumer Sentiment

Monday 2/13
No Data Scheduled

Tuesday 2/14
CPI; NFIB Small Business Optimism

Wednesday 2/15
Retail Sales; Industrial Production

Thursday 2/16
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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