Fixed Income Market Insights

February 2, 2023

Key takeaways

Bond yields were lower this week, with GT2s down 8 basis and GT10s lower by 11 basis points respectively and 2s/10s more inverted by 3 basis points (-71), driven largely by dovish comments from Federal Reserve Chairman Powell post yesterday's rate decision. On the data front, Consumer confidence was off fractionally in January to 107.1, driven largely by the recent moderation in core inflation and another month of lower energy prices, which was tempered by less upbeat attitudes regarding business conditions over the next six months. The JOLTS data revealed that the number of available jobs unexpectedly rose 572,000 to 11.01 million in December as chronic labor shortages and robust demand continue to drive tight job markets. As expected, the FOMC raised the Federal Funds rate by 25 basis points to 4.75% on Wednesday afternoon with a unanimous vote of 12-0, the highest level since October 2007.

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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InspereX

Dovish Fed Redux?

Federal Reserve Chairman Powell surprised investors and markets yesterday with a curiously dovish set of comments regarding goods disinflation and loosening financial conditions and, most importantly, the Chairman appeared to open the door for rate cuts prior to the end of 2023, a first during the most aggressive FOMC monetary policy tightening campaign in over forty years. While the Fed chief started his post-meeting comments by reiterating the need for ongoing rate increases and that inflation still remains too high, particularly in the sticky PCE core services (excluding housing rents) metric, which has run above 4% for the all but one of the past twenty months (4.96/3.93% high/low), the Chairman quickly ginned up investors by emphasizing his mounting optimism regarding the soft economic landing scenario and by being remarkably unconcerned about the sharp loosening of financial conditions to kick off the new year. Indeed, this is a marked reversal for the Chairman, who has previously been able to message the market down, followed promptly by a slew of Fed Governors hammering home the same message.

Market Snapshot

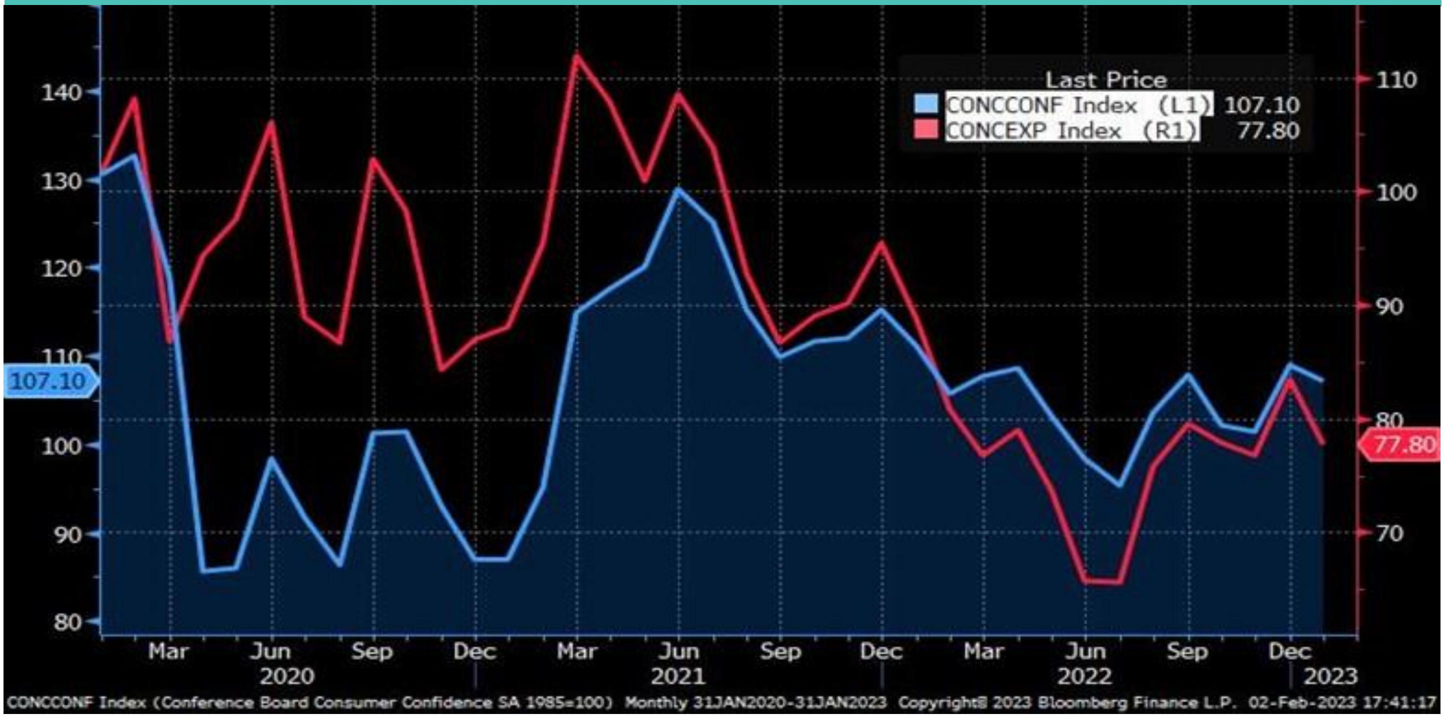
	This week 2/2/23	Last week 1/26/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	4.79%	4.80%	-1	-0.21%	0.42%
SOFR	4.31%	4.30%	1	0.23%	0.23%
2-year US Treasury	4.11%	4.18%	-7	-1.67%	-7.22%
5-year US Treasury	3.49%	3.60%	-11	-3.06%	-12.97%
10-yr US Treasury	3.40%	3.50%	-10	-2.86%	-12.37%
2s-10s UST Spread	-71.00	-68.00	-3.00	4.41%	29.09%
DJIA	34,054	33,949	105.00	0.31%	2.74%
S&P 500	4,180	4,060	120.00	2.96%	8.85%
Spot Gold	1,930	1,947	-17.00	-0.87%	5.70%
WTI (Oil) Current Contract	75.84	81.01	-5.17	-6.38%	-5.51%
1-year Brokered CD	4.70%	4.70%	0	0.00%	2.17%
5-year Brokered CD	3.80%	3.80%	0	0.00%	-5.00%
5-year Bullet US Agency	3.56%	3.71%	-15	-4.04%	-12.75%
5-year/NC1yr Callable US Agcy.	4.95%	5.05%	-10	-1.98%	-8.33%
CDX IG Spread Index	67.58	71.48	-3.90	-5.46%	-17.61%
CDX High Yield Index Spread	103.65	102.71	0.94	0.92%	3.01%
15-yr UMBS	3.97%	4.04%	-7	-1.73%	-14.81%
30-yr UMBS	4.64%	4.84%	-20	-4.13%	-12.95%

Source: Bloomberg data as of 5pm ET 2/2/2023 and 3:15pm ET 1/26/2023

Perhaps the real damage of the day, assuming that maintaining some semblance of tighter financial conditions is the objective, was opening a lane to rate cuts by the end of the year. As expected, market yields fell and credit spreads ripped tighter, along with the NASDAQ and S&P 500 up 16.6% and 8.9% respectively, with the former representing the best performance through February 2nd since 1975. While inflation has surely receded across much of the goods complex and has started to slow in spot rents and other services, the Chairman’s more benign messaging yesterday appears to be a bit premature to us, much in the same way it would have to the Committee a few short weeks ago.

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

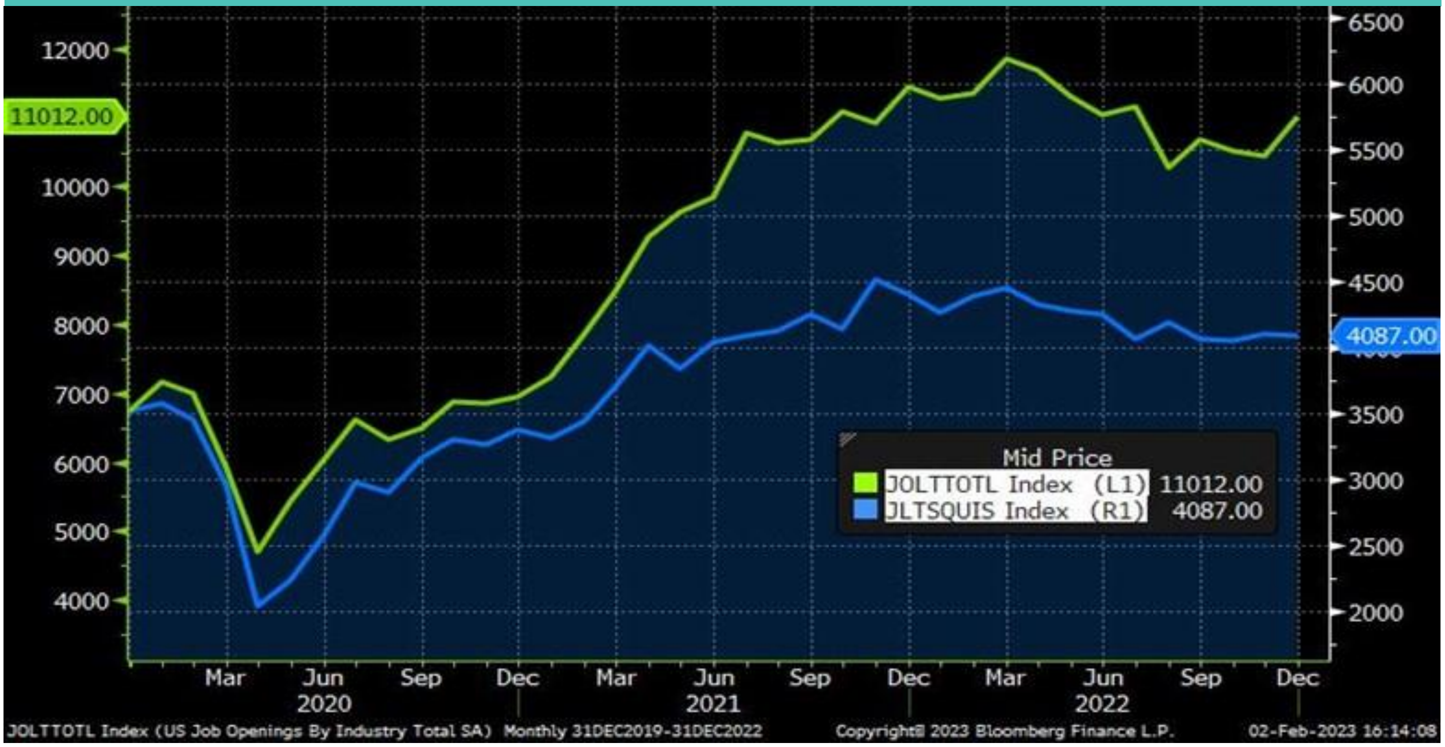
Consumer Confidence & Expectations – Monthly – 3 Years



Source: Bloomberg as of 2/2/2023

Consumer confidence was off fractionally in January to 107.1 (vs. 109 est./109 December), the second highest level since September, driven largely by the recent moderation in core inflation and another month of lower energy prices, which was tempered by less upbeat attitudes regarding business conditions over the next six months. Leading this month's decline was the expectations component, a measure of consumers' six-month outlook, which fell to 77.8 (83.4 Dec.), dipping below the recessionary reading of 80 for the tenth time over the last twelve months, as more respondents expect the economy to worsen (21.6% vs. 19.9% Dec.) and fewer expect business conditions to improve (18.6% vs. 20.9% Dec.), along with an uptick in median inflation expectations over the next year (6.8% vs. 6.6% Dec.). Conversely, the current conditions component rose to 150.9 (147.4 Dec.), the highest level since April 2022, led by moderating inflation, more job market optimism and less respondents seeing poor current business conditions (19.2% vs. 19.7% Dec.). Looking at the text of the report, the senior director of the survey stated that "Consumers' assessment of present economic and labor market conditions improved at the start of 2023. However, the Expectations Index retreated in January reflecting their concerns about the economy over the next six months. Consumers were less upbeat about the short-term outlook for jobs. They also expect business conditions to worsen in the near term." and that "Meanwhile, purchasing plans for autos and appliances held steady, but fewer consumers are planning to buy a home—new or existing. Consumers' expectations for inflation ticked up slightly from 6.6 percent to 6.8 percent over the next 12 months, but inflation expectations are still down from its peak of 7.9 percent last seen in June." To be sure, overall confidence has been largely supported by durable strength in the labor market this year, and January's data revealed another rise in the share of consumers seeing job opportunities as "plentiful" to 48.2% (46.4% Dec.), the highest level in four months and fewer respondents saw jobs as "hard to get" (11.3%; 11.9% Dec.), hovering near all-time lows. All in all, while another welcome reversal of weakness earlier in the fourth quarter, the risks of further softening in consumer spending have risen given higher interest rates, plummeting personal savings rates and surge in consumer credit balances, a union likely to weaken confidence in the months to come.

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



Source: Bloomberg as of 2/2/2023

The number of available jobs unexpectedly rose 572,000 to 11.01 million (10.3 million est.) in December as chronic labor shortages and robust demand continue to drive tight job markets. By industry, job openings increased in leisure & hospitality (+430,000), trade & transport (+175,000), and construction (+82,000), with decreases in information services (-107,000) and manufacturing (-39,000), as employers continue to report difficulty attracting and retaining enough workers to keep up with still robust demand for goods and services. Indeed, the labor participation rate remains over 1% lower than its 2019, pre-pandemic peak as higher retirement rates, skill mismatches and mixed participation have stunted employer efforts to add new workers. Additionally, the quits rate, which measures voluntary job separations per month as a percent of total employment, was unchanged at 2.7% (4.1 million jobs; 2.3% Dec. 2019), just shy of last December's all-time high (3%), as compensation increases, recruiting incentives and the sheer magnitude of job vacancies continue to drive higher employee turnover. Further evidence of job market snugness can be seen in the layoffs and discharge rate, which ticked up to 1% during December (record low .8% December 2021) and the 1.92x ratio of jobs available to each unemployed worker (cycle high 1.99x March 2022; 1.15 Dec. 2019), the highest level since July 2022 (1.95x) and indicative of very tight labor markets. To be sure, durable labor shortages are forcing companies to increase compensation to attract and retain workers, with little relief expected during the first half of 2023. While selected job market imbalances should subside given FOMC rate hikes and slowing demand, we believe the JOLTS data will remain high as the pandemic and elevated, state-level direct economic assistance drove structural changes to the labor force that have slowed the return to pre-pandemic levels of labor participation. All in all, open positions and the job openings rate (6.7%; 7.3% peak in March 2022) remain historically high and will keep the FOMC on track to continue raising rates during the first quarter as chronic labor supply/demand imbalances will likely support solid wage growth and broad-based pricing pressures in the months to come.

FOMC Rate Decision & Statement Analysis

As expected, the FOMC raised the Federal Funds rate by 25 basis points to 4.75% on Wednesday afternoon with a unanimous vote of 12-0, the highest level since October 2007. As with the last several meetings, Chairman Powell reiterated the Committee's stance that ongoing increases in the target rate are appropriate and maintained that a pathway to a soft economic landing still exists. While this remains at odds with many investors and the general public, the Chairman stated that continued strength in job creation will likely be enough to avoid a meaningful economic contraction. Importantly, he stated multiple times that additional rate hikes will be necessary to render sufficiently restrictive monetary policy, a stance that essentially endorsed the latest version of the Dot Plot relating to the peak level of the terminal rate as the Committee's current view. To review, the December Dot Plot, which outlines rate projections by the 18 FOMC members, now sits at 50 basis points of additionally tightening this year, to a median terminal rate of 5.125% by May. Additionally, the December SEP data revealed that the Committee forecasted PCE inflation to come in at 3.5% and 2.5% at the end of 2023 and 2024 respectively, both well above the 2% target, and Real GDP growth of .5% for both this and next year. That said, there were a number of dovish takeaways from yesterday's meeting, which were underscored during the post-meeting press conference where the Chairman stated, for the first time this cycle, that the 'disinflation process has started,' and his seemingly dismissive posture regarding the recent and dramatic loosening of financial conditions, stating that he was more focused on 'long-term trends.' Perhaps most importantly and in another first, the Fed chief appeared to open the door to rate cuts by the end of the year, by not explicitly endorsing the end of year forecast component of December's dot plot, which left the terminal rate unchanged at 5.125% for all of 2023. While the Chairman did reiterate that the Committee believes the current trajectory of goods disinflation was likely to normalize in the near term and that PCE core services (excluding housing rents), a key inflation metric for the FOMC, has stabilized around 4% with few signs of slowing, both supportive of more rate hikes, bond yields moved lower during the post-meeting press conference given the patently dovish comments regarding disinflation and loosening financial conditions. While Powell again delivered the Committee's party line on inflation, that we understand the hardship and have the tools and resolve to break it, we remain skeptical of the Fed's ability to break inflation without breaking the economy given their constraint of possessing demand side tools only and the Chairman's insistence that this FOMC will not make the same policy mistakes of the 1970s. While many continue to cite solid consumer and business balance sheets and still elevated real estate valuations as a hedge against a meaningful economic downturn, we believe that the persistent slide in consumer savings, surging consumer debt and cumulative rate hikes have increased the risk of a larger contraction in consumption and investment later in 2023.

Comparing February and December statements, the changes centered upon the addition of easing inflation language, elimination of language related to pandemic, supply-chain effects and the inflationary effects of the war in Ukraine, and transition from the pace to the extent of tightening language:

"Inflation has eased somewhat but remains elevated," which replaced December's "Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures."

"Russia's war against Ukraine is causing tremendous human and economic hardship and is contributing to elevated global uncertainty," which replaced December's "Russia's war against Ukraine is causing tremendous human and economic hardship. The war and related events are contributing to upward pressure on inflation and are weighing on global economic activity."

'In determining the extent of future increases in the target range," which replaced December's "In determining the pace of future increases in the target range."

All and all, Chairman Powell delivered a remarkably dovish set of messages yesterday, headlined by repeated usage of 'disinflation' language, lack of pushback against loosening financial conditions and, most importantly, opening the door for potential rate cuts by the end of 2023. Judging by the bond market reaction of lower yields, tighter credit spreads and falling Federal Funds futures levels post-meeting, the market appears to be buying what the FOMC is selling, for now. Stay tuned!

Date	Target	BN Survey	Survey vs Actual	Direction	Change	Discount	Vote
02/01/23	4.50%-4.75%	4.50%-4.75%	Expected	Tightening	0.25%	4.75%	12-0
12/14/22	4.25%-4.50%	4.25%-4.50%	Expected	Tightening	0.50%	4.50%	12-0
11/02/22	3.75%-4.00%	3.75%-4.00%	Expected	Tightening	0.75%	4.00%	12-0
09/21/22	3.00%-3.25%	3.00%-3.25%	Expected	Tightening	0.75%	3.25%	12-0
07/27/22	2.25%-2.50%	2.25%-2.50%	Expected	Tightening	0.75%	2.50%	12-0
06/15/22	1.50%-1.75%	1.25%-1.50%	Surprise	Tightening	0.75%	1.75%	10-1
05/04/22	0.75%-1.00%	0.75%-1.00%	Expected	Tightening	0.50%	1.00%	9-0
03/16/22	0.25%-0.50%	0.25%-0.50%	Expected	Tightening	0.25%	0.50%	8-1
01/26/22	0.00%-0.25%	0.00%-0.25%	Expected	None	None	0.25%	9-0

Source: Bloomberg as of 2/2/2023

The Week Ahead

The data calendar slows down over the next week, headlined by Non-Farm Payrolls, ISM Services, and Initial Jobless Claims. Looking ahead, markets remain focused on inflation, jobs data and further signs of slowing economic activity. On the new issue front, ABS volumes slowed during the first week of February given the FOMC rate decision yesterday with four deals totaling $1.60 billion priced through the 1st and $21.8 billion year to date ($25.2 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance also slowed with $7.7 billion in deals priced through the 1st and $147.4 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.

Friday 2/3

Non-Farm Payrolls; ISM Services

Monday 2/6

No Data Scheduled

Tuesday 2/7

Consumer Credit; Trade Balance

Wednesday 2/8

MBA Mortgage Applications

Thursday 2/9

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.