Fixed Income Market Insights

August 17, 2023

Key takeaways

Bond yields were higher this week, with GT2s up 11 basis points and GT10s higher by 19 basis points and 2s/10s less inverted by 8 basis points (-65), driven by durable strength in consumer spending and FOMC minutes for the July 28th meeting that revealed most FOMC members continued to see significant upside risks to inflation. On the data front, Headline PPI again came in a bit stronger than expected during July with prices up +.3%, as rebounding services and food prices were partially tempered by flat core goods (less food & energy) given the ongoing trend of improving supply chains and better supply/demand balance. The University of Michigan Consumer Sentiment Index came in as expected at 71.2 in August, the second highest level since October 2021, again driven by moderating inflation and durable strength in the labor market. Headline retail sales rebounded during July with receipts up +.7%, the second largest monthly advance this year, as Amazon Prime Day and back to school shopping buttressed spending despite ongoing headwinds of higher prices, elevated interest rates and depleted pandemic-era excess savings, particularly for lower income earners.

We suggest

We continue to prefer playing defense given elevated inflationary expectations and the likelihood of elevated short-term interest 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.

Author

David Petrosinelli, CFA
Managing Director
Senior Trader

Insperex®

The Home Price Paradox

As consumers and businesses grapple with the fallout from elevated inflation and the most aggressive FOMC tightening in over 40 years, home values have surprised most investors to the upside with national median prices for existing homes less than 1% lower than the all-time high of $413,800 registered last June. Indeed, mortgage rates have soared since the Federal Reserve started raising interest rates last March, with the average rate for a 30-year, fixed loan hitting 7.16% last week according to Mortgage Bankers Association data, the highest contract rate since December 2001. While today's rate environment would not appear to be supportive of such home price resilience, the rapidity and absolute size of this cycle's jump in mortgage rates have served to depress both demand and supply in offsetting fashion, stabilizing prices and further eroding already rock-bottom affordability. Regarding the payment impact of higher mortgage rates, monthly payments on a $600,000 mortgage at today's rates would run nearly $4,100, up from $2,600 per month just prior the start of the current tightening cycle early last year. To be sure, this meteoric rise in financing costs has sharply slowed demand, with home purchase applications reaching the second lowest level since 1995 last week.

Market Snapshot

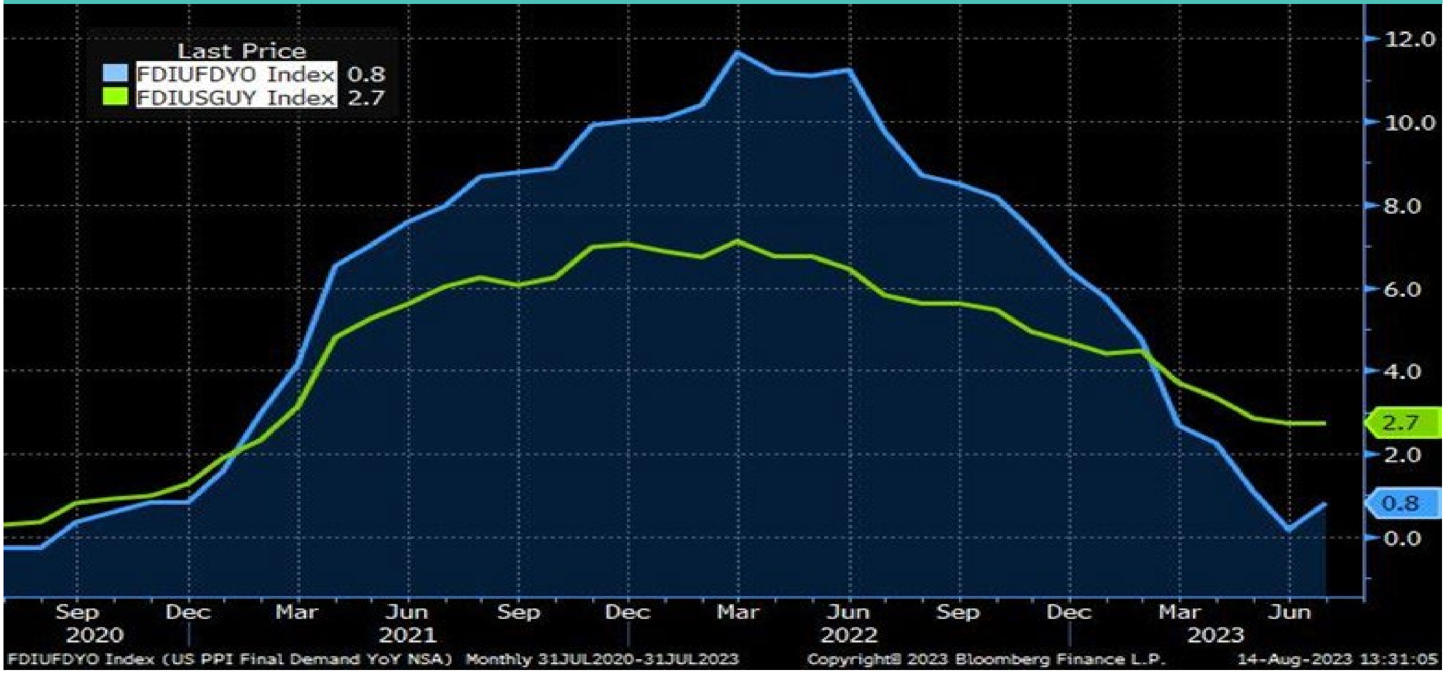
	This week 8/17/23	Last week 8/10/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.64%	5.63%	1	0.18%	18.24%
SOFR	5.30%	5.30%	0	0.00%	23.26%
2-year US Treasury	4.93%	4.82%	11	2.28%	11.29%
5-year US Treasury	4.41%	4.20%	21	5.00%	9.98%
10-yr US Treasury	4.28%	4.09%	19	4.65%	10.31%
2s-10s UST Spread	-65.00	-73.00	8.00	-10.96%	18.18%
DJIA	34,475	35,252	-777.00	-2.20%	4.01%
S&P 500	4,370	4,478	-108.00	-2.41%	13.80%
Spot Gold	1,915	1,947	-32.00	-1.64%	4.87%
WTI (Oil) Current Contract	80.39	82.96	-2.57	-3.10%	0.16%
1-year Brokered CD	5.30%	5.25%	5	0.95%	15.22%
5-year Brokered CD	4.45%	4.45%	0	0.00%	11.25%
5-year Bullet US Agency	4.52%	4.32%	20	4.63%	10.78%
5-year/NC1yr Callable US Agcy.	5.85%	5.65%	20	3.54%	8.33%
CDX IG Spread Index	70.88	66.66	4.22	6.33%	-13.58%
CDX High Yield Index Spread	101.77	102.72	-0.95	-0.92%	1.14%
15-yr UMBS	5.58%	5.33%	25	4.69%	19.74%
30-yr UMBS	6.06%	5.78%	28	4.84%	13.70%

Source: Bloomberg data as of 5:00pm ET 8/17/2023 and 3:00pm ET 8/10/2023

Additionally, many of those existing homeowners looking to move would need to give up a much lower mortgage rate to do so, a major roadblock that has served to drastically reduce traditional housing turnover and, by extension, supply. Indeed, the supply of existing homes for sale has averaged just 1 million units during the first half of this year, roughly 50% lower than pre-pandemic averages, and those that are listed sell quickly, further dampening supply and supporting elevated prices. For data points, the magnitude of this tighter supply is apparent in the months of supply and days on the market metrics for June, which came in at 3.1 months (record low 1.8 months) and 18 days (record low 14 days) respectively, both very low by historical standards. This unenviable combination of much higher mortgage rates and all-time highs in median home prices has priced out most potential home buyers, with data analytics firm Black Knight, Inc. estimating that housing affordability is now at the lowest level since 1984, a year when the Federal Funds rate and the 10-year U.S. Treasury yield averaged 10.2% and 12.4% respectively. While a resilient labor market and higher nominal wages have staved off mortgage defaults and supported elevated home prices for now, the specter of 'higher for longer' regarding interest rates, record-high credit card debt, depletion of pandemic-era excess savings and tighter credit conditions may very well crack the code for lower home prices during 2024.

Still 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, 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 two weeks ago by the New Civil Liberties Alliance (NCLA), who argued 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. As with the Administration's larger, Executive Order ultimately struck down by the Supreme Court, the NCLA lawsuit was dismissed earlier this week by a U.S. circuit court, the first venue prior to appeals, with the judge stating that the plaintiffs lacked standing to bring suit. Like the Executive Order, we expect an appeal to the Supreme Court in the weeks to come. Stay tuned!

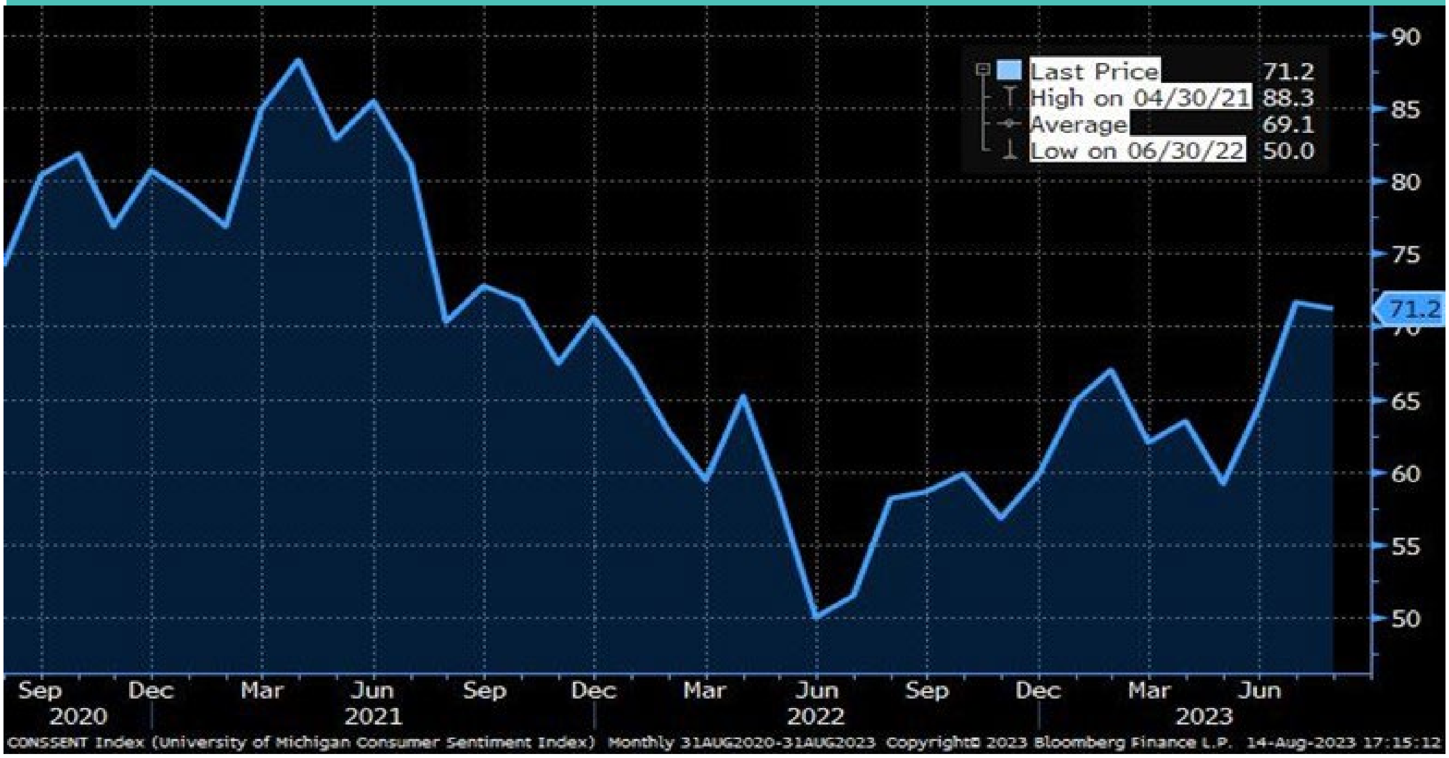
PPI Final Demand – Headline & Core YoY – Monthly – 3 years



Source: Bloomberg as of 8/17/2023

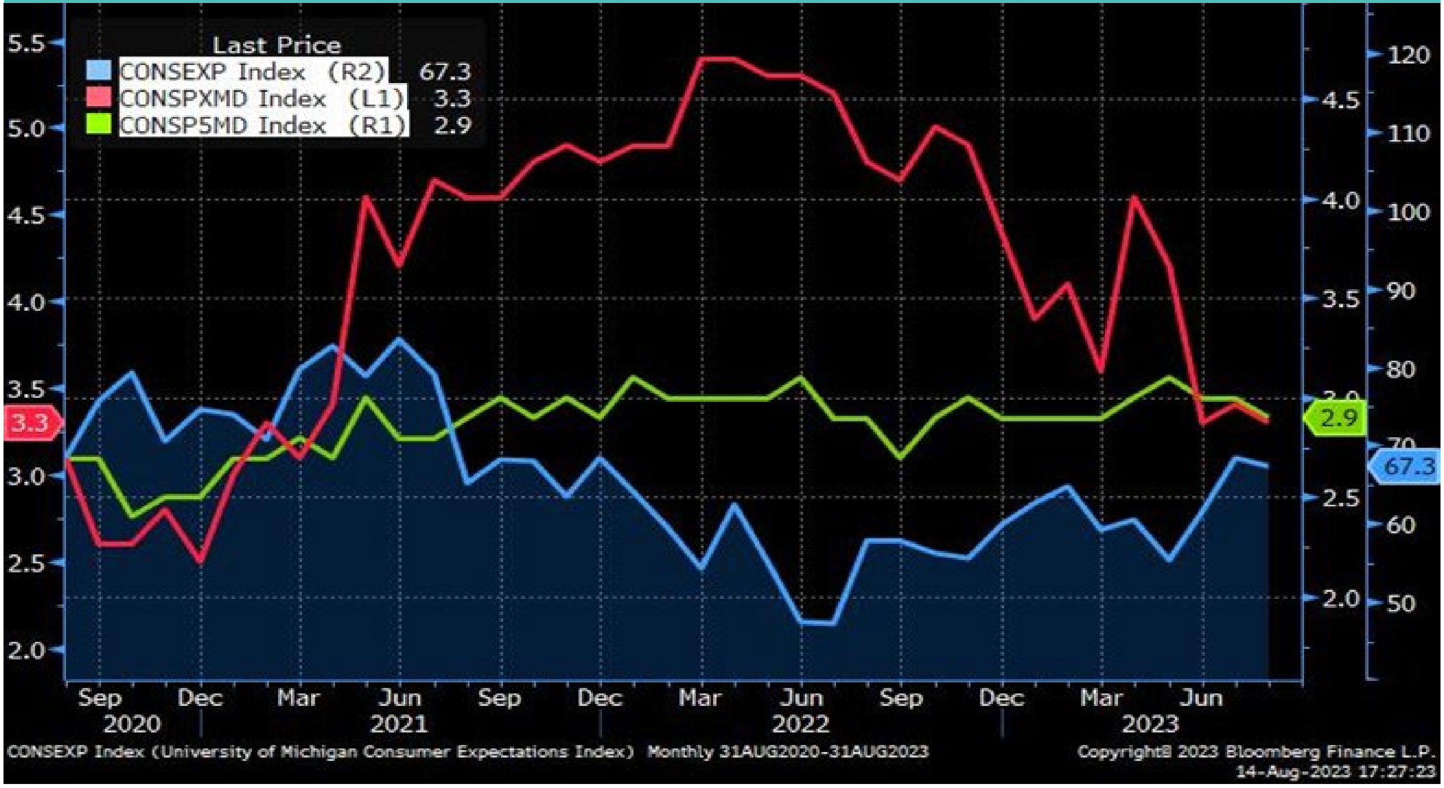
Headline PPI again came in a bit stronger than expected during July with prices up +.3% (+.2% est.; +0% Jun.), as rebounding services and food prices were partially tempered by flat core goods (less food & energy) given the ongoing trend of improving supply chains and better supply/demand balance. In the aggregate, prices for goods and services were up last month, with goods advancing +.1% (-2.5% year over year/+0% Jun.), and services higher by +.5% (+2.5% year over year/-.1% Jun.), continuing the trend of headline PPI disinflation that started last year and driving expectations for more easing of wholesale prices. From a contribution standpoint, continued weakness in core goods (+0%; -.2% Jun.) was offset by a +.5% jump in food prices, with higher services prices driving the remaining headline advance. Core PPI (less food, energy and trade) was up +.2% last month (+.2% est.; +2.7% last 12 months), well off last March's 9.7% cycle high, but still indicative of elevated inflationary pressures away from food and energy. As with much of the past two years, the chronic natures of these cost increases have enabled businesses to raise prices, which have been passed along to consumers and served to keep inflation expectations elevated above the FOMC's stated target of 2%. As reported in the NFIB Small Business Optimism index last week, more than 25% (all-time high of 66 in March 2022) of small businesses surveyed stated that they raised selling prices last month and 38% of respondents said they raised compensation to recruit and retain employees, both lower from last year's all-time highs, but still likely to support elevated prices in the coming months. That said, receding supply chain frictions and softer goods demand have weighed on the cost of processed goods for intermediate demand, reflecting prices earlier in the production pipeline, which fell -.6% in July (-7.8% YOY; -.5% Jun.), the twelfth contraction over the past thirteen months, driven by a -7.6% drop in steel mill products and declines across several energy and industrial material components. All in all, another tepid report indicative of disinflation at the wholesale level as weak core goods prices weighed down last month's rebound in services costs.

U of Michigan Consumer Sentiment – Monthly – 3 Years



Source: Bloomberg as of 8/17/2023

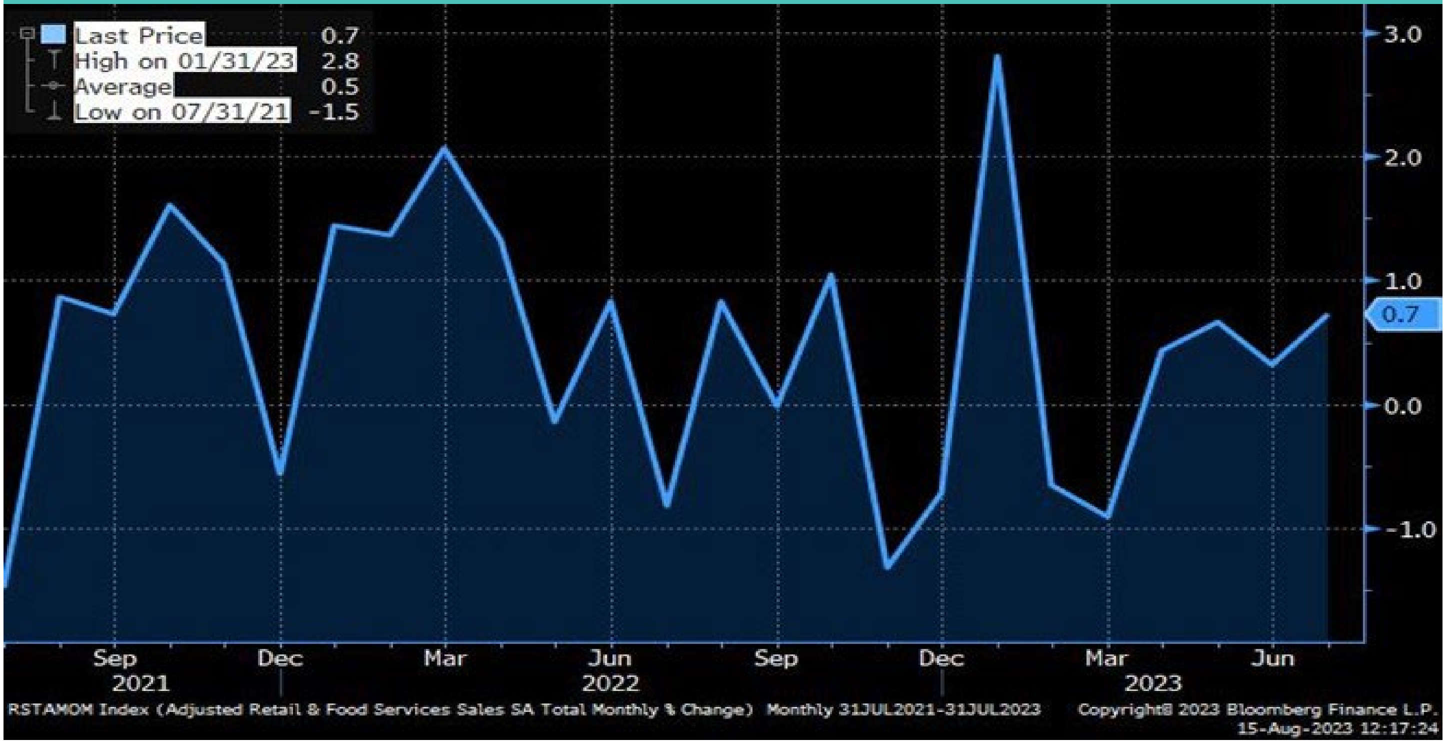
U of Michigan Consumer Expectations, 1yr and 5-10yr Inflation – Monthly – 3 Years



Source: Bloomberg as of 8/17/2023

The University of Michigan Consumer Sentiment Index came in as expected at 71.2 in August (71.2 est.; 71.6 July), the second highest level since October 2021, again driven by moderating inflation and durable strength in the labor market. Notwithstanding this improvement, nearly 37% of consumers attributed their negative views regarding personal finances to inflation (36% July; 36% in Jan.), shy of the all-time high during the 2008 financial crisis (49%), and a mere 20% expect their incomes to rise more than inflation, an improvement over last June's 13% cycle low, but still historically low. Additionally, just 32% of consumers expect good economic times over the next year (July 2022 cycle low: 13%) as higher interest rates, elevated inflation and dissatisfaction with government's economic policies (45%) continue to weigh on consumer optimism regarding their near-term financial health. A deeper dive into the survey revealed small changes in both components of headline sentiment, with current conditions fractionally higher to 77.4 (76.6 July; 68.4 Jan) and expectations lower to 67.3 (68.3 July; 62.7 Jan), at or just shy of the highest levels since October and December 2021 respectively, but still well below pre-pandemic levels. On the price front, year-ahead inflationary expectations edged slightly lower to 3.3%, the lowest level since March 2021 (3.4% July; 2.6% 2019 average; cycle high 5.4% March 2022) and longer-term expectations ticked lower to 2.9% (3.0% July; 2.4% 2019 average; cycle high 3.1% May 2023), both historically high and well above of the FOMC's target of 2%. Looking at the text of the report, the director of the survey stated that "In general, consumers perceived few material differences in the economic environment from last month, but they saw substantial improvements relative to just three months ago," and that "Consumers have exhibited greater confidence that inflation will indeed continue to slow both in the short and long run." Notwithstanding the recent improvement in sentiment, inflation, elevated interest rates and discontent regarding government policies continue to weigh on consumer optimism, a combination that threatens to dampen consumption in the months to come as the cumulative effects of FOMC policy tightening become fully-embedded in the economy.

Retail Sales Advance MoM – Monthly – 3 Years



Source: Bloomberg as of 8/17/2023

Headline retail sales rebounded during July with receipts up +.7% (+.4% est./+.3% Jun.), the second largest monthly advance this year, as Amazon Prime Day and back to school shopping buttressed spending despite ongoing headwinds of higher prices, elevated interest rates and depleted pandemic-era excess savings, particularly for lower income earners. In total, 9 of the 13 categories posted gains last month, led by higher receipts for non-store retailers (+1.9%), sporting goods (+1.5%), eating/drinking outlets (+1.4%), clothing (+1.0%), department stores (+.9%), food/beverage (+.8%), health/personal care (+.7%), which were partially offset by declines in furniture (-1.8%), electronics (-1.3%) and motor vehicles/parts (-.3%). Additionally, control-group sales, which exclude autos, building-material stores, food services, gasoline stations and feed directly into GDP calculations, rose a robust +1.0% in July (+5.8% 3M Annualized), the largest monthly advance since January and a marked pick-up from a more modest second quarter, where comparable sales growth totaled 2.7% on an annualized basis, a meaningful pullback from the 5.1% advance during the first quarter (+2.0% Q4 2022). While labor market strength and excess liquidity via pandemic-era stimulus have propelled consumer spending post the darkest days of COVID-19, soaring credit card balances and depleted excess savings have increased the risks of deeper slowdown in consumption in the coming months, particularly given the likelihood of 'higher for longer' interest rates and the cumulative effects FOMC monetary policy tightening yet to be fully embedded in the economy. While a very strong report driven by Amazon Prime day, back to school spending and summer vacations, this momentum is likely unsustainable heading into the fall once pent-up demand for travel cools, the weight of higher financing costs sets in and depleted excess pandemic-era savings weigh more heavily on discretionary spending.

The Week Ahead

The data calendar slows over the coming week, headlined by the Durable Goods Orders, Existing Home Sales and Weekly Jobless Claims. Looking ahead, markets remain focused on inflation, employment data and signs of slower economic activity. On the new issue front, ABS volumes remained robust during the third week of August with seven deals totaling $7.8 billion priced through the 16th and $191.1 billion year to date ($205.3 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance slowed with $13.8 billion priced through the 16th and $853.3 billion year to date ($962.3 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 wide array of ABS and corporate issuers as investor demand remains strong.

Friday 8/18

Bloomberg U.S. Economic Survey (August)

Monday 8/21

No Data Releases

Tuesday 8/22

Existing Home Sales; Philadelphia Fed Non-Manufacturing Activity

Wednesday 8/23

S&P U.S. Manufacturing & Services PMI; New Home Sales

Thursday 8/24

Durable Goods Orders; Weekly Jobless Claims

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.

This message was prepared by InspereX LLC as of 8/17/2023 at approximately 5:00pm ET for informational and educational purposes only. The author of this material is a Managing Director and Senior Trader for InspereX and is not a Research Analyst. Any opinions expressed herein may differ from opinions expressed by other departments of InspereX. The information and data contained herein is subject to change without notice. Additionally, the content of this material was obtained from sources believed to be reliable, but InspereX does not warrant the accuracy or completeness of any information contained herein and provides no assurance that this information is, in fact, accurate. The information contained herein is for illustrative purposes only and may not represent specific securities available at any given time.

InspereX LLC ("InspereX") and its affiliates explicitly disclaim any responsibility for product suitability or suitability determinations related to individual investors. This information should not be regarded by recipients as a substitute for the exercise of their own independent judgment and the information provided herein is not an offer, solicitation, or a recommendation to buy, sell or hold any security or investment strategy. This material should not be considered, construed, or followed as investment advice, an investment recommendation or research material. InspereX does not provide financial planning, legal, or tax advice. Past performance is not indicative of future results.

This material may include discussions of securities or financial products in which InspereX may have positions, long or short, held proprietarily or in trust. InspereX may execute transactions that may not be consistent with any discussion or conclusion contained herein. InspereX may also have received compensation for performing investment banking services or be (or previously been) engaged in soliciting or performing other services for the issuer(s) of the securities discussed herein. Further, InspereX may have received compensation as a manager or co-manager in a public offering for the issuer(s) mentioned herein.

Investing involves the risk of loss. Investments discussed here may not be suitable for all investors. You should not purchase an investment product until you have read the specific offering documentation and understand the specific investment terms and risks of such investment. The information contained herein does not constitute an offer to sell or a solicitation of an offer to buy securities. Investment products described herein may not be offered for sale in any state or jurisdiction in which such an offer, solicitation or sale would be unlawful or prohibited by the specific offering documentation.

All bonds and fixed income products are subject to a number of risks, including the possibility of issuer default, credit risk, market risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities. Lower-quality fixed-income securities generally offer higher yields, but also carry more risk of default or price changes due to potential changes in the credit quality of the issuer. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities and, as a result, they may have a higher probability of default.

InspereX®