Fixed Income Market Insights

July 13, 2023

Key takeaways

Bond yields moved sharply lower this week, with GT2s down 38 basis points and GT10s lower by 28 basis points respectively, and 2s/10s less inverted by 10 basis points (-86), as softer CPI and PPI inflation data raised the likelihood the FOMC will culminate its current tightening cycle with one more, 25-basis point hike on July 26th. On the data front, Headline Non-Farm Payrolls came in weaker than expected with 209,000 new jobs added in June, the lowest since December 2020, as a deceleration in private payrolls (services) was offset by persistent strength in government hiring. The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, was fractionally higher at 91 during June, hovering near pandemic-era lows (89.5 June 2022) as durably elevated inflation, high interest rates and anemic business expectations continue to dampen sentiment. Headline CPI rose +.2% during June and up 3.0% over the past year, the smallest annual gain since March 2021, as the first drop in core goods prices this year was offset by an increase in energy and another month of tepid advances in services and food/beverage prices. Headline PPI again came in weaker than expected during June with prices up +.1%, driven by lower core goods (less food & energy) and transportation prices given the ongoing trend of lower commodities costs and improving supply chains and logistics.

We suggest

We continue to prefer playing rate defense given elevated inflationary expectations and the likelihood of additional FOMC rate hikes this year. We favor barbell strategies in securitized products, anchored by short, higher current cash flow assets and longer, high quality bonds.

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Money Market Flows & Regulatory Woes

Among the many firsts ushered in by the COVID-19 pandemic, perhaps one of the more pronounced asset allocation firsts has benefited a sector historically known as one of the sleepier parts of the bond market- Money Market Funds (MMF). Initially sparked by the pandemic's outbreak during the first quarter of 2020 and further fueled by the precipitous rise in short term interest rates since the FOMC started tightening monetary policy last March, assets in money market funds have soared to an all-time high of $5.5 trillion (ICI MMF Assets; July 5th), up $1 trillion over the last ten months and nearly $2 trillion from the end of 2019. While the largest MMF managers have been the primary beneficiaries of excess fees generated by the surge in assets under management, many are now crying foul regarding new rules imposed on MMF this week by the Securities and Exchange Commission (SEC) to prevent potential runs on MMF assets that could trigger more government backstops like those undertaken in 2008 and again in 2020.

Market Snapshot

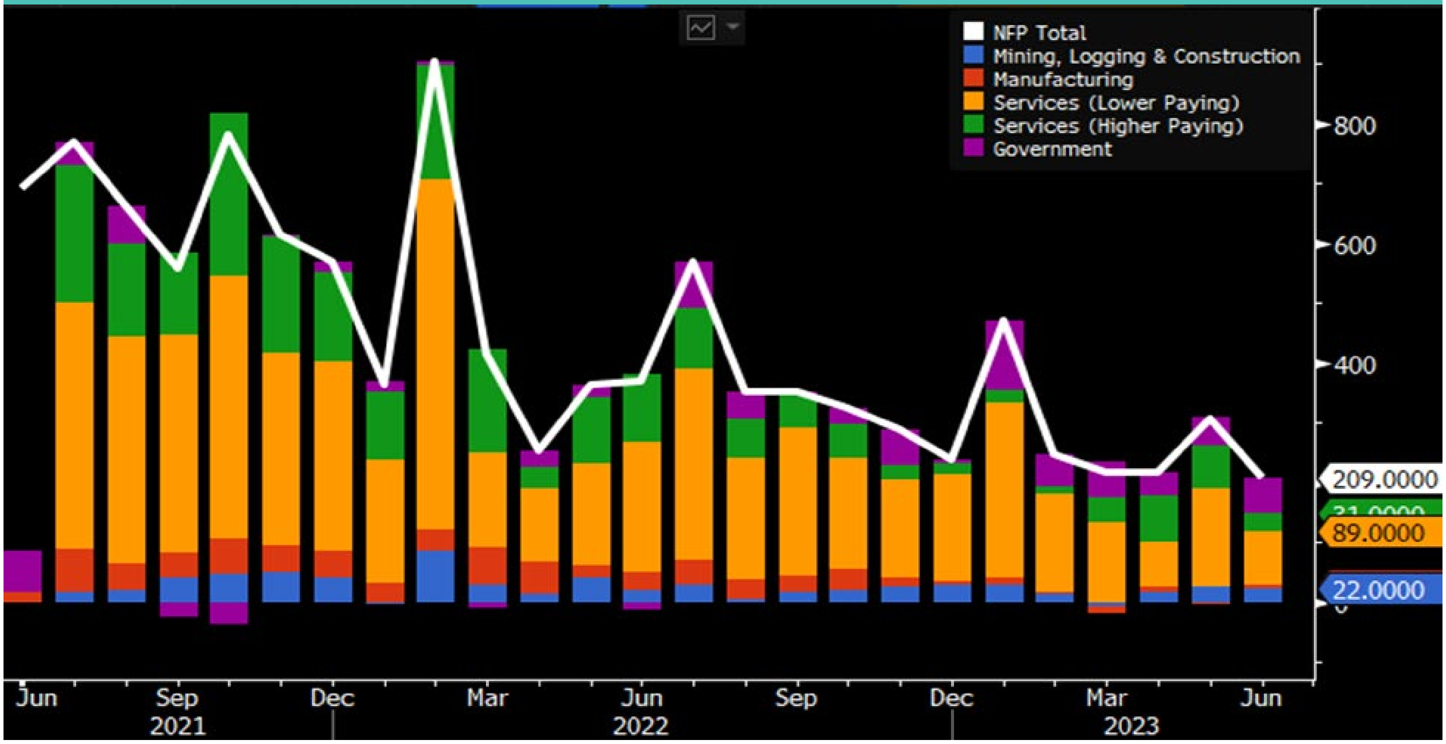
	This week 7/13/23	Last week 7/6/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.57%	5.54%	3	0.54%	16.77%
SOFR	5.05%	5.06%	-1	-0.20%	17.44%
2-year US Treasury	4.62%	5.00%	-38	-7.60%	4.29%
5-year US Treasury	3.94%	4.36%	-42	-9.63%	-1.75%
10-yr US Treasury	3.76%	4.04%	-28	-6.93%	-3.09%
2s-10s UST Spread	-86.00	-96.00	10.00	-10.42%	56.36%
DJIA	34,394	33,930	464.00	1.37%	3.76%
S&P 500	4,517	4,412	105.00	2.38%	17.63%
Spot Gold	1,965	1,918	47.00	2.45%	7.61%
WTI (Oil) Current Contract	77.21	71.89	5.32	7.40%	-3.80%
1-year Brokered CD	5.25%	5.30%	-5	-0.94%	14.13%
5-year Brokered CD	4.45%	4.60%	-15	-3.26%	11.25%
5-year Bullet US Agency	4.01%	4.43%	-42	-9.48%	-1.72%
5-year/NC1yr Callable US Agcy	5.44%	5.85%	-41	-7.01%	0.74%
CDX IG Spread Index	65.15	70.90	-5.75	-8.11%	-20.57%
CDX High Yield Index Spread	103.20	101.78	1.42	1.40%	2.56%
15-yr UMBS	4.89%	5.39%	-50	-9.28%	4.94%
30-yr UMBS	5.37%	5.87%	-50	-8.52%	0.75%

Source: Bloomberg data as of 3:45pm ET 7/13/2023 and 3:00pm ET 7/6/2023

The new rules, scheduled to take full effect in 2024, require certain Institutional MMF to charge a 'liquidity fee' payable by investors who redeem their shares when daily net redemptions exceed 5% of the host fund's net assets, along with stricter asset allocation rules that mandate these funds to maintain at least 25% of their holdings in assets that mature in one day (vs. 10%) and at least 50% of their holdings in assets that mature within one week (vs. 30%). In concept, the 'liquidity fee' would discourage a run on MMF assets during times of market volatility, given that mass redemptions would both increase costs to the affected funds and dilute remaining shareholders' assets, along with potential MMF 'contagion' risks where block selling of short-term debt instruments could pressure $1 net asset values (NAV) of other funds. To review, MMF accumulate investor deposits to buy shorter-term debt like government bonds and commercial paper, which creates a mismatch between the funds' investments with longer maturities versus daily liquidity requirements of investors, exposing the fund to risks akin to a proverbial 'run on the bank.' As expected, the reaction from the mutual fund industry has been, in a word, unsurprising. Indeed, the CEO of the Investment Company Institute, a trade association representing regulated investment funds, stated that "The SEC has missed the mark by forcing certain money market funds to adopt an expensive and clunky mandatory fee on investors," arguing that the new rules will increase costs for the wide swath of institutional investors that utilize MMF. While these rules will not take full effect until 2024, suffice it to say that the costs of adding more regulation and forcing expensive and hard to implement rules upon institutional MMF will ultimately be shouldered by the fund's investors in the form of lower yields and higher redemption hurdles.

Still quiet on the fiscal front post the debt ceiling deal. 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 last week, 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 ruling, the administration is working on another, end-around the Court and Congress to lower payments for some that possess student loan debt. Stay tuned!

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



Source: Bloomberg as of 7/13/2023

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

Source: Bloomberg as of 7/13/2023

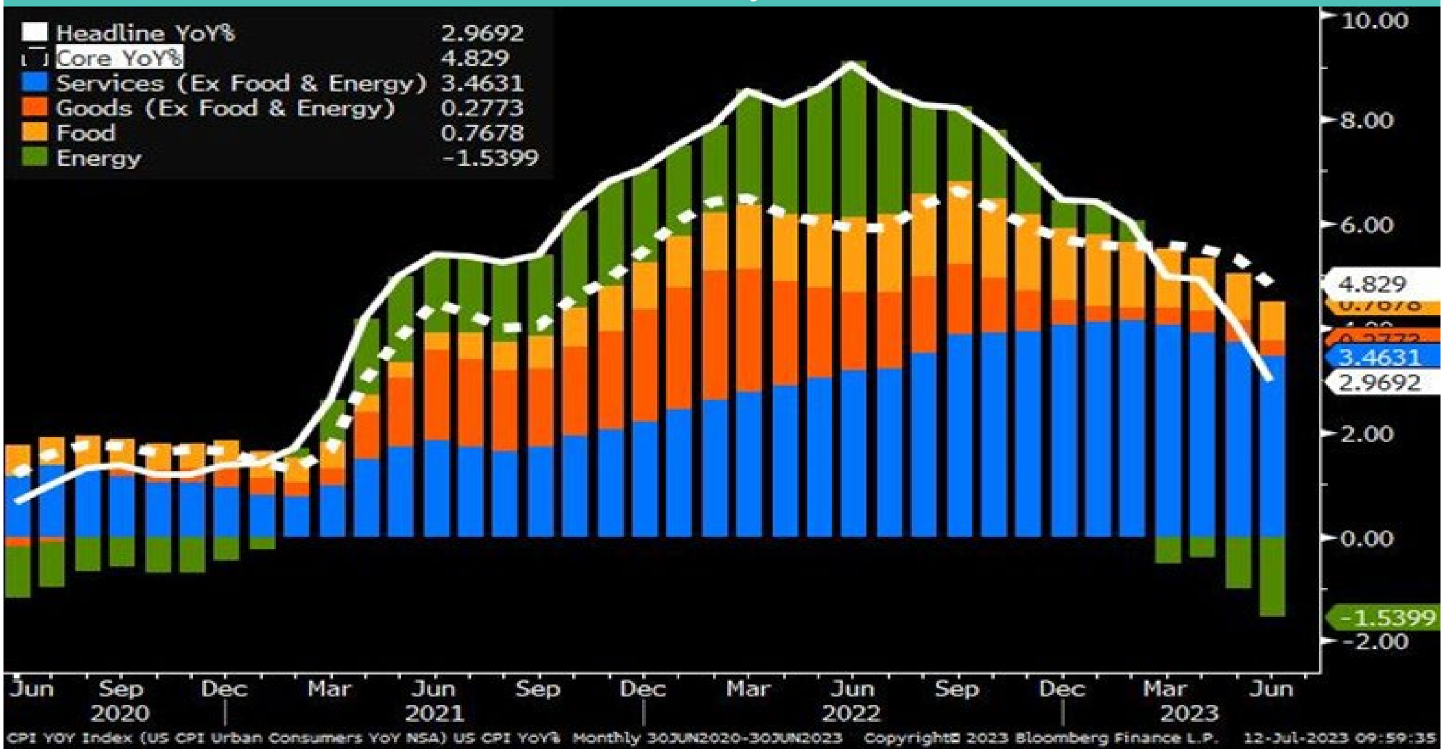
Headline Non-Farm Payrolls came in weaker than expected with 209,000 new jobs added in June (230,000 est.), the lowest since December 2020, as a deceleration in private payrolls (services) was offset by persistent strength in government hiring. Taken together with revisions that subtracted 110,000 jobs in the prior two months, job creation still remains healthy with average monthly gains of 244,00 during the second quarter, a deceleration from last quarter's 312,000 pace (vs. 284,000 Q4 2022). Looking by industry revealed broad based gains, albeit at a slower pace, led by advances in education/health (+73k), government (+60k), construction (+23k), professional/business services (+21k) and leisure/hospitality (+21k). Beyond the softer headline number, the other big takeaways were the drop in the unemployment rate (UER 3.6%/3.7% May) and the uptick in average hourly earnings (+.4%/+.3% est. 4.4% YOY/4.2% est.), conditions likely to pave the way for additional rate hikes this year given the chronic tightness of labor markets and durability of elevated, nominal wage gains post pandemic. Regarding the labor market, last week's JOLTS job openings (9.8 million), the number of available positions per unemployed worker (1.6x) and quits rate (2.6% or 4 million jobs) remain historically high, suggesting that wage inflation will remain durable in the coming months. Additionally, labor participation remains nearly a percentage point lower than the 2019, pre-pandemic high as elevated retirement rates, skill mismatches and increased entrepreneurship have dampened efforts to fill millions of job openings. This lower participation has driven down the unemployment rate, which fell to 3.6% from April's cycle low of 3.4% (lowest since 1969) and supported higher average hourly earnings (4.4% YOY), both conditions expected to persist in the near term. All in all, a weaker employment report that, when taken with downward revisions to prior months, may portend further cooling in the labor market and, ultimately, some relief from still elevated nominal wage growth.

NFIB Small Business Optimism – Monthly – 2 Years

Source: Bloomberg as of 7/13/2023

The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, was fractionally higher at 91 during June (89.9 est.; 89.4 May), hovering near pandemic-era lows (89.5 June 2022) as durably elevated inflation, high interest rates and anemic business expectations continue to dampen sentiment. On the inflation front, 24% of respondents reported that inflation was their most significant business problem, lower from 25% last month and shy of last July's cycle high 37% print (highest since 1979), but still historically elevated and indicative of the durable nature of inflationary pressures afflicting small businesses. Additionally, labor quality was tied with inflation as the largest business problem at 24%, again indicative of elevated labor market friction as employers push to find qualified candidates for millions of open positions. Indeed, a full 42% of small businesses said they had unfilled job openings (51% record high; May 2022) and 36% stated they have increased compensation over the last three months to add new workers as durably tight labor markets continue to compound wage pressures. As with other elevated input costs, higher labor expenses are being passed along to customers with 29% of the small businesses surveyed stating that they anticipate higher selling prices, a drop from March 2022's all-time high of 66% (1974 inception) and the lowest share since March 2021, but still historically elevated. The combination of still elevated inflation and chronic labor shortages have dampened optimism, with businesses expecting better economic conditions over the next six months running at -40% last month, a 10-point improvement versus May (-50) and better since last June's -61% cycle low, but still historically pessimistic. Indeed, the NFIB chief economist stated that "Halfway through the year, small business owners remain very pessimistic about future business conditions and their sales prospects," and "Inflation and labor shortages continue to be great challenges for small businesses. Owners are still raising selling prices at an inflationary level to try to pass on higher inventory, labor, and energy costs." In summary, the chronic weakness in small business optimism aligns with consumer sentiment data and underscores softening economic expectations, mounting concerns regarding a material credit contraction on the heel of last quarter's bank failures and durably elevated inflation expectations.

CPI Urban Consumers Headline & Core YoY – Monthly – 3 Years



Source: Bloomberg as of 7/13/2023

Headline CPI rose +.2% (+.3% est.) during June and up 3.0% over the past year (+3.1% est.), the smallest annual gain since March 2021, as the first drop in core goods prices this year was offset by an increase in energy and another month of tepid advances in services and food/beverage prices. Core CPI (less food and energy) was up +.2% (+.3% est.) in June, the smallest monthly advance since August 2021, and 4.8% (+5.0% est./+5.3% May) over the past 12 months, a moderation from September's year-over-year cycle high (6.6%; highest since 1982), but historically high and still indicative of sustained inflationary pressures across both services and selected goods. While receding, the breadth of price gains remains elevated with 42% of index components up by more than 4% on an annualized basis, down from 56.4% in May (59.5/66.1 Apr./Mar.) and more than 150% of the pre-pandemic run rate. From a contribution standpoint, core goods were down -.1% in June, the first decline in 2023 and the lowest read since last November, driven by falling airline fares and used car prices, along with services up +.3% and 5.7% from a year ago, shy of January's cycle high (7.6%), driven by a +.4% gain in shelter (worth +.14% Headline), and a +.6% advance in energy prices. Drilling down into headline CPI components, prices were mixed, with the largest gains seen in gasoline (+1.0%), rent of primary residence (+.5%), apparel (+.3%) and food (+.1%), which were partially offset by lower airfares (-8.1%) and used car (-.5%) prices. Additionally, real estate prices remain high, with values at or close to record levels in many parts of the country, driving another increase in owner's equivalent rent during May (+.4%; +7.8% year over year), just shy of May's record high, 8% annual gain. Given that inflation expectations are highly correlated to food, energy and shelter costs, the durable nature of elevated prices across these aggregates has unmoored near-term, consumer expectations away from the FOMC's 2% target, a key consideration for policymakers and supportive of the FOMC's 'higher for longer' stance regarding short term interest rates. While another benign report, the breadth of inflationary pressures still remains troublesome, particularly in shelter and other services, with the silver lining of recent deceleration in rents, a lagging indicator given the gradual process of lower spot leasing contract rates bleeding into price data.

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

Source: Bloomberg as of 7/13/2023

Headline PPI again came in weaker than expected during June with prices up +.1% (+.2% est.; +.1% last 12 months), driven by lower core goods (less food & energy) and transportation prices given the ongoing trend of lower commodities costs and improving supply chains and logistics. In the aggregate, prices for goods and services were mixed last month, with goods unchanged (-4.4% year over year/-1.6% May), and services higher by +.2% (+2.3% year over year/+.2% May), continuing the trend of headline PPI disinflation that started last year and advancing expectations for more easing of wholesale prices. From a contribution standpoint, weakness in core goods (-.2%; +.1% May) was offset by a +3.4% jump in gasoline, with higher services prices driving the muted headline advance. Core PPI (less food, energy and trade) was up +.1% last month (+.1% est.; +2.6% last 12 months), well off last March's 9.7% cycle high and reflective of base effects, but still indicative of elevated inflationary pressures away from food and energy. As with much of the past two years, the durability of these cost increases has 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 this week, more than 29% (all-time high of 66 in March 2022) of small businesses surveyed stated that they raised selling prices last month and 36% of respondents said they raised compensation to hire and retain employees, both receding from last year's all-time highs, but still likely to support elevated prices in the near term. That said, receding supply chain bottlenecks and softer goods demand have dampened the cost of processed goods for intermediate demand, reflecting prices earlier in the production pipeline, which fell -.6% in June (-9.4% YOY; -1.5% May), the eleventh contraction over the past year and driven by a -3.5% drop for industrial chemicals and declines across several energy components. All in all, another anemic report indicative of disinflation at the wholesale level as lower core goods and transportation costs weighed down strength in other services.

The Week Ahead

The data calendar slows over the coming week, headlined by UM Consumer Sentiment, Retail Sales and Existing Home Sales. Looking ahead, markets remain focused on inflation, employment data and further signs of slower economic activity. On the new issue front, ABS volumes picked up this week post the July 4th holiday, with nine deals totaling $7.8 billion priced through the 12th and $155.4 billion year to date ($168.2 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance remained light, with $8 billion priced through the 12th and $721.8 billion year to date ($780.2 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 normalized 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 7/14
UM Consumer Sentiment

Monday 7/17
Empire Manufacturing

Tuesday 7/18
Retail Sales; Industrial Production

Wednesday 7/19
Housing Starts; Building Permits

Thursday 7/20
Weekly Jobless Claims; Existing Home Sales; Leading Economic Indicators

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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