Fixed Income Market Insights

November 3, 2023

Key takeaways

Bond yields were lower this week, with GT2s down 5 bps and GT10s lower by 18 bps and 2s/10s more inverted by 13 bps (-33), driven by another 'dovish' pause by the FOMC and the Treasury Department's plans to slow the pace of rising long-term debt sales. Headline PCE prices came in stronger than expected and were up +0.4%, as another month of higher energy prices and rebounding services costs were tempered by a 4th consecutive month of lower durable goods prices. Consumer confidence deteriorated again, driven by further deterioration in business expectations, higher market interest rates, and elevated gasoline prices. The number of available jobs again came in stronger than expected at 9.55 million, the 2nd consecutive increase and highest level since May, as a jump in leisure and hospitality and financial services openings continued the reversal of this year's trend of dissipating excess labor demand. As expected, the FOMC left the Federal Funds rate unchanged at 5.50% with a unanimous vote of 12-0, holding at the highest level since 2001 and the 2nd consecutive meeting without a rate increase.

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Last Call for the Fed?

As widely expected, the Federal Reserve left short-term rates unchanged yesterday – the second consecutive 'pause' and third of the last four meetings – fueling mounting speculation that the most aggressive FOMC tightening cycle in 40 years has come to an end. Frequently citing the significant progress made on bringing inflation down and the growing threat of tighter financial and credit conditions, Federal Reserve Chairman Powell made a much more persuasive case to stop hiking rates versus resuming them. Indeed, the rapid rise of longer-term U.S. Treasury note yields over the last three months appears to have made the difference at the FOMC, with the Chairman repeatedly addressing the negative effects of higher, long-term rates for consumers and businesses, seemingly a nod to the notion that sell-off in the bond market has obviated the need for more hikes in the Federal Funds policy rate. While Chairman Powell added that the drag from higher market yields had to be persistent in order to be an effective proxy for more rate hikes, we believe that most members of the committee have seen enough given the already restrictive level of the Federal Funds rate when backing out inflation. This was underscored by the Chairman during the post-meeting press conference, where he stated that, "if you take the policy rate minus one-year expected inflation you will see a real (inflation-adjusted) policy rate that is well above estimates of a neutral policy rate."

Market Snapshot

	This Week 11/2/23	Last Week 10/26/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.65%	5.65%	0	0.00%	18.45%
SOFR	5.33%	5.30%	3	0.57%	23.95%
2-year US Treasury	4.99%	5.04%	-5	-0.99%	12.64%
5-year US Treasury	4.64%	4.79%	-15	-3.13%	15.71%
10-yr US Treasury	4.66%	4.84%	-18	-3.72%	20.10%
2s-10s UST Spread	-33.00	-20.00	-13.00	65.00%	-40.00%
DJIA	33,839	32,811	1,028	3.13%	2.09%
S&P 500	4,318	4,143	175	4.22%	12.45%
Spot Gold	1,994	1,993	1	0.05%	9.20%
WTI (Oil) Current Contract	82.46	83.25	-0.79	-0.95%	2.74%
1-year Brokered CD	5.45%	5.50%	-5	-0.91%	18.48%
5-year Brokered CD	4.95%	5.00%	-5	-1.00%	23.75%
5-year Bullet US Agency	4.69%	4.87%	-18	-3.70%	14.95%
5-year/NC1yr Callable US Agcy.	5.80%	5.95%	-15	-2.52%	7.41%
CDX IG Spread Index	72.16	81.34	-9.18	-11.29%	-12.02%
CDX High Yield Index Spread	100.84	99.15	1.69	1.70%	0.22%
15-yr UMBS	5.84%	6.02%	-18	-2.99%	25.32%
30-yr UMBS	6.30%	6.61%	-31	-4.69%	18.20%

Source: Bloomberg data as of 5:00 p.m. ET 11/2/2023 and 3:00 p.m. ET 10/26/2023

What remains for the FOMC is their collective view regarding inflationary expectations, with the necessary condition of a 'sustainable path towards 2%' required to end the current rate hiking cycle. While shelter (rent) inflation continues to run hot, moderation has been seen more broadly, with the Core PCE, a preferred inflation gauge at the FOMC, coming in at 2.4%, 2.6%, and 3.2% (September-July) on a three-month annualized basis as of the end of September – a trend that's starting to look like a sustainable path towards 2%. Adding in the likelihood of further credit contraction and the drag provided by meaningfully tighter financial conditions, high consumer debt, the cumulative effects of 525 basis points (bps) of rate hikes, and resumption of student loan repayments, we believe that fourth quarter economic data will support what we believe the FOMC has already largely decided: that the most aggressive FOMC tightening cycle since the 1980s has ended. Stay tuned!

PCE Deflator YoY% & CORE PCE Deflator YoY% – Monthly – 3 Years

Source: Bloomberg as of 11/2/2023

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.

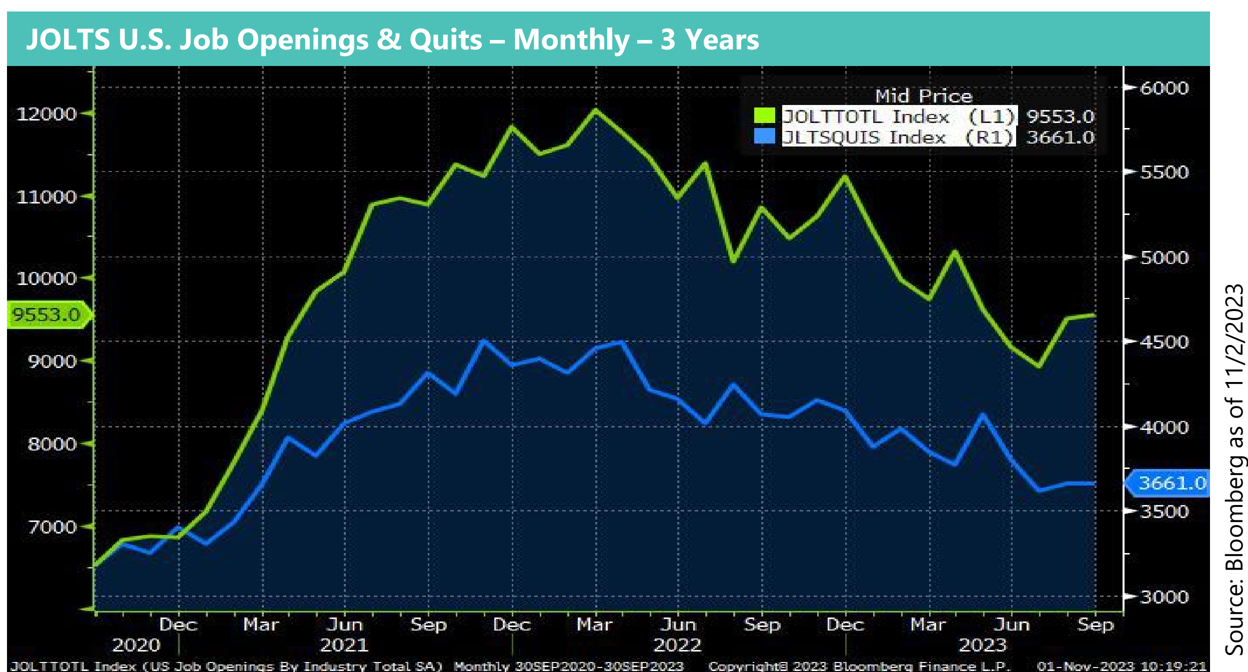
Headline PCE prices came in stronger than expected during September and were up +0.4% (+0.3% est./+0.4% Aug.), as another month of higher energy prices and rebounding services costs were tempered by a fourth consecutive month of lower durable goods prices. Notwithstanding the rebound in services prices, driven largely by a surge in travel and entertainment costs, we believe this momentum will slow into the fourth quarter and more moderation should follow. From a contribution standpoint, goods prices were up +0.2% and services higher by +0.5% during the month, and +0.9% and +4.7% on a year-over-year basis. Additionally, PCE Supercore (services ex. housing and energy) rebounded from August's soft patch and advanced +0.4% (+4.3% YOY), fueled by broad-based gains in discretionary services, including transportation, recreation, and food service/accommodations. In the aggregate, September's headline PCE prices were up 3.4% during the past year, the largest annual advance since May, revealing the stubbornly slow descent from last June's 7% cycle high, which was the largest annual increase since December 1981. This closely followed inflation gauge, known as the 'PCE Deflator,' has surged since the first quarter of 2021 as higher food, energy, shelter, and other services costs have pressured prices higher. The Core PCE Deflator (excluding food and energy) also rebounded in September, up +0.3% for the month (+0.1% Aug.) and higher by 3.7% over the past year, the second consecutive sub-4% read since June 2021, but still a stubbornly slow deceleration versus last December's 4.6% annual increase and indicative of durable inflationary pressures. That said, Core PCE prices index advances have started to slow, running 2.4%, 2.6%, and 3.2% (Sept – July) on a three-month annualized basis, data that should support additional rate hike 'pauses' during the fourth quarter given the months of progress towards policymakers' terminal goal of containing core price gains to a sustainable path towards the FOMC's 2% target rate. All in all, services inflation remains elevated and continues to offset progress on the goods front, a condition that supports the current, 'higher for longer' interest rate stance by the Federal Reserve.

Consumer Confidence & Expectations – Monthly – 3 Years

Source: Bloomberg as of 11/2/2023

Consumer confidence deteriorated again during October and came in at 102.6 (100.5 est./104.3 Sept.), the third consecutive decline and the lowest level since May, driven by further deterioration in business expectations, higher market interest rates, and elevated gasoline prices, a landscape that threatens to derail this summer's surge in consumer spending. Leading this month's decline was the present situation component, which fell to 143.1 (146.2 Sep./147.4 Dec.), the lowest level since November 2022 and driven by fewer respondents stating that business conditions were good (19.1% vs. 21.0% Sept.) and more stating that jobs were not so plentiful (47.5% vs. 46.1% Sept.). Adding to this month's lackluster data was the expectations component, a measure of consumers' six-month outlook, which dropped to 75.6 (76.4 Sept./83.4 Dec.), representing a three-month plunge of more than 12 points and the second consecutive read below the recessionary reading (80), as more respondents expect business conditions to worsen (20.2% vs. 18.7% Sept.) and fewer see higher income (15.6% vs. 17.9% Sept.). Looking at the text of the report, the chief economist of the survey stated that, **"Write-in responses showed that consumers continued to be preoccupied with rising prices in general, and grocery and gasoline prices in particular. Consumers also expressed concerns about the political situation and higher interest rates,"** and that **"Worries around war/conflicts also rose, amid the recent turmoil in the Middle East. The decline in consumer confidence was evident across householders aged 35 and up, and not limited to any one income group."** On the jobs front, labor market conditions appear to have retained much of the loosening observed during August as the Labor Index metric, which measures the labor differential of jobs plentiful less those hard to get, came in at 26.3% (25.5% Sept./36.5% Mar.), the second lowest level since April 2021. All in all, the weight of higher interest rates and durable inflation have fully reversed the summer's run-up in confidence, with further deterioration in consumer spending expected during this fall as job creation slows, pandemic-era excess savings deplete, consumer debt mounts, and the resumption of student loan payments after a three-year hiatus.

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



Source: Bloomberg as of 11/2/2023

The number of available jobs again came in stronger than expected during September at 9.55 million (9.40 est./9.50 million Aug.), the second consecutive increase and highest level since May, as a jump in leisure & hospitality and financial services openings continued the reversal of this year's trend of dissipating excess labor demand. By industry, job openings increased for leisure & hospitality (+181,000), financial activities (+94,000), trade/transport (+88,000), and construction (+56,000), with decreases in professional/business services (-105,000), government (-81,000), and information (-41,000), with employers still reporting difficulty recruiting and retaining enough workers to keep pace with demand. To be sure, the labor participation rate remains roughly 1% lower than its 2019, pre-pandemic peak as higher retirement rates, skill mismatches, and mixed participation have stunted employer efforts to add new employees. Additionally, the quits rate, which measures voluntary job separations per month as a percent of total employment, was unchanged for the third straight month at 2.3% (3.66 million jobs), shy of last March's all-time high (3%) and more in line with pre-pandemic averages, as higher compensation, new employee incentives, and the magnitude of job vacancies continue to influence employee turnover. Additionally, further evidence of labor market tightness can be seen in the layoffs and discharge rate, which ticked lower to 1.0% during September (record low 0.9% Dec. 2021) and the 1.5x ratio of jobs available to each unemployed worker (cycle high 1.99x March 2022; 1.15 Dec. 2019), a retreat from January (1.9x), but still reflective of snug labor markets. To be sure, chronic labor shortages have pressured employers to raise compensation to recruit and retain workers, with little relief expected in the near term. While labor market imbalances should improve given the cumulative amount of FOMC policy tightening and the likelihood of slower consumer spending, we believe the JOLTS data will remain elevated in the coming months as the pandemic hastened structural changes to the labor force that have stymied the return to pre-pandemic levels of participation. While demand for labor appears to be cooling given the cumulative drop of nearly 1.7 million job vacancies since December 2022, open positions and the job openings rate (5.7% Sep.; 7.4% peak Mar. 2022) remain historically high and are likely to encourage strong nominal wage growth in the near term given the durability of labor supply and demand imbalances.

FOMC Rate Decision & Statement Analysis

As expected, the FOMC left the Federal Funds rate unchanged at 5.50% on Wednesday afternoon with a unanimous vote of 12-0, holding at the highest level since 2001 and the second consecutive meeting without a rate increase. As has been customary during this tightening cycle, Chairman Powell reiterated the Committee's resolve to reduce inflation and maintained that a pathway to a soft economic landing still exists, which he reiterated was still the FOMC staff's 'base case' forecast for the economy given the resilience of recent activity data. Indeed, the Committee appeared to convey this pickup in economic expectations by adjusting statement language regarding growth from 'solid' to 'strong,' likely signaling that most members want to leave the door open for another rate hike. Amplifying this change, the Chairman stated, "We've been gratified to be able to achieve significant progress on inflation without a big increase in unemployment. Same is true for growth. We've been saying we need to see below potential growth, and I and my colleagues, for the most part, believe that is likely to be true to fully restore price stability." The implication is that the Committee would hike rates further should above-trend growth remain durable. As with past meetings, the Chairman reiterated that inflation remains too high and labor markets are still very tight, stating that, "Inflation has moderated since the middle of last year and readings over the summer were quite favorable, but a few good months of data are only the beginning of what it will take to build confidence that inflation is moving down sustainably – that process has a long way to go," and that the "labor market is rebalancing, but it's still very tight." That said, there were some dovish undertones during the post-meeting press conference, notably the Chairman's repeated references to the surge in longer-end market yields and how this move has tightened financial conditions and that the FOMC's policy stance remains restrictive, stating that "if you take the policy rate minus one-year expected inflation you will see a real (inflation-adjusted) policy rate that is well above estimates of a neutral policy rate." **While Powell again delivered the Committee's party line on inflation and growth – that we understand the hardship and believe that a 'soft landing' is possible – we still remain skeptical that the Federal Reserve can break inflation without pushing the economy into recession, particularly given tighter financial and credit conditions.** Indeed, the likelihood of further credit contraction and the drag provided by meaningfully tighter financial conditions, high consumer debt, the cumulative effects of 525 basis points of rate hikes, and resumption of student loan repayments have increased the risk of a more meaningful contraction in consumption and investment as we close in on 2024. While the Chairman stated that every meeting remains 'live' regarding more rate hikes, we believe that the FOMC's tightening cycle is likely done given the meaningful full progress on the inflation front, with Core PCE coming in at 2.4%, 2.6% and 3.2% (Sept – July) on a three-month annualized basis, and the dramatic tightening in financial conditions resulting from the surge in longer-term UST yields since the end of August, which we view as a much more effective catalyst to slow consumption versus another rate hike or two.

Comparing November and September statements, the changes were minor and made to reflect last quarter's acceleration in economic activity and to acknowledge tighter financial conditions via higher longer-term market rates:

"Recent indicators suggest that economic activity has been expanding at a strong pace in the third quarter.."
replaced September's
"Recent indicators suggest that economic activity has been expanding at a solid pace."

"Job gains have moderated since earlier in the year."
replaced September's
"Job gains have slowed in recent months."

"Tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation."
replaced September's
"Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation."

All and all, Chairman Powell delivered, on balance, a dovish performance during the post meeting press conference, frequently referencing the significant progress made on inflation, tightening financial conditions via much higher longer-term UST yields, and that the real (inflation-adjusted) policy rate is "well above estimates of a neutral policy rate," comments we believe underscore the notion that the FOMC is either done or one and done. Stay tuned!

Date	Target	BN Survey	Survey vs Actual	Direction	Change	Discount	Vote
11/1/23	5.25%-5.50%	5.25%-5.50%	Expected	None	None	5.50%	12-0
09/20/23	5.25%-5.50%	5.25%-5.50%	Expected	None	None	5.50%	12-0
07/26/23	5.25%-5.50%	5.25%-5.50%	Expected	Tightening	0.25%	5.50%	11-0
06/14/23	5.00%-5.25%	5.00%-5.25%	Expected	None	None	5.25%	11-0
05/03/23	5.00%-5.25%	5.00%-5.25%	Expected	Tightening	0.25%	5.25%	11-0
03/22/23	4.75%-5.00%	4.75%-5.00%	Expected	Tightening	0.25%	5.00%	11-0
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

Source: The Federal Reserve and Bloomberg as of 11/2/2023

The Week Ahead

The data calendar slows over the coming week, headlined by Non-Farm Payrolls, ISM Services, and Initial Jobless Claims. Looking ahead, markets remain focused on inflation, employment data, and more signs of weaker economic activity. On the new issue front, ABS picked after a conference-shortened week with $5.8 billion priced through November 2nd and $253.1 billion year to date ($247.7 billion over same period last year; $276.7 billion for 2022). IG corporate issuance ramped up significantly with $30.5 billion priced through November 2nd and $1.07 trillion year to date ($1.14 trillion over same period last year; $1.26 trillion for 2022). While new issue supply has generally slowed this year given FOMC rate hikes, market conditions have improved since the first-quarter bank failures and the new deal landscape remains favorable for a wide array of securitized products and corporate issuers as investor demand remains strong.

Friday 11/3

Non-Farm Payrolls; ISM Services

Monday 11/6

No data scheduled

Tuesday 11/7

Consumer Credit

Wednesday 11/8

Mortgage Applications

Thursday 11/9

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.

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