Fixed Income Market Insights

June 15, 2023

Key takeaways

Bond yields were mixed this week, with GT2s up 13 basis points and GT10s higher unchanged respectively and 2s/10s more inverted by 12 basis points (-91), driven hawkish FOMC comments regarding the likelihood of more rate hikes post yesterday's pause. On the data front, the NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, was little changed at 89.4 during May, remaining below the pandemic-era bottom (89.5 June 2022) and the second lowest level since January 2013, as elevated inflation, high interest rates and anemic business expectations continue to dampen sentiment. Headline CPI rose +.1% during May and up 4.0% over the past year, the smallest annual gain since March 2021, as a second consecutive month of core goods strength was dampened by lower energy prices and another month of tepid advances in services and food/beverage prices. Headline PPI again came in weaker than expected during May with prices down -.3%, driven by lower energy and food (goods) prices given the continued trend of lower commodities costs and improving supply chains and logistics. As expected, the FOMC left the Federal Funds rate unchanged at 5.25% on Wednesday afternoon with a unanimous vote of 11-0, the highest level since August 2007 and the first meeting without a rate increase since January 2022.

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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Anatomy of a Pause

As expected, the FOMC left the Federal Funds rate unchanged at 5.25%, the highest level since August 2007 and the first meeting without a rate increase since January 2022. While this news wasn't surprising given comments by Chairman Powell post May's meeting, which included his assessments that real (inflation-adjusted) rates were already 'sufficiently restrictive" and the negative effects of credit contraction are likely coming, the market was understandably surprised by the changes made to their interest rate Dot Plot and Summary of Economic Projections (SEP) from the latest version delivered in March. Most notably, the Committee raised the median forecast for the terminal Federal Funds rate to 5.60% (5.1% March) and nudged up expectations of the Core PCE deflator to 3.9% (3.6% March), with the former drawing the most attention, particularly given the recent moderation in the inflation aggregates (CPI, PPI), higher jobless claims, jump in the unemployment rate and slower services growth. While the Chairman pointed out that Core PCE, the FOMCs preferred measure of inflation, has been stubbornly sticky (YOY 4.70% May/5.20% Sept. 2022), the Committee's own projections call for 2023 Core PCE to come in at 3.9% and, more importantly, his discussion during yesterday's post-meeting news conference conference appeared to imply that the condition. necessary to bend inflation to a sustainable path towards 2% were in place.

Market Snapshot

	This week 6/15/23	Last week 6/8/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.51%	5.51%	0	0.00%	15.51%
SOFR	5.05%	5.05%	0	0.00%	17.44%
2-year US Treasury	4.64%	4.52%	12	2.65%	4.74%
5-year US Treasury	3.92%	3.85%	7	1.82%	-2.24%
10-yr US Treasury	3.72%	3.72%	0	0.00%	-4.12%
2s-10s UST Spread	-91.00	-79.00	-12.00	15.19%	65.45%
DJIA	34,413	33,819	594.00	1.76%	3.82%
S&P 500	4,434	4,284	150.00	3.50%	15.47%
Spot Gold	1,971	1,979	-8.00	-0.40%	7.94%
WTI (Oil) Current Contract	70.62	71.59	-0.97	-1.35%	-12.01%
1-year Brokered CD	5.30%	5.35%	-5	-0.93%	15.22%
5-year Brokered CD	4.50%	4.50%	0	0.00%	12.50%
5-year Bullet US Agency	3.97%	3.95%	2	0.51%	-2.70%
5-year/NC1yr Callable US Agcy	5.50%	5.38%	13	2.33%	1.85%
CDX IG Spread Index	70.29	71.09	-0.80	-1.13%	-14.30%
CDX High Yield Index Spread	102.45	102.21	0.24	0.23%	1.82%
15-yr UMBS	4.90%	4.93%	-3	-0.61%	5.15%
30-yr UMBS	5.34%	5.38%	-4	-0.74%	0.19%

Source: Bloomberg data as of 3:15pm ET 6/15/2023 and 2:00pm ET 6/8/2023

During the Q&A session, the Chairman stated that he would "almost say that the conditions we need to see to in place to get inflation down are coming into place," and "that would mean growth meaningfully below trend, it would be a labor market loosening, and it would be goods pipelines getting healthier. The things are in place that we need to see, but the process of that working on inflation is going to take some time." He also alluded to spot rents, which have been coming down for months, having a meaningful impact on dampening inflation during the second half of this year given the lagged effect of annual lease roll off. These comments appear to run contra to several more rate hikes, particularly given policymakers' persistent message that the cumulative economic impacts of 500 basis points of tightening and coming fallout from credit contraction post SVB/SBNY/FRBK have yet to be fully felt by consumers and businesses alike. All in all, we believe, for now, that the hawkish adjustments to the interest rate dot plot and SEP are more about messaging to stock and bond market bulls that they should stay on sides and not assume the FOMC is done with the most aggressive monetary policy tightening cycle since the 1980s. Judging by Federal Funds futures levels, which currently show a peak terminal rate of 5.29% in September and a 25-basis point rate cut by January 2024, and the massive rally in stocks today, the market isn't buying what the FOMC is selling, for now. Stay tuned!

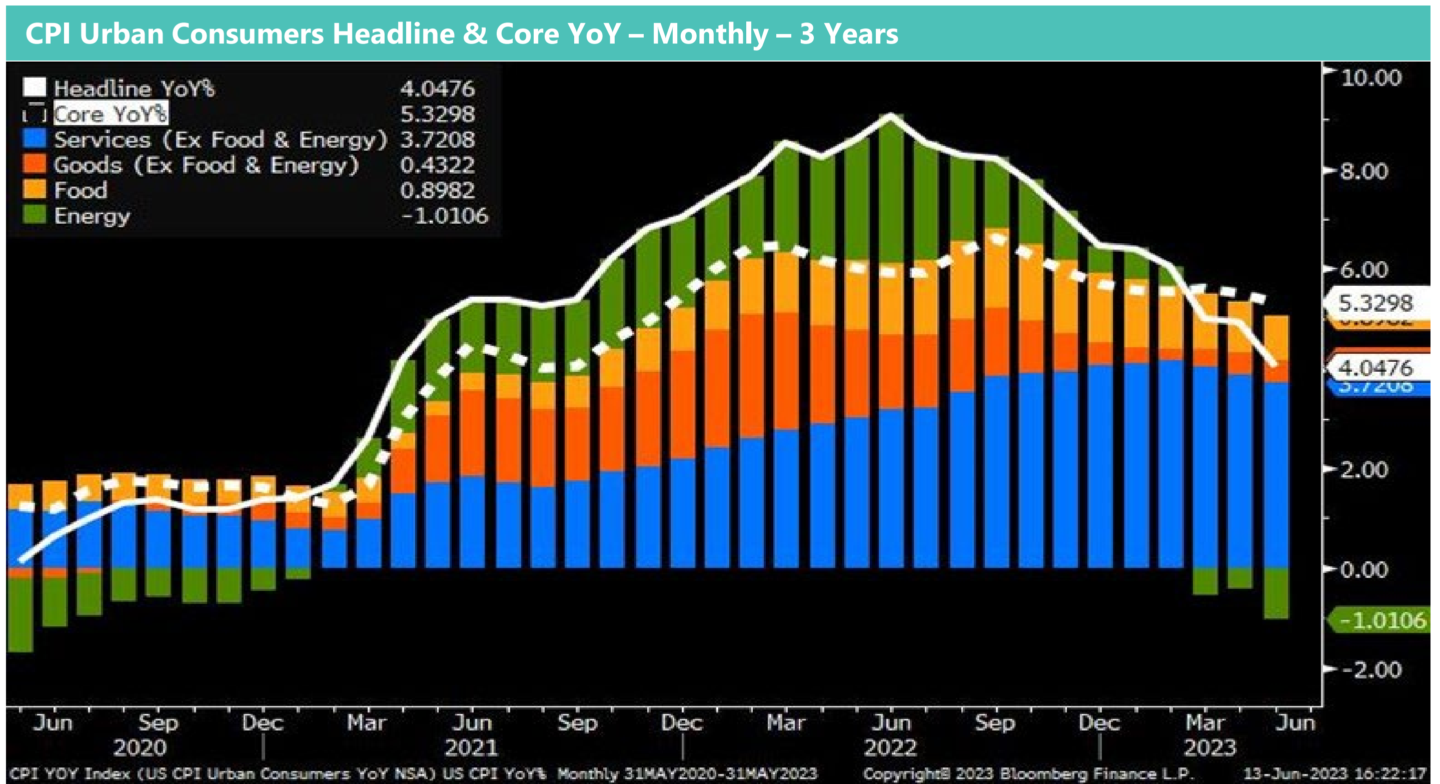
All quiet on the fiscal front post the debt ceiling deal. To recap, the President signed the debt ceiling bill into law last week, known as the "Fiscal Responsibility Act of 2023," averting a potential U.S. debt default and subsequent rating agency downgrades. Additionally, the President vetoed a bipartisan bill that would have suspended the Executive Order regarding student loan forgiveness, which aims to cancel up to $20,000 per borrower and sports a price tag of at least $400 billion (with some scoring upwards of $1 trillion), with the looming Supreme Court decision regarding the legality of the Executive order expected this month. Stay tuned!

NFIB Small Business Optimism – Monthly – 2 Years

Source: Bloomberg as of 6/15/2023

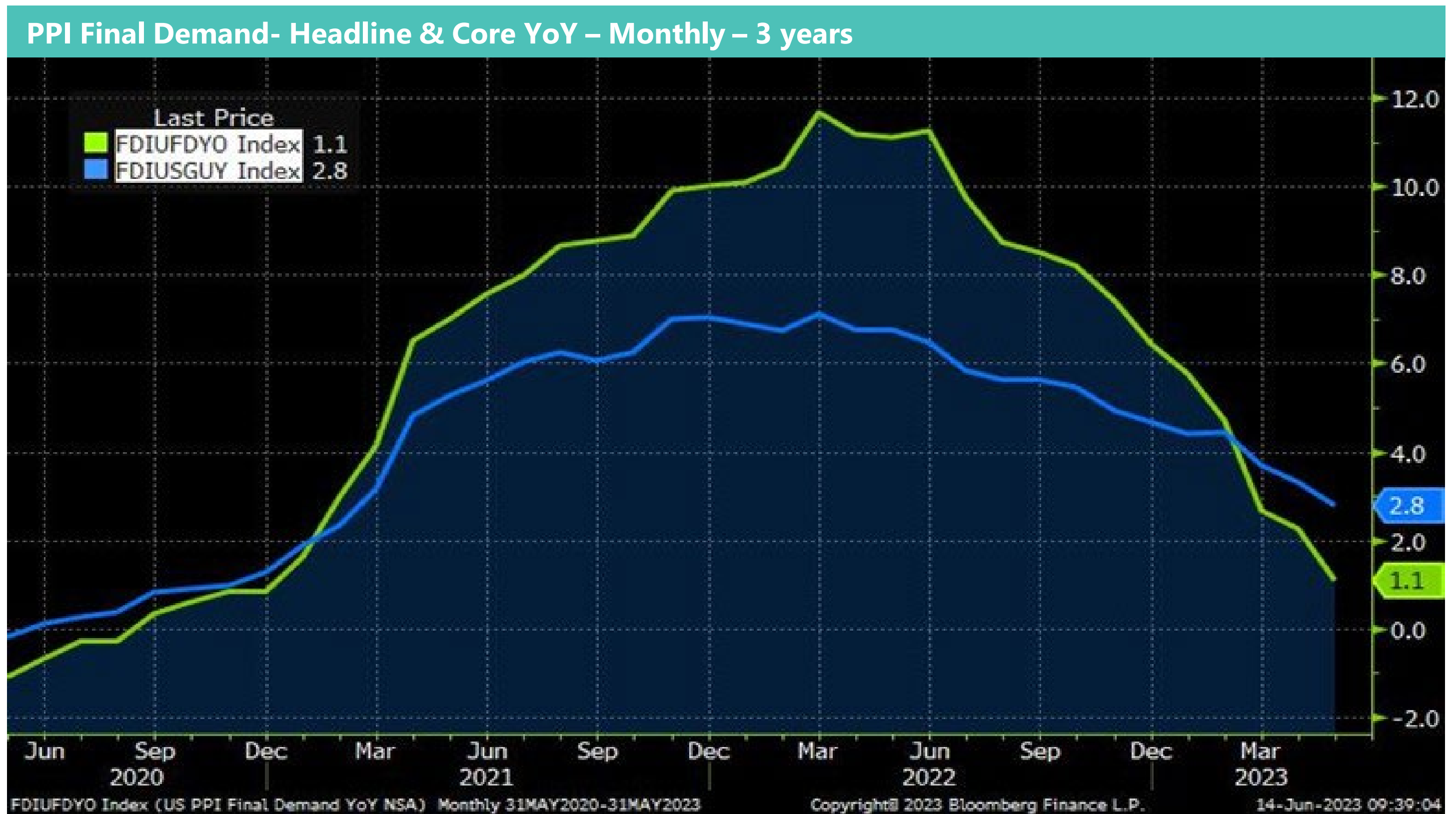
The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, was little changed at 89.4 during May (88.5 est.; 89 Apr.), remaining below the pandemic-era bottom (89.5 June 2022) and the second lowest level since January 2013, as elevated inflation, high interest rates and anemic business expectations continue to dampen sentiment. On the inflation front, 25% of respondents reported that inflation was their most significant business problem, up from 23% 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 plaguing small businesses. Additionally, labor quality was cited as the second largest business problem at 24%, just shy of inflation and indicative of heightened labor market friction as employers struggle to find qualified applicants for millions of open positions. Indeed, a full 44% of small businesses said they had unfilled job openings (51% record high; May 2022) and 41% stated they have increased compensation over the last three months to add new workers as chronically tight labor markets continue to add to wage pressures. As with other elevated input costs, higher labor expenses are being passed along to customers with 32% 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 high. The combination of still steamy inflation and durable labor shortages have dampened optimism, with businesses expecting better economic conditions over the next six months fell to a new, year-to-date low of -50% last month (versus -38% pandemic low), an improvement versus last June's -61% cycle low, but still very weak. Indeed, the NFIB chief economist stated that "Overall, small business owners are clearly in a recession mood, expressing great concern for future business conditions," and "Supply chain disruptions and labor shortages will continue to limit the ability of many small firms to meet the demand for their products and services." In summary, durable weakness in small business optimism squares with consumer sentiment data and underscores worsening economic expectations, growing concerns regarding a meaningful credit contraction on the heels of SVB/SBNY/FRBK bank failures and chronically elevated inflation expectations.

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



Source: Bloomberg as of 6/15/2023

Headline CPI rose +.1% (+.4% est.) during May and up 4.0% over the past year (+4.1% est.), the smallest annual gain since March 2021, as a second consecutive month of core goods strength was dampened by lower energy prices and another month of tepid advances in services and food/beverage prices. Core CPI (less food and energy) was up +.4% (+.4% est.) in May and 5.3% (+5.2% est./+5.5% Apr.) over the past 12 months, a moderation from September's year-over-year cycle high (6.6%; highest since 1982), but historically high and indicative of durable inflationary pressures across both services and selected goods. Indeed, the breadth of price gains remains problematic, with 56.4% of index components up by more than 4% on an annualized basis, down from 59.5% in April (66.1 Mar.) and nearly double the pre-pandemic run rate. From a contribution standpoint, core goods were up +.6% in May, matching April's gain and the largest monthly advance since June 2022, driven by a 4.4% jump in used car prices (worth +.12% Headline), along with services up +.3% and 6.3% from a year ago, shy of January's cycle high (7.6%), driven by a +.6% gain in shelter (worth +.21% Headline), which were partially offset by a -3.6% decline in energy prices (worth -.28% Headline) and lower costs for new cars and airline fares. Drilling down into headline CPI components, prices were mixed, with the largest gains seen in used cars (+4.4%), rents (+.5%), apparel (+.3%) and food (+.2%), which were partially offset by lower gasoline (-5.6%), airfares (-3.0%) and commodities (-.2%) 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 (+.5%; +8.0% year over year), matching February'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' posture regarding short term interest rates. While a more benign report, the breadth of inflationary pressures remains broad-based, particularly in shelter and other services, with a silver lining in owners' equivalent rent, a lagging indicator given the gradual process of lower spot rents bleeding into price data.



Source: Bloomberg as of 6/15/2023

Headline PPI again came in weaker than expected during May with prices down -.3% (-.1% est.; +1.1% last 12 months), driven by lower energy and food (goods) prices given the continued 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 down -1.6% (-2.4% year over year/+.2% Apr.), and services higher by +.2% (+2.7% year over year/+.3% Apr.), continuing the trend of headline PPI disinflation that started last year and driving expectations for more easing of wholesale prices. From a contribution standpoint, nearly 60% of the decrease in Headline prices was driven by a -13.8% slide in gasoline, accompanied by lower prices for food, diesel and jet fuel and steel scrap prices, which were partially offset by higher services. Core PPI (less food, energy and trade) also came in weaker than expected with prices unchanged last month (+.2 est.; +2.8% last 12 months), well off 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 32% (all-time high of 66 in March 2022) of small businesses surveyed stated that they raised selling prices last month and 41% of respondents said they raised compensation to hire and retain employees, both 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 -1.5% in May (-7.1% last twelve months; -.4% Apr.), the tenth contraction in eleven months and driven by a -13.7% drop in diesel fuel and broad-based declines across other energy and food components. All in all, a weaker than expected report as lower energy and food prices and declining transportation costs weighed down strength in other services.

FOMC Rate Decision & Statement Analysis

As expected, the FOMC left the Federal Funds rate unchanged at 5.25% on Wednesday afternoon with a unanimous vote of 11-0, the highest level since August 2007 and the first meeting without a rate increase since January 2022. As has been customary, Chairman Powell reiterated the Committee's resolve to reduce inflation and advanced more hawkish than expected revisions to their interest rate Dot Plot and Summary of Economic Projections (SEP). Regarding the Dot Plot, which outlines rate projections by 18 FOMC members, the median interest rate forecast was unexpectedly increased and now reflects an additional 50 basis points of tightening during the balance of 2023, followed by 100 and 125 basis point rate cuts in 2024 and 2025 respectively. Said differently, the FOMC raised the terminal Federal Funds rate to 5.60% during 2023, the first increase since last December's Dot Plot, with both 2024 and 2025 rate forecasts raised 25 basis points compared to March's projections. Additionally, the SEP data revealed that Core PCE inflation was also revised higher for 2023, coming in at 3.9% (versus 3.6% in March), and left unchanged in 2024 at 2.5%, both above the 2% target. Accordingly, the SEP for 2023 Real GDP growth was raised to 1.0% from .4% from March, with 2024 and 2025 little changed at 1.1 and 1.8% respectively, all indicative of FOMC expectations for below trend growth through 2025. In addition to the pause, the other big takeaway was the 50-basis point increase in the terminal Federal Funds rate projection above March's SEP by the Committee to 5.60% for 2023. As with past meetings, the Chairman reiterated that inflation remains too high and labor markets are still very tight, stating that while "Inflation has moderated somewhat since the middle of last year, nonetheless getting inflation down to 2% has a long way to go," and that "Nearly all expect that it will be appropriate to raise rates somewhat further by year end." Indeed, nine of the eighteen members indicated their preference for 50-basis points of additional tightening and, surprisingly, three more preferred 75-100 basis during 2023. 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 breaking the economy, particularly given the addition of 50 basis points in tightening projected by year end and that rate cuts during 2023 remain unlikely until a sustainable path towards a 2% inflation rate is achieved. Indeed, the mounting specter of some form of credit contraction via the SVB/SBNY/FRBK failures, surging consumer debt and the cumulative effects of 500 basis points of rate hikes have increased the risk of a larger contraction in consumption and investment later in 2023. While the Chairman stated several times that the July meeting remains 'live' regarding another hike, we believe that the FOMC's tightening cycle will be done if the May's news regarding cooling inflation and slowing services is repeated during June.

Comparing June and May statements, the changes were minor and made to reflect the pause and to accommodate for the additional rate hikes now forecasted by the SEP for 2023.

"Recent indicators suggest that economic activity has continued to expand at a modest pace," which replaced March's " Economic activity expanded at a modest pace in the first quarter."

"Holding the target range steady at this meeting allows the Committee to assess additional information and its implications for monetary policy" which replaced "The Committee will closely monitor incoming information and assess the implications for monetary policy."

"In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time" which replaced "In determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time."

All and all, Chairman Powell delivered what many perceived to be a mixed message, where the 'pause' was accompanied by decidedly bearish SEP updates- A higher Federal Funds terminal rate and stepped-up Core PCE (inflation) and Real GDP forecasts. Judging by Federal Funds futures levels post-meeting, which revealed a peak terminal rate of 5.29% in September and a 25-basis point rate cut by the January 2024 rate decision, the market remains skeptical. Stay tuned!

Date	Target	BN Survey	Survey vs Actual	Direction	Change	Discount	Vote
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
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

Source: Federal Reserve and Bloomberg as of 6/15/2023

The Week Ahead

The data calendar slows over the next, holiday shortened week, headlined by UM Consumer Sentiment, Weekly Jobless Claims and Existing Home Sales. Looking ahead, markets remain focused on inflation, employment data and further signs of slowing economic activity. On the new issue front, ABS volumes slowed dramatically this week given the FOMC rate decision yesterday, with 2 deals totaling $1 billion priced through the 14th and $125.8 billion year to date ($148.2 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance also slowed, with $9.8 billion priced through the 14th and $670.8 billion year to date ($736.7 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 improved post SVB/SBNY/FRBK bank failures and the new deal landscape remains favorable for a wider array of ABS and corporate issuers as investor demand remains robust.

Friday 6/16

UM Consumer Sentiment

Monday 6/19

Market Holiday

Tuesday 6/20

Housing Starts; Building Permits

Wednesday 6/21

MBA Mortgage Applications

Thursday 6/22

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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