# Fixed Income Market Insights

October 26, 2023

## Key takeaways

Bond yields were lower this week, with GT2s down 13 basis points (bps), GT10s lower by 13 bps, and the 2s/10s slope unchanged (-20) as investors continue to refine their views regarding the emerging conflict in the Middle East and expected impact on market yields. On the data front, real GDP was up for the fifth consecutive quarter and grew at a faster than expected 4.9% annualized rate during the third quarter, the largest advance since the fourth quarter of 2021; a sharp rebound in consumer spending, inventory build, and government spending were partially offset by an unexpected decline in business fixed investment, suggesting that factors like this summer's surge in entertainment spending and inventory build may prove difficult to repeat in the fourth quarter. Initial unemployment claims ticked up during the week ended October 21st to 210,000, extending the post-summer downtrend and reflective of chronic strength in demand for labor and employer preference to retain hard-to-find workers.

# Flirting with Disaster?

Despite a growing number of headwinds, the overall strength and resilience of economic activity post-2022's soft patch appears to be gaining momentum. Indeed, the growth contraction during the first half of last year seems like a distant memory as consumers continued to spend at a pace thought to be incongruent with durably elevated inflation and dramatically higher market interest rates. Buoyed by remaining pandemic-era excess savings, tight labor markets, and rising nominal wages, consumer spending rebounded during the third quarter, advancing at a dizzying 4% annualized rate, driving overall Gross Domestic Product (GDP) higher to 4.9% on an annualized basis, both representing the highest quarterly gains since December 2021. While the data revealed broad-based gains across both goods and services, we don't expect this momentum to carry into the fourth quarter given more temporary factors like this summer's surge in entertainment spending, outsized inventory building, and sizeable government spending, all of which are unlikely to be repeated in the coming months. That said, it's this resilience in consumer spending that has supported relatively benign credit spreads across most fixed income product sectors, suggesting that robust investor demand at today's elevated market yields has largely outweighed concerns of a deeper contraction in economic activity as we get closer to 2024 – concerns that we believe are underestimated given the mounting economic headwinds facing both consumers and businesses.

**Market Snapshot**

| | This Week 10/26/23 | Last Week 10/19/23 | Basis Points Change | Weekly % Change | YTD % Change |
|---|---|---|---|---|---|
| 3-month USD Libor | 5.65% | 5.68% | -3 | -0.53% | 18.45% |
| SOFR | 5.30% | 5.30% | 0 | 0.00% | 23.26% |
| 2-year US Treasury | 5.04% | 5.17% | -13 | -2.51% | 13.77% |
| 5-year US Treasury | 4.79% | 4.95% | -16 | -3.23% | 19.45% |
| 10-yr US Treasury | 4.84% | 4.97% | -13 | -2.62% | 24.74% |
| 2s-10s UST Spread | -20.00 | -20.00 | 0.00 | 0.00% | -63.64% |
| DJIA | 32,811 | 33,644 | -833 | -2.48% | -1.01% |
| S&P 500 | 4,143 | 4,304 | -161 | -3.74% | 7.89% |
| Spot Gold | 1,993 | 1,985 | 8 | 0.40% | 9.15% |
| WTI (Oil) Current Contract | 83.25 | 89.16 | -5.91 | -6.63% | 3.73% |
| 1-year Brokered CD | 5.50% | 5.50% | 0 | 0.00% | 19.57% |
| 5-year Brokered CD | 5.00% | 5.00% | 0 | 0.00% | 25.00% |
| 5-year Bullet US Agency | 4.87% | 5.02% | -15 | -2.99% | 19.36% |
| 5-year/NC1yr Callable US Agcy. | 5.95% | 6.00% | -5 | -0.83% | 10.19% |
| CDX IG Spread Index | 81.34 | 79.02 | 2.32 | 2.94% | -0.83% |
| CDX High Yield Index Spread | 99.15 | 99.58 | -0.43 | -0.43% | -1.46% |
| 15-yr UMBS | 6.02% | 6.16% | -14 | -2.27% | 29.18% |
| 30-yr UMBS | 6.61% | 6.72% | -11 | -1.64% | 24.02% |

Source: Bloomberg data as of 3:00 p.m. 10/26/2023 and 2:00 p.m. ET 10/19/2023

## Author

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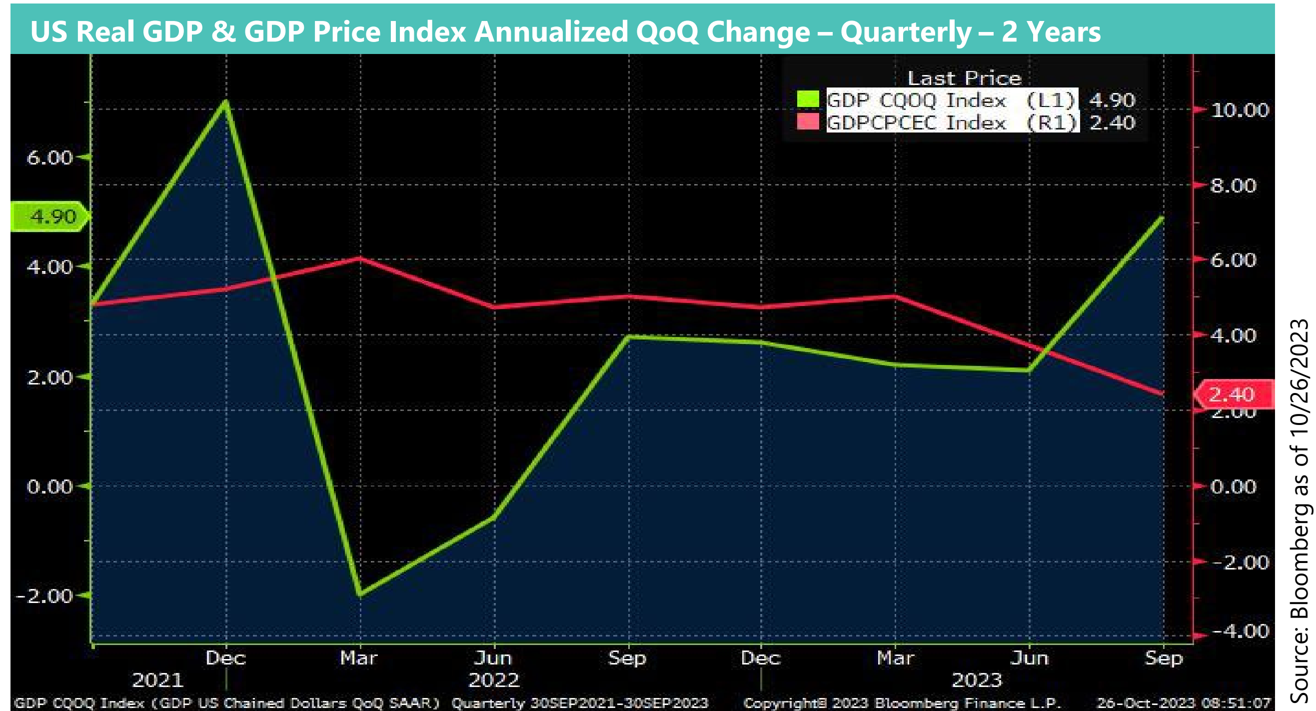
Indeed, several reports released this week revealed durable advances in corporate defaults and subprime auto loan delinquencies, data that will likely pressure credit spreads wider in the quarters to come should the current trend continue and bleed into a wider swath of borrowers. Regarding the former, Moody's Investors Service reported that default rates for U.S. speculative-grade corporates rose to 4.9% as of September 30th, nearly a four-fold surge from just over 1% at the end of 2021. Additionally, Bloomberg reported that 175 large companies have filed for bankruptcy protection this year as of the middle of October, a more than 60% increase compared to the average for that period since the early 2000s. Regarding auto loans, Fitch Ratings reported that the share of subprime auto borrowers at least 60 days delinquent reached 6.11% by September 30th, the highest level since 1994. As the top 20% of income earners account for nearly 80% of all consumer spending, with this cohort still in possession of meaningful amounts of pandemic-era excess and traditional savings, the risks of a dramatic contraction in consumer spending appear low as we approach year end. That said, the bottom 80% of income earners have run out of pandemic-era excess savings and now have less cash on hand than they did at the start of the pandemic, with bank deposits and other liquid assets (inflation-adjusted) estimated to be lower by the end of June than they were in March 2020, according to a recent report by the Federal Reserve Bank of San Francisco. While this deterioration has not derailed the chronic resilience in consumer spending seen for most of the year, we believe that consumption is likely to slow into 2024 given the durability of elevated inflation, likelihood of 'higher for longer' interest rates, and further reductions in business fixed investment, which is largely predicated upon producers' expectations of future demand conditions. More to follow!

All quiet on the fiscal front as both houses of Congress returned from recess last week, with this week's election of a new House Speaker and rapidly approaching Continuing Resolution (CR) deadline taking center stage. To review, the CR passed last month funds the government through November 17th, a looming deadline leaving the House and Senate limited time to strike a mutually agreeable budget deal to avoid a government shutdown. Away from that, we expect more legal challenges to the Biden Administration's student loan cancellation plans, with an appeal to the Supreme Court increasingly likely. Stay tuned!

**We suggest**

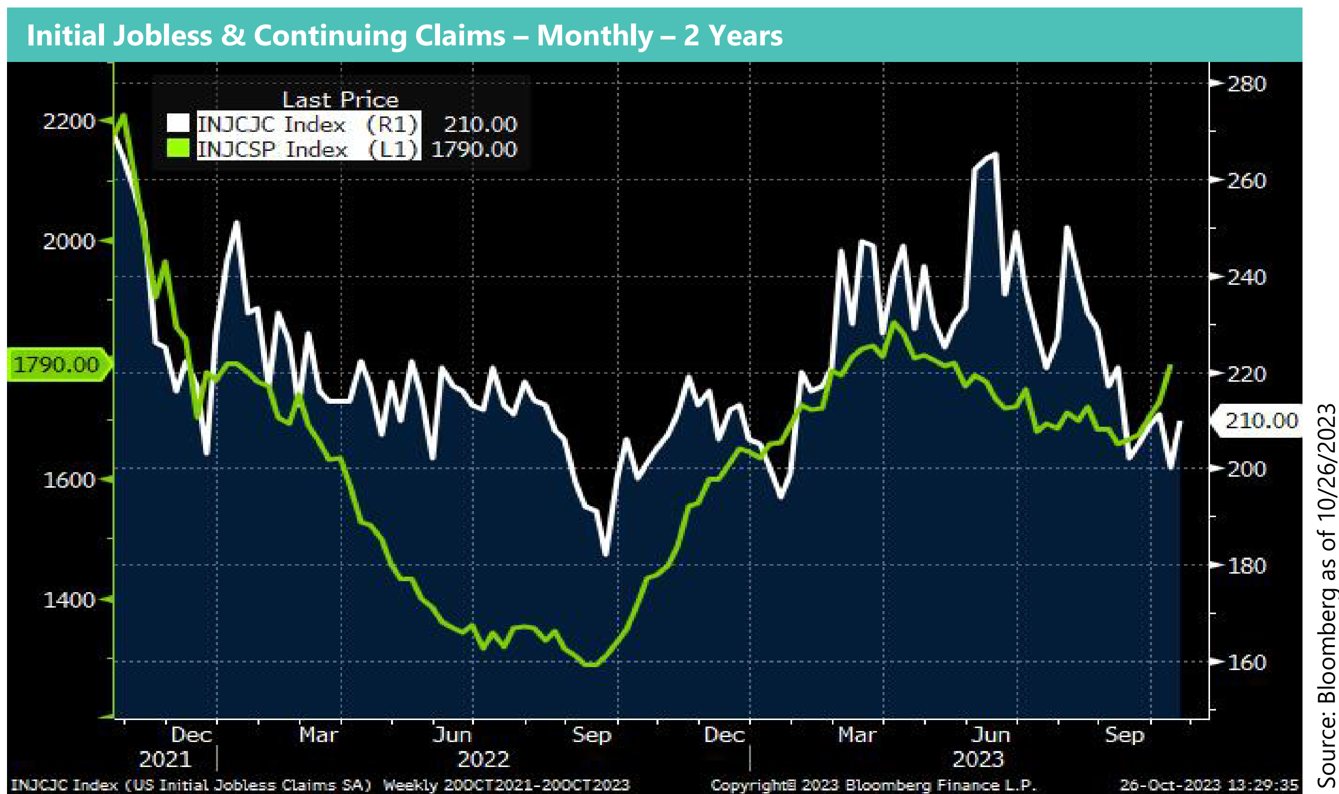
We continue to prefer playing defense given elevated inflationary expectations and the likelihood of elevated short-term interest rates in the quarters to come. We favor barbell strategies in securitized products, anchored by short, higher current cash flow assets and longer, high quality bonds.




US Real GDP & GDP Price Index Annualized QoQ Change – Quarterly – 2 Years

Source: Bloomberg as of 10/26/2023

Real GDP was up for the fifth consecutive quarter and grew at a faster than expected 4.9% annualized rate during the third quarter (+4.5% est.; +2.1% Q2), the largest advance since the fourth quarter of 2021, as a sharp rebound in consumer spending (+2.7% of headline), inventory build (+1.3% of headline) and government spending (+0.8% of headline) were partially offset by an unexpected decline in business fixed investment, suggesting that factors like this summer's surge in entertainment spending and inventory build may prove difficult to repeat in the fourth quarter. On the consumption side, consumer spending surged from last quarter's tepid pace to +4.0% (+0.8% Q2/+3.8% Q1), with resilience seen in both goods and services, which came in at +4.8% and +3.6%, respectively. Another bright spot was durable strength in real (inflation-adjusted) final sales to private domestic buyers – a key measure of underlying demand that subtracts out trade, inventories, government spending, and investment – that advanced +3.3% during the quarter (+1.7% Q2/+3.6% Q1), indicative of persistent strength in consumer spending buoyed by strong labor markets, higher wages, and moderating inflation. Additionally, inflation-adjusted business and residential fixed investment data were mixed, coming in at -0.1% and +3.9% respectively, with the former driven by a retreat in equipment spending (-3.8%/+7.7% Q2/-4.1% Q1), and the latter representing the first quarterly increase in residential investment since Q1 2021, momentum not expected to continue given the recent surge in mortgage rates and the FOMC's steadfast commitment to 'higher for longer' regarding short-term interest rates. On the inflation front, today's report revealed another, meaningful deceleration in the Core PCE deflator to a +2.4% annualized rate (+3.7% Q2/+4.9% Q1), the smallest advance since Q4 2020, indicative that the cumulative effects of FOMC tightening may be more fully embedding into the economy. All in all, a very strong quarter driven by the sharp rebound in consumer spending, with the caveat that much of this momentum is unlikely to carry through into the fourth quarter given the outsized contribution of entertainment outlays during the summer and heavy inventory build. Additionally, residential and business investment are likely to be challenged in the months to come as the negative headwinds of higher interest rates and elevated inflation continue to weigh on consumers and businesses.




Initial unemployment claims ticked up during the week ended October 21st to 210,000 (207k est./200k last), extending the post-summer downtrend and reflective of chronic strength in demand for labor and employer preference to retain hard-to-find workers. Additionally, the four-week moving average of initial claims, which smooths out outsized observations in the data, continued the downtrend from the end of August to 207,500, hovering near first quarter lows and more in line with pre-pandemic averages seen during 2019. That said, continuing unemployment claims have trended higher since the beginning of September, coming in at 1.79 million for the week ended October 13th (1.645 million on Dec 30th) and include people who have already received unemployment benefits for a week, suggesting that workers are finding it increasingly difficult to find new employment despite nearly 10 million job openings estimated by the last JOLTS survey. All in all, another solid report that revealed still muted layoffs and tight labor markets, data supportive of the FOMC's policy stance of 'higher for longer' regarding short-term interest rates.

## The Week Ahead

The data calendar heats up over the coming week, headlined by the FOMC rate decision, PCE Deflator, JOLTS job openings, and Consumer Confidence. Looking ahead, markets remain focused on inflation, employment data and more signs of slower economic activity. On the new issue front, ABS remained on hiatus this week given the ABS East conference, with no deals priced through the 25th and $246.2 billion year to date ($236.4 billion over same period last year; $276.7 billion for 2022). IG corporate issuance slowed dramatically with $5 billion priced through the 25th and $1.04 trillion year to date ($1.11 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 robust.

**Friday 10/27**

PCE Deflator; Personal Income/Spending

**Monday 10/30**

Dallas Fed Manufacturing Activity

**Tuesday 10/31**

Consumer Confidence; S&P CoreLogic HPI; Employment Cost Index

**Wednesday 11/1**

FOMC Rate Decision; JOLTS Job Openings; ISM Manufacturing

**Thursday 11/2**

Factory Orders; 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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