Fixed Income Market Insights

March 16, 2023

Key takeaways

Bond yields were sharply lower this week, with GT2s down 77 basis points and GT10s lower by 34 basis points respectively and 2s/10s less inverted by 43 basis points (-59), driven by the SVB/SBNY bank failures and investor speculation of near-term rate cuts. On the data front, headline Non-Farm Payrolls again came in stronger than expected with 311,000 new jobs added in February, led by broad-based gains in services employment, including continued strength in leisure and hospitality, professional/business services and healthcare. The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, edged up to 90.9 in February, still hovering near pandemic-era lows, as high inflation, labor shortages and weakening business expectations continue to weigh on sentiment. Headline CPI was again robust in February, rising +.4%, the second largest gain since last October, and up 6.0% during the last year, as chronic strength in food, shelter and other core services was partially offset by flat core goods prices and a small decline in energy prices. Headline PPI came in much weaker than expected during February with prices down -.1%, the second contraction in three months, driven by a third consecutive month of declining food prices and an unexpected drop in services.

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.

Author

David Petrosinelli, CFA
Managing Director
Senior Trader

InspereX

Will SVB Stop the FOMC?

The fast-moving developments surrounding the Silicon Valley (SVB) and Signature (SBNY) bank failures, along with warnings regarding the stability of Credit Suisse (CS), have roiled stock and bond markets around the globe, raising questions regarding the health and well-being of banking sectors both at home and abroad. While poor asset/liability management and imprudent industry concentration (Venture Capital-backed technology and cryptocurrency) rendered both SVB and SBNY unable to meet depositor redemptions during a classic 'run on the bank' scenario, market participants remain on edge and concerned that these high-profile collapses may be the start of a wider contagion that could stifle economic growth and tip the world's largest economy into recession. On the one hand, it appears that the unique circumstances surrounding the failures of SVB and SBNY have not spread to the broader regional/community bank sector, in no small measure due to the Federal government's extraordinary measures to calm the nation's depositors, namely the creation of a new, Bank Term Liquidity Fund (BTLF) established as a supplemental source of funds to meet excess depositor withdrawals.

Market Snapshot

	This week 3/16/23	Last week 3/9/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	4.91%	5.12%	-21	-4.10%	2.94%
SOFR	4.58%	4.55%	3	0.66%	6.51%
2-year US Treasury	4.17%	4.94%	-77	-15.59%	-5.87%
5-year US Treasury	3.73%	4.23%	-50	-11.82%	-6.98%
10-yr US Treasury	3.58%	3.92%	-34	-8.67%	-7.73%
2s-10s UST Spread	-59.00	-102.00	43.00	-42.16%	7.27%
DJIA	32,220	32,586	-366.00	-1.12%	-2.80%
S&P 500	3,956	3,975	-19.00	-0.48%	3.02%
Spot Gold	1,924	1,834	90.00	4.91%	5.37%
WTI (Oil) Current Contract	68.20	76.41	-8.21	-10.74%	-15.03%
1-year Brokered CD	5.35%	5.25%	10	1.90%	16.30%
5-year Brokered CD	5.00%	4.85%	15	3.09%	25.00%
5-year Bullet US Agency	3.93%	4.38%	-45	-10.27%	-3.68%
5-year/NC1yr Callable US Agcy	5.25%	5.90%	-65	-11.02%	-2.78%
CDX IG Spread Index	83.71	76.24	7.47	9.80%	2.06%
CDX High Yield Index Spread	99.95	101.45	-1.50	-1.48%	-0.67%
15-yr UMBS	4.65%	5.07%	-42	-8.28%	-0.21%
30-yr UMBS	5.19%	5.56%	-37	-6.65%	-2.63%

Source: Bloomberg data as of 3:30pm ET 3/16/2023 and 1:30pm ET 3/9/2023

That said, these failures will surely trigger a more rigorous review by banks and their regulators of industry concentration and asset/liability mismatches across the banking industry, with the potential for reduced, traditional credit extension by those banks currently in an unfavorable risk position. Ultimately, some form of credit contraction risk seems more likely than a wave of bank runs and one that couldn't come at a worse time, given still-steamy inflation and global economies still recovering from the pandemic, both conditions that favor more interest rate hikes this year. To be sure, any meaningful credit contraction would bring the U.S. economy to a screeching halt, surely a help on the inflation front, but at the heavy cost of a severe economic downturn and a surge in unemployment. The more plausible risk, in our view, would be a broader, reacceleration of inflation should the FOMC not follow through with more monetary policy tightening, which would likely trigger a steeper decline in market interest rates and a rally in the stock market, both conditions likely to extend the current inflationary run. A rate hike pause may also have the unintended consequence of signaling to markets that U.S. banks may be under more duress than currently advertised, further adding to market choppiness after a week of soaring VIX and MOVE indices, the market's measure of volatility for the stock and bond markets. To be sure, Federal Reserve Chairman Powell has repeatedly assured markets that the FOMC will not stop tightening until inflation is on a sustainable path towards 2%, which it's not, and that the Committee would not repeat the mistakes of the Arthur Burns Federal Reserve of the 1970s, where rate hikes were paused while inflation was too high, which accelerated price gains and required heavier rate increases during the early 1980s to reign in. With the next FOMC meeting is on deck for next Wednesday, which will test the Committee's resolve, the bond market appears to be leaning towards more monetary policy tightening, with Federal Funds Futures implying roughly a 75% chance of a 25-basis point hike. Stay tuned!

Still little news on the fiscal front as extended breaks and house hearings continue to dominate the congressional calendar. Among several legislative initiatives, negotiations regarding the debt ceiling will take center stage in the weeks to come. Also look for heightened calls for tighter bank regulation in the wake of the SVB/SBNY failures last week, with public hearings likely.

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

Source: Bloomberg as of 3/16/2023

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

Source: Bloomberg as of 3/16/2023

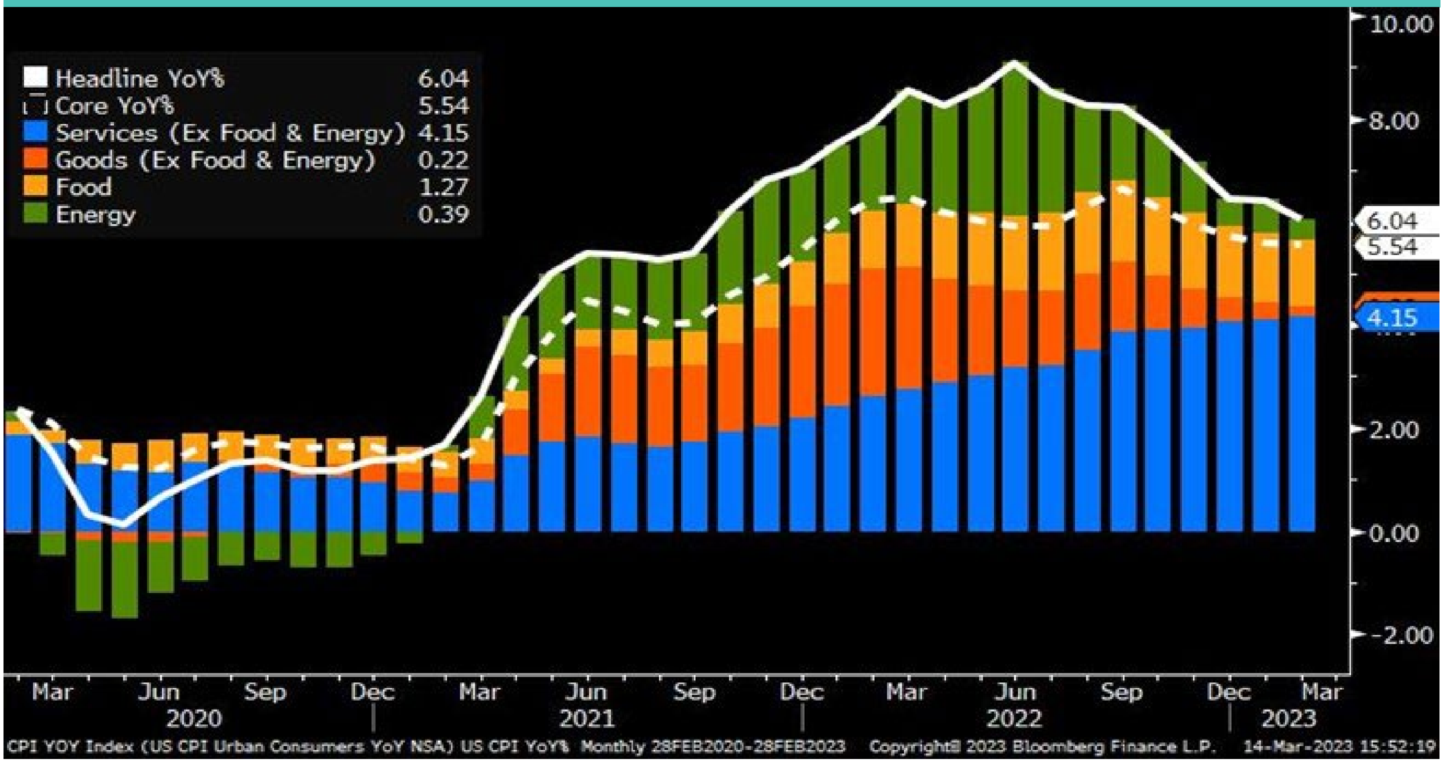
Headline Non-Farm Payrolls again came in stronger than expected with 311,000 new jobs added in February (225,000 est.), led by broad-based gains in services employment, including continued strength in leisure and hospitality, professional/business services and healthcare. Taken together with revisions that subtracted 34,000 jobs in the prior two months, job creation remains strong with average monthly gains of 351,000 during the last ninety days, an acceleration from the fourth quarter's 291,000 pace (vs. 423,000 Q3 2022). Looking by industry revealed broad based strength, led by leisure and hospitality (+105k), education/health (+74k), retail (+50k), government (+46k), professional/business services (+45k), and construction (+24k). Beyond the headline number, the big takeaways were the third consecutive uptick in labor participation (62.5% vs. 62.4% est.) and another moderation in average hourly earnings (+.2% vs. +.3% Jan./+4.6% YOY vs. 4.4% Jan.), welcome news for the FOMC and investors given the chronic tightness of labor markets and durability of elevated, nominal wage gains post pandemic. To be sure, last week's JOLTS job openings (10.8 million), the number of available positions per unemployed worker (1.92) and quits rate (2.5% or 3.9 million jobs) remain near all-time highs, suggesting that wage inflation will remain elevated in the near term. Additionally, labor participation remains over a percentage point lower than the 2019, pre-pandemic high as elevated retirement rates, skill mismatches and increased entrepreneurship have stymied employer efforts to fill millions of job openings. This lower participation has driven down the unemployment rate to 3.6%, just shy of last month's cycle low of 3.4% (lowest since 1969), and forced average hourly earnings higher (4.6% YOY), both conditions expected to persist in the months to come. All in all, another solid employment report with some silver linings regarding wage growth moderation and better labor participation.

NFIB Small Business Optimism – Monthly – 2 Years

Source: Bloomberg as of 3/16/2023

The NFIB Small Business Optimism index, which surveys hundreds of small businesses across a range of issues, edged up to 90.9 in February (90.3 est.; 89.8 Dec.), still hovering near pandemic-era lows, as high inflation, labor shortages and weakening business expectations continue to weigh on sentiment. On the inflation front, 28% of respondents reported that inflation was their most significant business problem, up from 26% last month and shy of last July's cycle high 37% print (highest since 1979), but still historically high and indicative of sustained inflationary pressures afflicting small businesses. Additionally, a near record high of 47% of small businesses said they had unfilled job openings (51% record high; May 2022) and 46% stated they have increased compensation over the last three months to attract new workers as 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 38% of the small businesses surveyed stating that they anticipate higher selling prices, a backup from last March's all time high of 66% (1974 inception) and the lowest share since April 2021, but still historically high. The union of elevated inflation and durable labor shortages have softened optimism with businesses expecting better economic conditions over the next six months dipped lower to -47% last month (versus -38% pandemic low), an improvement versus last June's -61% cycle low, but historically anemic. Indeed, the survey stated that "Small-business owners remain doubtful that business conditions will get better in the coming months," and "They continue to struggle with historic inflation and labor shortages that are holding back growth. Despite their economic challenges, owners are working hard to create new jobs to strengthen the economy and their firms." All in all, persistent weakness in small business optimism aligns with consumer sentiment data and underscores sustained economic pessimism, low confidence in policymakers and chronically elevated inflation expectations.

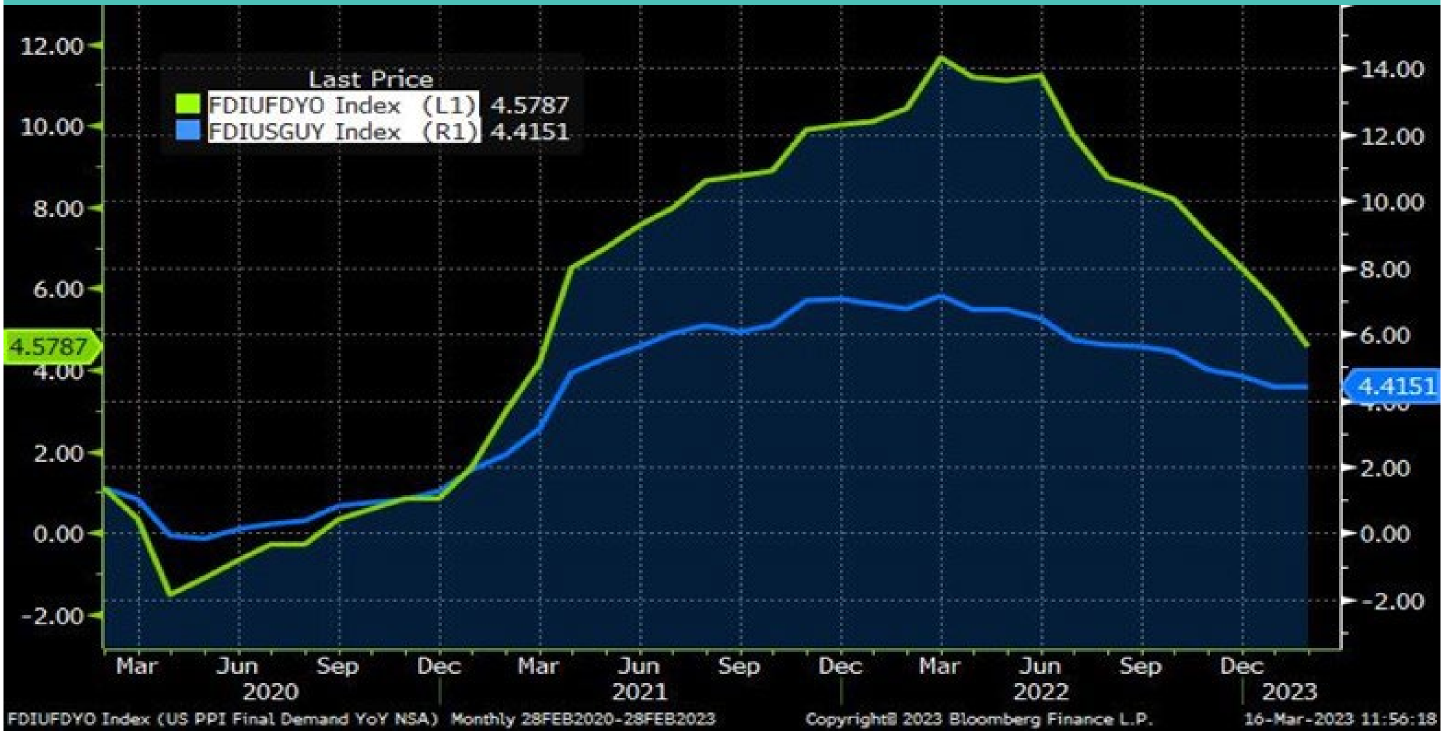
CPI Urban Consumers Headline & Core YoY – Monthly – 3 Years



Source: Bloomberg as of 3/16/2023

Headline CPI was again robust in February, rising +.4% (+.4% est.), the second largest gain since last October, and up 6.0% during the last year (+6.0% est.), as chronic strength in food, shelter and other core services was partially offset by flat core goods prices and a small decline in energy prices. Core CPI (less food and energy) was up .5% (+.4% est.), the most in five months, and 5.5% (+5.5% est.) on the same basis, shy of September's year-over-year cycle high (6.6%; highest since 1982), but still historically red-hot and indicative of the durable and broad-based nature of inflationary pressures across both services and selected goods. Indeed, the breadth of price gains remains troublesome, with 64.2% of index components up by more than 4% on an annualized basis, up from 60.9% in January and more than double the pre-pandemic run rate. From a contribution standpoint, services continue to run hot and again drove the advance in prices, up .5% (worth +.31% Headline) in February and 7.6% from a year ago, matching January's cycle high and the largest annual advance in more than 30 years (shelter component of services +.8%/worth .28% Headline), which were partially offset by lower used car and medical care prices, which fell -2.8% and -.5% respectively (worth just over -.11% Headline). Drilling down into headline CPI components, prices were mostly higher, with the largest gains seen in airline fares (+6.4%), gasoline (+1.0%), recreation (+.9%), shelter (+.8%), apparel (+.8%), and food (+.4%), which were partially offset by declines in used cars (-2.8%), utilities (-1.4%), and medical care (-.5%) as discretionary goods spending moderates and pivots towards services. Additionally, real estate prices remain high, with values at or close to record levels in many parts of the country, driving another large increase in owner's equivalent rent during February (+.7%; +8.0% year over year), another record high, annual advance. Given that inflation expectations are closely tied 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 one likely to extend the FOMC's tightening cycle. All in all, the breadth of inflationary pressures remains broad-based, particularly in food, shelter and other services.

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



Source: Bloomberg as of 3/16/2023

Headline PPI came in much weaker than expected during February with prices down -.1% (+.3% est.; +4.6% last 12 months), the second contraction in three months, driven by a third consecutive month of declining food prices and an unexpected drop in services (trade/warehousing). In the aggregate, both goods and services prices were lower, with goods down -.2% (+5.4% year over year/+1.2% Jan.), and services lower by -.1% (+3.8% year over year/-.1% Jan.) as downward revisions to January's headline read (+.3% vs. +.7%) and last month's deceleration revived hope for a broader easing of wholesale prices. Core PPI (less food, energy and trade) also came in weaker than expected with prices up +.2% last month (+.3 est.; +4.4% last 12 months), well off March's 9.7% cycle high, but still reflective 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 38% (all-time high of 66 in March 2022) of small businesses surveyed stated that they raised selling prices last month and a near record 46% of respondents said they raised compensation to attract and retain employees, both likely to add to pricing pressures in the near term. That said, loosening supply chain bottlenecks and slower goods demand have dampened the cost of processed goods for intermediate demand, reflecting prices earlier in the production pipeline, which fell -.4% in February (+2.1% year over year), driven by a -4.7% decline in diesel fuel, which accounted for over 50% of last month's drop. All in all, a much weaker report (including January revisions) than expected, albeit driven narrowly by a 36% decline in eggs (80% of goods drop) and 3.9% slide in warehousing (majority of services drop), though not indicative of broad-based price relief at the wholesale level, for now.

The Week Ahead

The data calendar remain robust over the next week, headlined by the FOMC Rate Decision, UM Consumer Sentiment, Industrial Production and Existing Home Sales. Looking ahead, markets remain focused on inflation, employment data and more fallout from the SVB/SBNY bank failures. On the new issue front, ABS volumes were muted given elevated volatility via the three bank closures last week, with 5 deals totaling $2.77 billion priced through the 15th and $55.8 billion year to date ($61.7 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance seized given banking news with no deals priced through the 15th and $357 billion year to date ($377.4 billion over same period last year; $1.26 trillion for 2022). While new issue supply slowed last year given FOMC rate hikes and higher volatility, market conditions have improved since the start of 2023 and the new deal landscape remains favorable for a wider breadth of ABS and corporate issuers as investor demand remains brisk, with the caveat that additional fallout from the SVB/SBNY failures will trigger issuance furloughs like observed this week.

Friday 3/17

UM Consumer Sentiment; Industrial Production

Monday 3/20

No Data Scheduled

Tuesday 3/21

Existing Home Sales

Wednesday 3/22

FOMC Rate Decision

Thursday 3/23

Weekly Jobless Claims; New Home Sales

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.

InspereX