Fixed Income Market Insights

October 5, 2023

Key takeaways

Bond yields were mixed this week, with GT2s down 6 basis points and GT10s higher by 11 basis points respectively and 2s/10s less inverted by 17 basis points (-30), driven by the unexpected jump in JOLTS job openings and increased likelihood of 'higher for longer' regarding interest rates. On the data front, headline PCE prices came in weaker than expected during August and were up +.4%, as surging energy prices were tempered by another month of lower durable goods prices, and more tepid advances in food, housing and other services. The number of available jobs came in much stronger than expected during August at 9.61 million, the first increase in four months and highest level since May, driven by the addition of a half-million new job openings for professional and business services and a partial reversal of this year's trend of dissipating excess labor demand.   The ISM Services PMI index came in as expected at 53.6 during September, still in expansionary territory (>50) as solid business activity was tempered by a sharp pullback in new orders and slowing employment, elevating concerns that durable strength in services may soften given the headwinds of higher prices, surging interest rates and the resumption of student loan payments.

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To the Moon

This summer's surge in longer-term, U.S. Treasury yields has rendered yet another grim milestone for homeowners and lenders alike- the highest contract rate on a 30-year fixed mortgage since November 2000. According to the Mortgage Bankers Association, this rate jumped to 7.53% by September 29th, as 'higher for longer' by the FOMC becomes more likely and rapidly deteriorating fiscal position drove 10-year U.S. Treasury yields higher by 46 basis points during September. The rise in financing costs continued into October given this week's leg up in longer term U.S. Treasury yields, a key driver of mortgage rates, with 30-year fixed rate mortgage rates surpassing 7.70% earlier this week according to Mortgage News Daily. Indeed, soaring mortgage rates and resilient, near-record home prices have hastened one of the least affordable home buying environments in decades, with The National Association of Realtors housing affordability index coming in at 87.8 by the end of July, matching the lowest level in data back to 1989. To put this in context, a level of 100 means a family earning the national median income qualifies for a mortgage at the median home price, levels not seen since the beginning of the year.

As we have lamented, this rock-bottom affordability has discouraged existing home sales and held down supply, as potential sellers with much lower, legacy mortgage rates are reluctant to trade up and recast financing above 7% and new home buyers priced out by both sky-high rates and selling prices. This, of course, has pushed more potential home buyers into the rental market, which has kept median rents near all-time highs, further pressuring household budgets already taxed by higher food and energy prices. Taken together with depleted, pandemic-era excess savings, soaring credit card debt and this month's resumption of student loan payments (after a 3+ year hiatus), a near perfect storm is brewing that threatens to upend the surprising resilience seen in consumer spending during the current policy tightening campaign and, by extension, derail the 'higher for longer' stance regarding rates by the FOMC should the consumer finally buckle under the weight of seemingly endless headwinds. Stay tuned!

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On the fiscal front, the big news this past week was the last-minute passage of a short-term funding bill, known as a Continuing Resolution (CR), to avert a widely anticipated government shutdown. The CR will fund the government for 45 days through November 17th, leaving both the House and Senate time to reconcile their considerable differences regarding the passage of the 12 required appropriations bills prior to the specter of another potential shutdown. Away from that, we anticipate additional appeals by the New Civil Liberties Alliance (NCLA), the group that sued the Biden Administration in August over the President's latest, proposed plan to cancel student loan debt for millions of borrowers. More to follow!

Market Snapshot

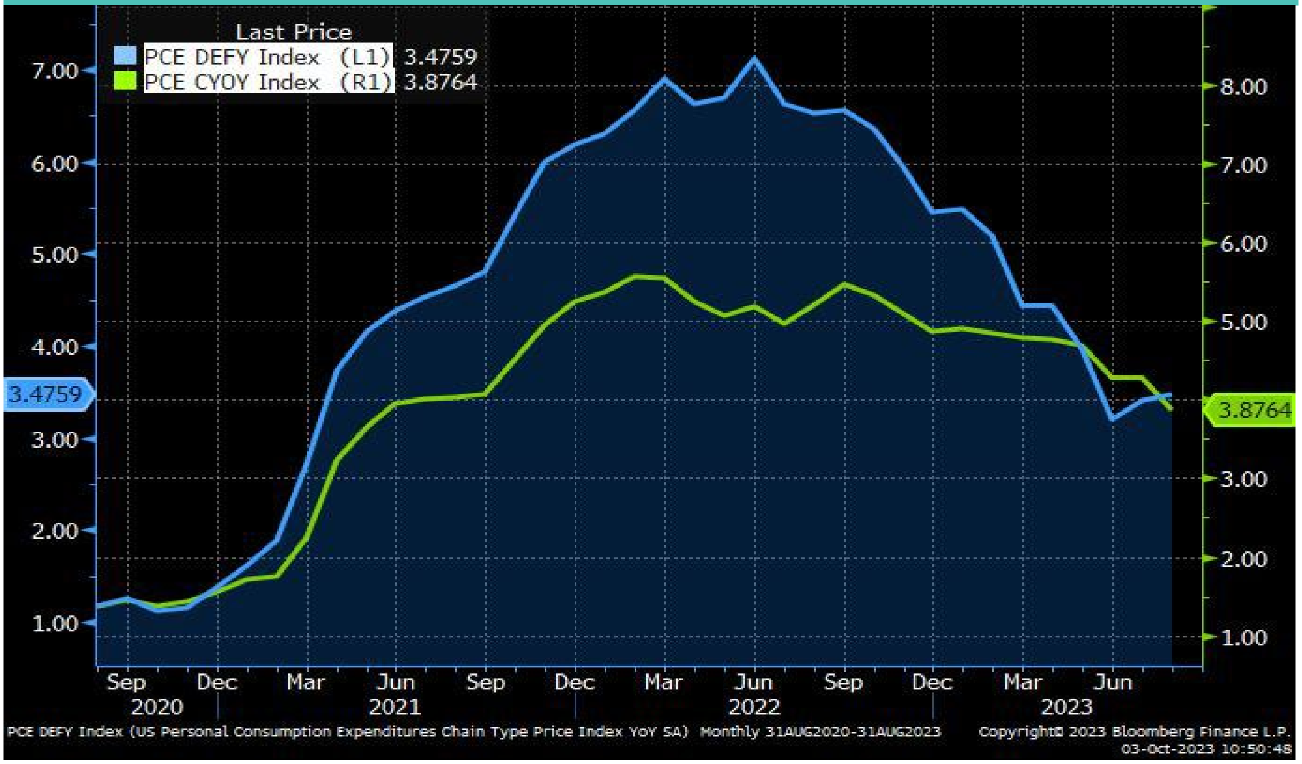
	This Week 10/5/23	Last Week 9/28/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.68%	5.65%	0.03%	0.53%	19.08%
SOFR	5.32%	5.32%	0.00%	0.00%	23.72%
2-year US Treasury	5.02%	5.08%	-0.06%	-1.18%	13.32%
5-year US Treasury	4.68%	4.65%	0.03%	0.65%	16.71%
10-yr US Treasury	4.72%	4.61%	0.11%	2.39%	21.65%
2s-10s UST Spread	-30.00	-47.00	17.00	-36.17%	-45.45%
DJIA	33,154	33,665	-511	-1.52%	0.02%
S&P 500	4,264	4,305	-41	-0.95%	11.04%
Spot Gold	1,834	1,881	-47	-2.50%	0.44%
WTI (Oil) Current Contract	82.31	91.59	-9.28	-10.13%	2.55%
1-year Brokered CD	5.45%	5.50%	-0.05%	-0.91%	18.48%
5-year Brokered CD	4.75%	4.75%	0.00%	0.00%	18.75%
5-year Bullet US Agency	4.75%	4.74%	0.01%	0.21%	16.42%
5-year/NC1yr Callable US Agcy.	5.93%	5.93%	0.00%	0.00%	9.81%
CDX IG Spread Index	77.88	73.77	4.11	5.57%	-5.05%
CDX High Yield Index Spread	100.00	101.00	-1.00	-0.99%	-0.62%

Source: Bloomberg data as of 3:00 pm ET 10/5/2023 and 2:30 p.m. 9/28/2023

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.

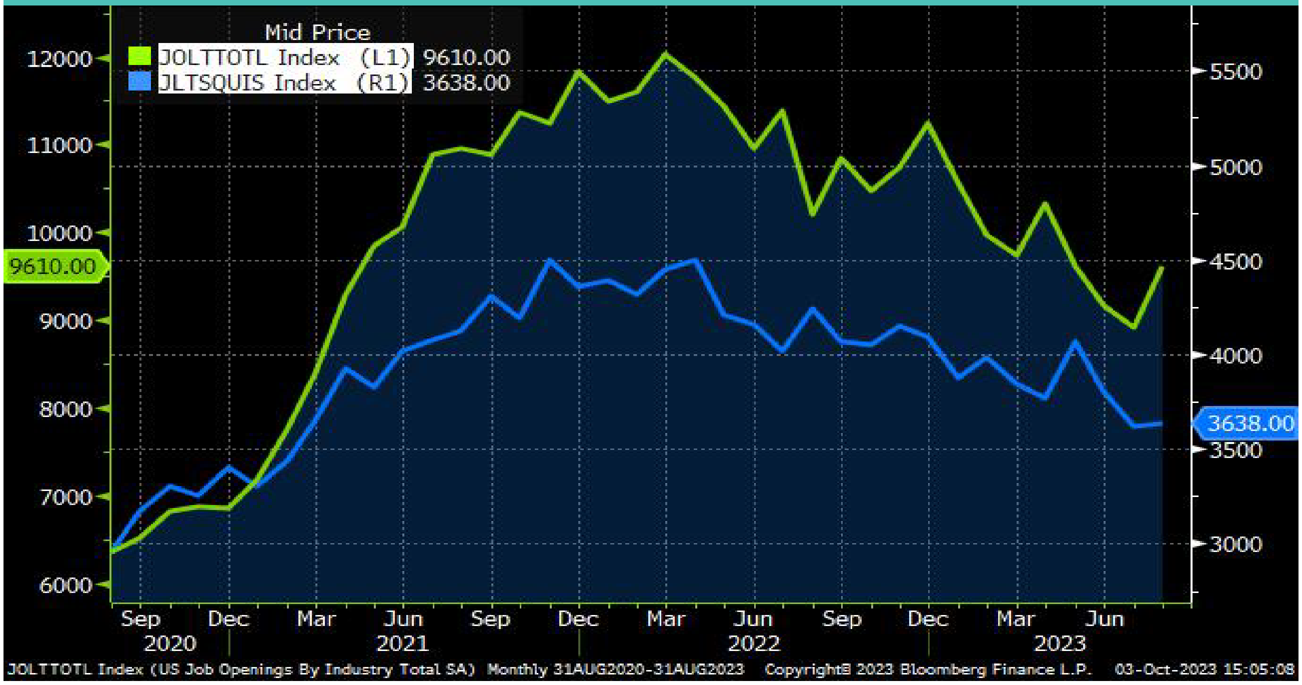
PCE Deflator YoY% CORE PCE Deflator YoY% - Monthly - 3 years



Source: Bloomberg as of 10/03/23

Headline PCE prices came in weaker than expected during August and were up +.4% (+.5% est./+.2% July), as surging energy prices were tempered by another month of lower durable goods prices and more tepid advances in food, housing and other services. Notwithstanding the jump in energy costs, August's continued moderation in core prices has mitigated concerns that April's reacceleration would be sustained, with goods prices up +.8% (+6.1% energy) and services higher by +.2% during the month, and +.7% and +4.9% on a year-over-year basis. Additionally, PCE Supercore (Services ex. housing and energy) advanced +.14% (+4.4% YOY), the smallest monthly advance since November 2020 and a reversal of July's outsized, one-time gain in asset management services. In the aggregate, July's headline PCE prices were up 3.5% during the past year, the largest annual advance in three months, revealing the stubbornly slow decline 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 soared since the first quarter of 2021 as higher food, energy, rents and other services costs have pushed prices higher. The Core PCE Deflator (excluding food and energy) was again muted in August, up +.1% for the month (+.2% July) and higher by 3.9% over the past year, the first sub-4% read since June 2021, but still a stubbornly slow step-down 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 2.2%, 3.3% and 3.7% (Aug.-Jun.) on a three-month annualized basis, data that may support additional rate hike 'pauses' for the balance of the year 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. Notwithstanding this month's muted gains, services inflation remains resilient and continues to offset progress on the goods front, and still supportive of the current, 'higher for longer' interest rate stance by the FOMC.

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



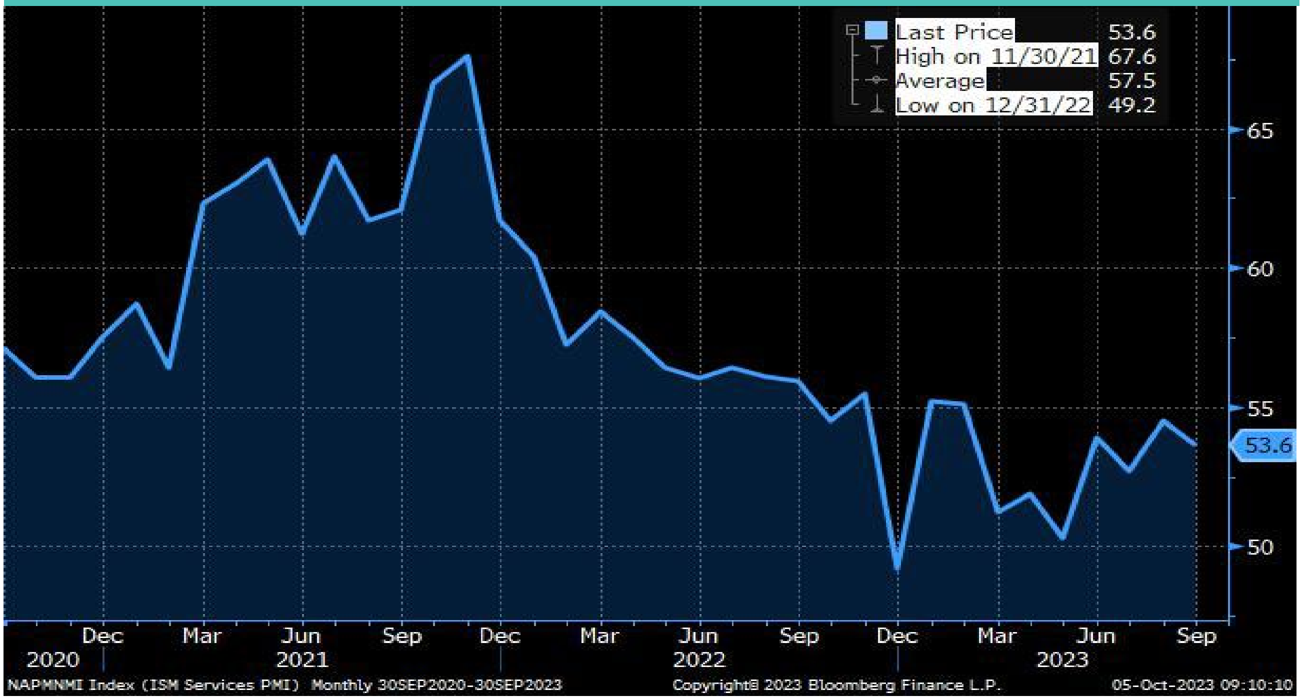
Source: Bloomberg as of 10/03/2023

The number of available jobs came in much stronger than expected during August at 9.61 million (8.92 million July), the first increase in four months and highest level since May, driven by the addition of a half-million new job openings for professional and business services and a partial reversal of this year's trend of dissipating excess labor demand. By industry, job openings increased for professional/business services (+509,000), government (+90,000), financial activities (+86,000) and manufacturing (+72,000), with decreases in trade/transport (-109,000), leisure & hospitality (-54,000), and information (-20,000) with employers still reporting difficulty attracting and retaining enough workers to keep pace with demand. Indeed, the labor participation rate remains roughly 1% lower than its 2019, pre-pandemic peak as higher retirement rates, skill mismatches and mixed participation have dampened employer efforts to add new workers.

Additionally, the quits rate, which measures voluntary job separations per month as a percent of total employment, was unchanged at 2.3% (3.6 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, more evidence of job market tightness can be seen in the layoffs and discharge rate, which was unchanged at 1.1% during August (record low .9% December 2021) and the 1.5x ratio of jobs available to each unemployed worker (cycle high 1.99x March 2022; 1.15 Dec. 2019), a pull-back from January (1.9x), but still reflective of tight labor markets. Indeed, durable labor shortages have pushed 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 and elevated, state-level direct economic assistance hastened structural changes to the labor force that have slowed the return to pre-pandemic levels of participation.

While demand for labor appears to be softening given the cumulative decline of over 1.62 million job vacancies since the end of last year, open positions and the job openings rate (5.8% Aug.; 7.4% peak Mar. 2022) remain historically high and are likely to push robust wage growth in the near term given the durability of labor supply and demand imbalances.

ISM Services PMI – Monthly – 3 Years



Source: Bloomberg as of 10/05/2023

The ISM Services PMI index came in as expected at 53.6 during September (est. 53.5/54.5 Aug.), still in expansionary territory (>50) as solid business activity was tempered by a sharp pullback in new orders and slowing employment, elevating concerns that durable strength in services may soften given the headwinds of higher prices, surging interest rates and the resumption of student loan payments. A deeper dive into the survey revealed broad-based gains across industries (13 of 18 reporting growth), with new orders sliding by 5.7 points (51.8/57.5 Aug.), the lowest level since last December, employment lower by 1.3 points (53.4/54.7 Aug.), and supplier delivery times edged higher (50.4/48.5 Aug.), with recent delivery times running at the fastest pace since 2009 and reflective of much improved supply chains. Additionally, the data also revealed that prices paid by service providers were unchanged last month (58.9/68.1 Dec.), hovering around levels last seen during mid-2020 and more in-line with historical averages. Looking at the text of the report, the Chairman of the survey committee stated that "There has been a slight pullback in the rate of growth for the services sector, which is attributed to slower rates of growth in the New Orders and Employment indexes," and that "The majority of respondents remain positive about business conditions; moreover, some respondents indicated concern about potential headwinds." All in all, another solid report indicating that demand for services remains in expansionary territory, with the caveat that last month's sharp pullback in new orders suggests that current levels of business will slow given the weight of higher interest rates, elevated inflation, depleted excess savings and the resumption of student loan payments this month.

The Week Ahead

The data calendar picks up over the coming week, headlined by the Non-Farm Payrolls, CPI, PPI and NFIB Small Business Optimism. Looking ahead, markets remain focused on inflation, employment data and more signs of slower economic activity. On the new issue front, ABS started October strong with 7 deals totaling $5.2 billion priced through the 4th and $228.9 billion year to date ($226.2 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance remained sluggish with $6.5 billion priced through the 4th and $988.3 billion year to date ($1.06 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 post 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 solid.

Friday 10/06

Non-Farm Payrolls

Monday 10/09

Market Holiday – Columbus Day

Tuesday 10/10

NFIB Small Business Optimism

Wednesday 10/11

PPI; FOMC Meeting Minutes (9/20)

Thursday 10/12

CPI; 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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