Fixed Income Market Insights

March 2, 2023

Key takeaways

Bond yields were sharply higher over the past week, with GT2s up 20 basis points and GT10s higher by 19 basis points and 2s/10s more inverted by 1 basis point (-83), driven by resurgent inflation data and more hawkish, 'higher (rates) for longer' public comments by FOMC policymakers. On the data front, headline PCE prices were up +.6% during January, the largest monthly gain since last June, as rebounding goods prices added to persistently brisk advances in rents and other services. U.S. durable goods orders were weaker than expected in January, with the headline down -4.5%, driven by an expected decline in the volatile commercial aircraft order component, partially reversing December's sharp increase, which offset broad-based strength across much of the capital goods sub-sector. Consumer confidence came in weaker than expected during February at 102.9, driven by inflation concerns and less upbeat attitudes regarding business conditions over the next six months.

We suggest

We continue to prefer playing rate defense given relatively low market rates, 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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Beware of the Bear

After an overtly bullish January for both stocks, bonds and credit spreads, last month proved much more challenging as resurgent inflation data, the specter of higher rates for longer and concerns about the real health of consumers and broader economy drove market yields higher and stock prices lower. On the interest rate front, yields on six month and two-year (GT2) Treasury securities both hit cycle highs (5.15/4.91%) this week, with the ten-year (GT10) breaking through 4% for the first time since early November, with yields at 4.08% this afternoon (4.24% cycle high on Oct. 24th). In total, yields jumped 71 and 51 basis points on GT2s and GT10s respectively since the end of January, along with commensurate moves in Federal Funds futures yields further out this year, a key indicator of expected FOMC rate actions, with the terminal rate at a new cycle high of 5.27% for the September 20th contract as of yesterday's close. Perhaps more importantly, the market has pared back expectations for rate cuts priced into these contracts around the end of 2023, with one, 25 basis point rate cut forecasted by January 2024, a meaningful reversal of the 50-75 basis points in easing implied at various times during the fourth quarter of last year.

Market Snapshot

	This week 3/2/23	Last week 2/23/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	4.98%	4.96%	2	0.40%	4.40%
SOFR	4.55%	4.55%	0	0.00%	5.81%
2-year US Treasury	4.90%	4.70%	20	4.26%	10.61%
5-year US Treasury	4.33%	4.11%	22	5.35%	7.98%
10-yr US Treasury	4.07%	3.88%	19	4.90%	4.90%
2s-10s UST Spread	-83.00	-82.00	-1.00	1.22%	50.91%
DJIA	32,962	33,154	-192.00	-0.58%	-0.56%
S&P 500	3,970	4,012	-42.00	-1.05%	3.39%
Spot Gold	1,842	1,827	15.00	0.82%	0.88%
WTI (Oil) Current Contract	78.03	75.39	2.64	3.50%	-2.78%
1-year Brokered CD	5.10%	5.00%	10	2.00%	10.87%
5-year Brokered CD	4.60%	4.45%	15	3.37%	15.00%
5-year Bullet US Agency	4.44%	4.21%	23	5.46%	8.82%
5-year/NC1yr Callable US Agcy	5.80%	5.60%	20	3.57%	7.41%
CDX IG Spread Index	75.25	74.36	0.89	1.20%	-8.25%
CDX High Yield Index Spread	101.61	101.80	-0.19	-0.19%	0.98%
15-yr UMBS	5.09%	4.88%	21	4.30%	9.23%
30-yr UMBS	5.67%	5.39%	28	5.19%	6.38%

Source: Bloomberg data as of 2:45pm ET 3/2/2023 and 5pm ET 2/23/2023

While FOMC policymakers have reiterated for months that short-term interest rates will have to stay higher for longer, with Chairman Powell bluntly stating that rate cuts are off the table for the remainder of this year, a majority of market participants remained skeptical through the early part of February, until they weren't. Indeed, the reacceleration of inflation aggregates (CPI, PPI, PCE Deflator), led by an abrupt halt in goods disinflation, consistently strong employment data, rebounding personal consumption and strong services metrics have brought the FOMC and broader market closer to parity regarding short term interest rates as the odds of a soft economic landing without a spike in unemployment have become more likely this year. While predicting the near-term path of interest rates during FOMC tightening cycles is notoriously difficult, particularly during the most aggressive rate hiking campaign since the early 1980s, suffice it to say that the market appears to be buying what Powell and company are selling, for now. Stay tuned!

Still quiet on the fiscal front as extended breaks and house hearings have dominated the congressional calendar. Among several legislative imperatives, negotiations regarding the debt ceiling will take center stage in the weeks to come. Away from legislation, the Supreme Court heard oral arguments on Tuesday regarding the legality of the Biden Administration's student loan debt forgiveness plan, with the decision expected by June. Additionally, the Democratic-led Senate voted 50-46 on Wednesday to block the Labor Department's ESG/Sustainable investment rule adopted last November that aims to encourage retirement plans to weigh climate change and other environmental, social and governance issues in their investment decisions, which the Biden Administration has vowed to veto.

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

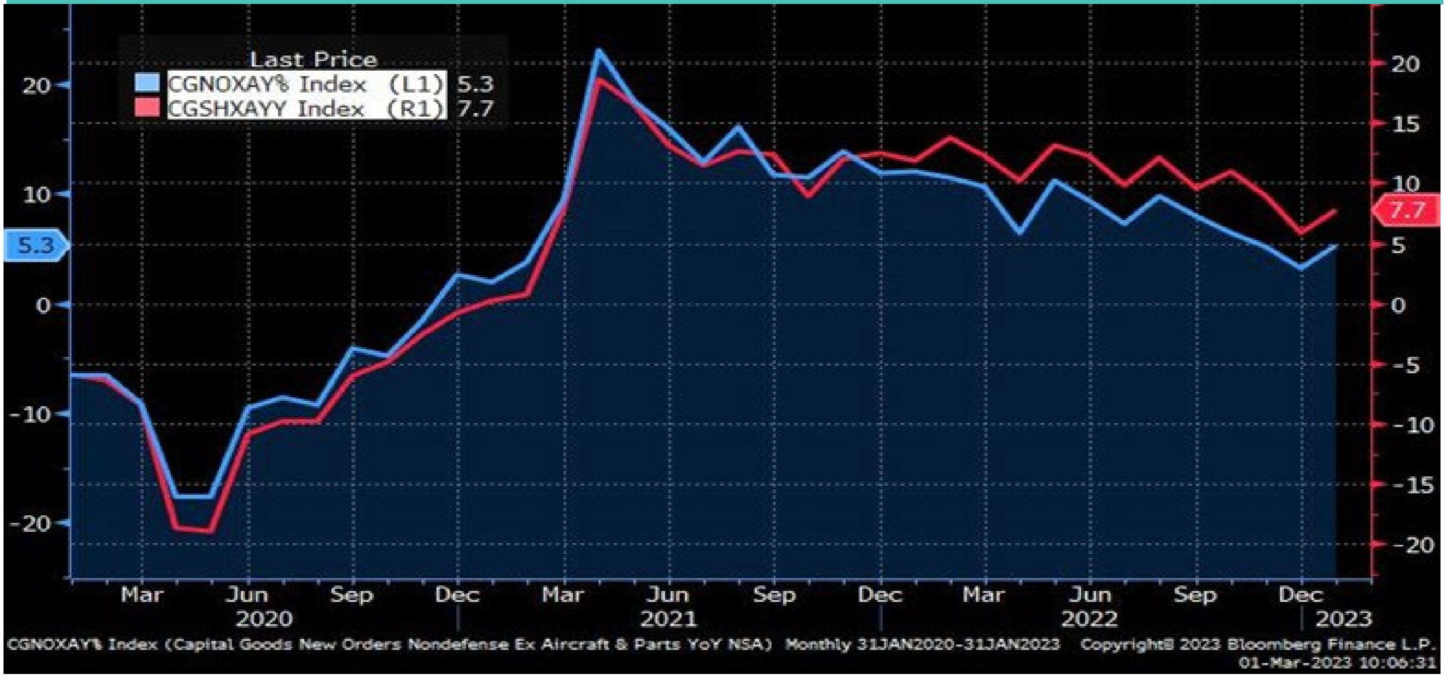
Source: Bloomberg as of 3/2/2023

Headline PCE prices were up +.6% during January (+.5% survey), the largest monthly gain since last June, as rebounding goods prices, led by food, energy and other non-durables, added to persistently brisk advances in rents and other services. Notably, January's broad-based gains erased much of the goods disinflation seen during the fourth quarter of last year, with goods prices up +.6% and services also higher by +.6% during the month, and +4.7% and +5.7% on a year-over-year basis, both reversing months of deceleration in these annual aggregates. In total, headline PCE prices were up 5.4% during the past year, the highest read in two months and a slow descent from this 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 moved sharply higher since the first quarter of 2021 as higher food and energy prices, elevated rents and chronic labor and materials shortages have slowed production alongside of still robust demand, pushing prices progressively higher. The Core PCE Deflator (excluding food and energy) reaccelerated again in January, up +.6% for the month and higher by 4.7% over the past year, a minor deceleration versus September's annual increase (5.2%) and clear evidence that today's broad-based inflation remains stubbornly high and increasingly sticky. That said, Core PCE price index advances have started to slowly moderate, running 4.1%, 4.4% and 4.6% (Dec-Oct) on a three-month annualized basis, surely welcome news for the FOMC and data that supports the current, 25 basis point rate hike cadence, with an eye towards a pause during the Summer. All in all, unwelcome news for the Federal Reserve that all but cements a series of additional rate hikes and, more importantly, bolsters the current 'higher for longer' short term interest rate stance by Powell and Company.

U.S. Durable Goods & Core Capital Goods Non-Defense Ex Air New Orders MOM % – Monthly – 2 Years

Source: Bloomberg as of 3/2/2023

Core Capital Goods Orders & Shipments Non-Defense Ex Air YOY % – Monthly – 3 Years



Source: Bloomberg as of 3/2/2023

U.S. durable goods orders were weaker than expected in January, with the headline down -4.5% (-4.0% est), driven by an expected decline in the volatile commercial aircraft order component, partially reversing December's sharp increase, which offset broad-based strength across much of the capital goods sub-sector, particularly in computers and machinery. To be sure, demand for equipment and other fixed business investment (excluding aircraft and military hardware) rebounded in January, resuming the resilience seen during much of 2022, sans the fourth quarter soft patch, as companies resumed their push to increase production and invest in labor-saving technologies. This metric, known as core capital goods orders, surged +.8% in January, which rendered three-month and year-over-year growth rates to -.5% and 5.3%, a sharp slowdown from the 7.5% and 7.6% run rates during the third quarter of last year. Notwithstanding January's rebound, trend data reveals a meaningful slowdown in larger-ticket spending (ex-aircraft) during the past several months, a moderation well-underway given FOMC rate hikes and heightened risks of recession, both of which may stifle new order momentum in the months to come.

Consumer Confidence & Expectations – Monthly – 3 Years

Source: Bloomberg as of 3/2/2023

Consumer confidence came in weaker than expected during February at 102.9 (vs. 108.5 est./106 Jan.), driven by inflation concerns and less upbeat attitudes regarding business conditions over the next six months. Leading this month's decline was the expectations component, a measure of consumers' six-month outlook, which deteriorated sharply to 69.7 (76.0 Jan.), the lowest level since last July and below the recessionary reading (80) for the eleventh time over the past year, as fewer respondents expect business conditions to improve (14.2% vs. 18.4% Jan.), a smaller share see more jobs added (14.5% vs. 17.7% Jan.), and fewer expect income to increase (13.4% vs. 17.4% Jan.). Conversely, the current conditions component edged up to 152.8 (151.1 Jan.), the highest level since April 2022, led by more respondents stating that jobs are plentiful (52.0% vs. 48.1% Jan.) and fewer seeing weaker current business conditions (17.7% vs. 19.0% Jan.). Looking at the text of the report, the senior director of the survey stated that "Consumer confidence declined again in February. The decrease reflected large drops in confidence for households aged 35 to 54 and for households earning $35,000 or more," and that "The outlook appears considerably more pessimistic when looking ahead. Expectations for where jobs, incomes, and business conditions are headed over the next six months all fell sharply in February. Consumers may be showing early signs of pulling back spending in the face of high prices and rising interest rates." Notwithstanding deteriorating expectations, overall confidence has been largely supported by durable strength in the labor market this year, and February's data revealed another rise in the Labor Index, which measures the labor differential of jobs plentiful less hard to get, to 41.5% (37.0% Jan.), the highest level since April 2022. All in all, a weak report that revealed the risks of further weakness in consumer spending continue to mount given higher interest rates, sinking personal savings rates and surging consumer credit balances, a triumvirate likely to soften confidence in the coming months.

The Week Ahead

The data calendar slows next week, headlined by the JOLTS Job Openings, ISM Services and Factory Orders. Looking ahead, markets remain focused on resurgent inflation, employment data and more signs of slowing economic activity. On the new issue front, ABS transactions were paused given the Structured Finance Association's SFVegas 2023 conference, which ended yesterday, with no deals priced through the 1st and $41.3 billion year to date ($46.1 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance was robust gain with $37.2 billion in deals priced through the 1st and $301.6 billion year to date ($249.1 billion over same period last year; $1.26 trillion for 2022). While new issue supply slowed during 2022 given FOMC rate hikes and higher volatility, market conditions have improved significantly 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 solid.

Friday 3/3

ISM Services

Monday 3/6

Factory Orders

Tuesday 3/7

Consumer Credit

Wednesday 3/8

JOLTS Job Openings; Trade Balance

Thursday 3/9

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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