Fixed Income Market Insights

May 4, 2023

Key takeaways

Bond yields were lower this week, with GT2s down 28 basis points and GT10s lower by 14 basis points respectively and 2s/10s less inverted by 14 basis points (-41), as softer PCE price data and another drop in JOLTS job openings triggered concerns of a harder economic landing later this year. On the data front, Headline PCE prices were up +.1% during March, the smallest monthly advance in eight months, as an unexpected decline in food, lower energy and other goods prices were again offset by advances in housing and other services. The number of available jobs again came in lower than expected at 9.59 million in March, the third consecutive monthly decline and lowest level since April 2021, suggestive of cooling demand in some industries, but still indicative of tight labor markets driven by chronic labor shortages and still robust demand. As expected, the FOMC raised the Federal Funds rate by 25 basis points to 5.25% on Wednesday afternoon with a unanimous vote of 11-0, the tenth consecutive rate hike and the highest level since August 2007.

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

About Done?

As expected, the FOMC raised short term interest rates for the tenth consecutive meeting, boosting the Federal Funds Rate by 25 basis points to 5.25%, the highest benchmark level since 2007. While it may seem odd that the FOMC would be raising rates at a time when three, large regional banks failed within 60 days of each other, this is no ordinary time. Boxed in by a late response to obvious inflationary pressures, the FOMC delivered 500 basis points of rate hikes in 13 months, the fastest pace of tightening in history, to tame the highest inflation since the early 1980s. Among other things, this white-hot pace has created a growing divide between bank deposit rates and the yields on other, short-term investment products, namely U.S. Treasury bills and Money Market Funds, triggering depositors to withdraw funds from banks in favor of these higher yielding alternatives. As a yet to be known number of regional/community banks now grapple with the reality of deposit withdrawals and asset shrinkage, the real question now is how far a meaningful credit contraction can go, and at what cost to the economy.

Market Snapshot

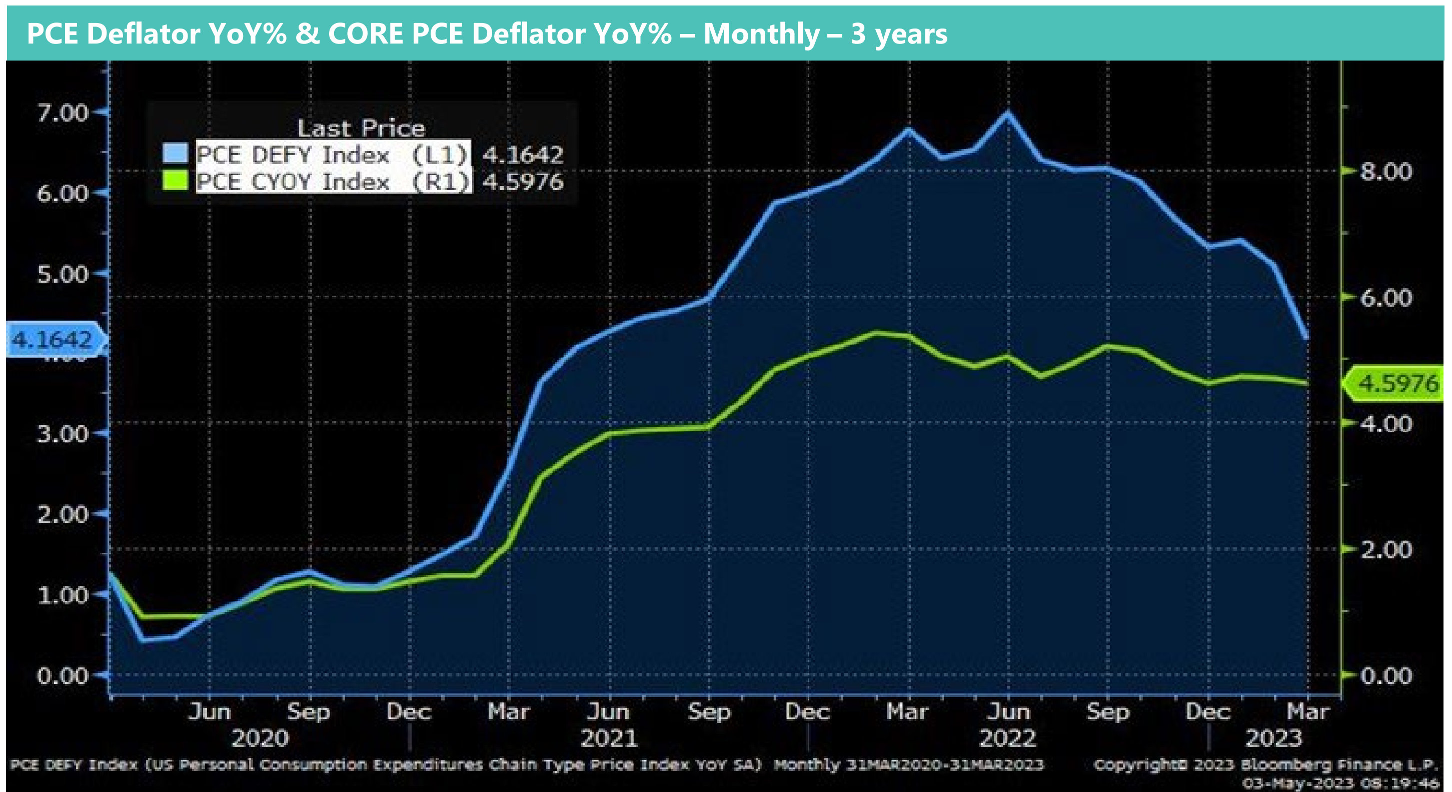
	This week 5/4/23	Last week 4/27/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.33%	5.27%	6	1.14%	11.74%
SOFR	5.06%	4.80%	26	5.42%	17.67%
2-year US Treasury	3.79%	4.07%	-28	-6.88%	-14.45%
5-year US Treasury	3.33%	3.59%	-26	-7.24%	-16.96%
10-yr US Treasury	3.38%	3.52%	-14	-3.98%	-12.89%
2s-10s UST Spread	-41.00	-55.00	14.00	-25.45%	-25.45%
DJIA	33,128	33,826	-698.00	-2.06%	-0.06%
S&P 500	4,061	4,135	-74.00	-1.79%	5.76%
Spot Gold	2,056	1,999	57.00	2.85%	12.60%
WTI (Oil) Current Contract	68.56	74.76	-6.20	-8.29%	-14.58%
1-year Brokered CD	5.10%	5.10%	0	0.00%	10.87%
5-year Brokered CD	4.50%	4.45%	5	1.12%	12.50%
5-year Bullet US Agency	3.50%	3.76%	-26	-6.91%	-14.22%
5-year/NC1yr Callable US Agcy.	4.91%	5.15%	-24	-4.66%	-9.07%
CDX IG Spread Index	80.83	76.41	4.42	5.78%	-1.45%
CDX High Yield Index Spread	100.24	101.26	-1.02	-1.01%	-0.38%
15-yr UMBS	4.47%	4.68%	-21	-4.49%	-4.08%
30-yr UMBS	4.95%	5.19%	-24	-4.62%	-7.13%

Source: Bloomberg data as of 5:00pm ET 5/4/2023 and 5:00pm ET 4/27/2023

To recap, recent data have revealed that smaller banks (up to $250 billion in assets) are responsible for nearly 50% of all commercial and industrial lending, with even larger market share when it comes to residential and commercial real estate lending, with estimates of upwards of 60% and more than 70% respectively. The gravity of this situation weighs a bit heavier this week with the implosion of First Republic Bank (FRBK), now the second largest bank to go bankrupt in American history, right on the heels of the third and fourth largest bank failures (SVB/SBNY) within the last two months. While there seems to be 'one off' explanations for these failures, whether it's asset concentration, reduced deposit friction via 'digitization,' buying low coupon MBS or making low rate, long IO mortgages to the wealthy, these one-offs really aren't one-offs. Their common thread has been shockingly poor asset/liability management and an equally puzzling lack of oversight, both by internal and external parties. Accordingly, it seems unlikely to us that this is the last of the bad news, which really brings home an increasingly plausible scenario of a much larger credit contraction that tips the economy over into something worse than a mild recession. Indeed, Chairman Powell addressed the fact that growth has been below trend for five quarters (.9% GDP 2022; 1.1% GDP Q123), and that we should expect more of the same as credit conditions will tighten further from here, already in tight territory. While he repeatedly stated that the extent of potential credit destruction is not yet known, the Chairman sounded much less sanguine regarding the prospects of a soft landing given the growing economic headwinds of higher rates, tighter credit and still-elevated inflation. Notwithstanding the Chairman's still resolute stance regarding the need to keep rates high for an extended period of time given inflation's slower descent, we can't help but think the FOMC's resolve will be challenged should deposit flight continue at the same time the economy continues to slow. Judging by Federal Funds Futures contacts, which now imply 100 basis points in rate cuts by January 2024, most market participants appear to agree. Stay Tuned!

The debt ceiling debate has begun with the passage of a House bill and an upcoming, May 9th meeting with the President and congressional leadership. To recap, the House of Representatives narrowly passed (217-215) a bill last week that increased the debt ceiling by $1.5 trillion in exchange for a package of spending reductions. While the bill in current form has been roundly criticized by Senate democrats and the President, passage by the House has set the table for what will likely be weeks of politically charged debate. Also, look for more debate regarding tighter bank regulation in the wake of the SVB/SBNY/FRBK failures, with public hearings to follow.

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



Source: Bloomberg as of 5/4/2023

Headline PCE prices were up +.1% during March (+.1% est./.3% Feb.), the smallest monthly advance in eight months, as an unexpected decline in food, lower energy and other goods prices were again offset by advances in housing and other services. Indeed, the last two months of more tepid price gains have mitigated concerns that January's reacceleration in goods prices would be sustained, with goods prices down -.2% and services higher by +.2% during the month, and +1.6% and +5.5% on a year-over-year basis, as core services (ex. housing and energy) advanced at the slowest pace since last July. In total, headline PCE prices were up 4.2% during the past year, the smallest annual advance since May 2021, but still a stubbornly slow descent 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 moved sharply higher since the first quarter of 2021 as higher food and energy prices and elevated rents and other services costs have pushed prices progressively higher. The Core PCE Deflator (excluding food and energy) also slowed during March, up +.3% for the month (+.4% Feb.) and higher by 4.6% over the past year, a small deceleration versus September's annual increase (5.2%) and evidence that broad-based inflation remains stubbornly high and sticky. Indeed, Core PCE price index advances reaccelerated during the first quarter, running 4.9%, 4.6% and 4.2% (Mar-Jan) on a three-month annualized basis, data supportive of the narrative by FOMC policymakers that more work needs to be done before the cessation of this cycle's inflation fight. All in all, services inflation remains resilient and continues to offset progress on the goods front, a condition supportive of the current 'higher for longer' short term interest rate stance by Powell and Company.

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

Source: Bloomberg as of 5/4/2023

The number of available jobs again came in lower than expected at 9.59 million (9.73 million est.) in March, the third consecutive monthly decline and lowest level since April 2021, suggestive of cooling demand in some industries, but still indicative of tight labor markets driven by chronic labor shortages and still robust demand. By industry, job openings decreased in trade/transport (-229,000), professional/business services (-135,000), healthcare (-71,000) and construction (-69,000), with increases in leisure/hospitality (+79,000), government (+34,000) and financial activities (+25,000), as employers continue to report difficulty attracting and retaining enough workers to keep up with strong demand for services and selected goods. To be sure, the labor participation rate remains roughly 1% lower than its 2019, pre-pandemic peak as higher retirement rates, skill mismatches and mixed participation have slowed employer efforts to add new workers. Additionally, the quits rate, which measures voluntary job separations per month as a percent of total employment, ticked down to 2.5% (3.9 million jobs; 2.3% Dec. 2019), shy of last March's all-time high (3%) but still elevated, as higher compensation, new hire incentives and the magnitude of job vacancies continue to drive elevated employee turnover. Further evidence of job market tightness can be seen in the layoffs and discharge rate, which ticked up to 1.2% during March (record low .9% December 2021) and the 1.6x 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) and the lowest since October 2021, but still indicative of tight labor markets. Indeed, durable labor shortages have forced companies to raise compensation to attract and retain workers, with little relief expected during the first half of 2023. While labor market imbalances should recede given FOMC rate hikes and cooling demand, we believe the JOLTS data will remain high as the pandemic and elevated, state-level direct economic assistance drove structural changes to the labor force that have slowed the return to pre-pandemic levels of labor participation. While the labor market is clearly cooling given the cumulative decline of over 1.6 million job vacancies during the first quarter, open positions and the job openings rate (5.8%; 7.4% peak Mar. 2022) remain historically high and will likely support solid wage growth in the months to come as labor supply/demand imbalances endure.

FOMC Rate Decision & Statement Analysis

As expected, the FOMC raised the Federal Funds rate by 25 basis points to 5.25% on Wednesday afternoon with a unanimous vote of 11-0, the tenth consecutive rate hike and the highest level since August 2007. As has been customary during this tightening cycle, Chairman Powell reiterated the Committee's resolve to reduce inflation and maintained that a pathway to a soft economic landing still exists. While this remains at odds with many market participants given the cumulative effects of 500 basis points in tightening and the likelihood of credit contraction in the wake of recent bank failures, the Chairman stated that persistent strength in job creation may be enough to avoid a meaningful economic downturn. That said, the Chairman repeatedly noted that the ultimate impact of recent duress in the regional/community banking cohort is too early to know, and that any meaningful contraction in lending would surely up the odds of a harder economic landing, which would change the FOMC's party line of 'higher for longer' regarding short term interest rates. Additionally, he reiterated multiple times that inflation remains too high and has been slow to recede, stating that "We on the committee have a view that inflation is going to come down not so quickly" and that "Non-housing services inflation hasn't moved much and in that world, it would not be appropriate for us to cut rates," further amplifying the divide between the FOMC's 'higher for longer' stance and the 100 basis points in rate cuts by early 2024 implied by Federal Funds futures. In our view, there were several, meaningful takeaways from the FOMC's official statement and post-announcement Q&A session with Chairman Powell, all centered upon the likely end of the current monetary policy tightening cycle. To start, a common theme throughout the post-meeting press conference was that tighter financial conditions have started to slow economic activity to below trend levels, which was underscored by the Chairman by stating that "The economy is likely to face further headwinds from tighter credit conditions. Credit conditions had already been tightening over the past year or so in response to our policy actions and a softer economic outlook. But the strains that emerged in the banking sector in early March appear to be resulting in even tighter credit conditions for households and businesses. In turn, these tighter credit conditions are likely to weigh on economic activity, hiring, and inflation." This was also reflected in language changes to the FOMC official statement, which shifted to "In determining the extent to which additional policy firming may be appropriate" from "some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive" in March, changes the Chairman repeatedly referenced as significant and a nod to the likelihood that the FOMC has reached its terminal rate for this cycle. Indeed, the Chairman further addressed the 'sufficiently restrictive' question fairly emphatically by referencing high real (inflation-adjusted) interest rates during the Q&A session, by stating that "I think that policy is tight. You've got 2 percent real rates. That's meaningfully above what most people would assess as the neutral rate. And you see that in interest sensitive activities, and also begin to see it more and more in other activities. If you put the credit tightening on top of that, and the QT that's ongoing, we may not be far off for. We're possibly even at that level." While Powell again delivered the Committee's party line on inflation, that we understand the hardship and have the resolve to break it, we remain less convinced that the Federal Reserve can break inflation without breaking the economy, particularly given that rate cuts during 2023 remain unlikely until a sustainable path towards a 2% inflation rate is achieved.

That said, the mounting specter of some form of credit contraction via the SVB/SBNY/FRBK failures, soaring 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. Taken together with the Chairman's comments regarding high (restrictive) real rates, we'd postulate, for now, that the most rapid monetary policy tightening in history has come to an end.

Comparing May and March statements, the major changes centered upon the softening of the 'additional policy firming' reference and elimination of 'sufficiently restrictive' language:

"The Committee will closely monitor incoming information and assess the implications for monetary policy. In determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time," which replaced March's "The Committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the extent of future increases in the target range."

All and all, Chairman Powell largely delivered the message that markets were expecting- Monetary policy now appears sufficiently restrictive and credit contraction in the wake of SVB/SBNY/FRBK bank failures is likely to be significant enough to slow the economy further above and beyond the cumulative effect of this past year's rate hikes. Stay tuned!

Date	Target	BN Survey	Survey vs Actual	Direction	Change	Discount	Vote
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
05/04/22	0.75%-1.00%	0.75%-1.00%	Expected	Tightening	0.50%	1.00%	9-0

Source: Federal Reserve and Bloomberg as of 5/4/2023

The Week Ahead

The data calendar remains heavy over the next week, headlined the Non-Farm Payrolls, CPI, PPI and NFIB Small Business Optimism. Looking ahead, markets remain focused on inflation, employment data and more signs of softening economic activity. On the new issue front, ABS volumes were anemic during the first week of May, with a mere 3 deals totaling $698 million priced through the 4th and $89.5 billion year to date ($107.4 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance rebounded with $28.4 billion priced as of the 4th and $488.9 billion year to date ($598.3 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 generally improved for much of 2023 and the new deal landscape remains favorable for a wider spectrum of ABS and corporate issuers as investor demand remains robust.

Friday 5/5
Non-Farm Payrolls

Monday 5/8
Wholesale Trade

Tuesday 5/9
NFIB Small Business Optimism

Wednesday 5/10
CPI

Thursday 5/11
PPI; Weekly Jobless Claims

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.

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