Fixed Income Market Insights

September 28, 2023

Key takeaways

Bond yields were mixed this week, with GT2s down 7 bps and GT10s higher by 11 bps respectively, and 2s/10s less inverted by 18 basis points (-47), driven by a looming U.S. government shutdown and Moody's warning that the current impasse may trigger a negative ratings action for the nation's sovereign debt. On the data front, the S&P CoreLogic Case-Shiller 20-city home price index rose +0.87% in July, the fifth consecutive monthly gain and largest three-month advance since June 2022, as the headwinds of record low affordability and higher mortgage rates have been more than offset by historically light inventories and durably resilient demand. Consumer confidence weakened again during September and came in below consensus at 103.0, the lowest level since May, driven by further weakness in labor market expectations; another leg-up in market interest rates and higher gasoline prices; and a union that threatens to derail this summer's strength in consumer spending. Initial unemployment claims again came in lower than expected during the week ended September 23rd at 204,000, the lowest level since January and reflective of chronic strength in demand for labor and employer propensity to hold onto hard-to-find workers.

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The Shutdown Showdown

As expected given today's hyper-partisan environment in Congress, the U.S. government is less than three days away from another shutdown unless Congress enacts a temporary spending bill before the nation's fiscal year ends on September 30th. Judging by the news filtering out of Washington this week, congressional Republicans and Democrats are miles apart regarding the passage of a short-term funding bill acceptable to both houses of Congress and the President, with further government spending cuts, more restrictive asylum and immigration policies, and limitations for future aid to Ukraine emerging as key sticking points. These temporary spending bills, known as Continuing Resolutions (CR), are stop-gap measures that allow the federal government to remain open and provide services when final spending appropriations have not been approved by Congress and the executive branch.

To review, the federal government operates via 12 appropriations bills passed by Congress and signed into law by the President each fiscal year. Given the lack of appropriations progress in the House of Representatives and rejection by House leadership of a bipartisan Senate plan unveiled earlier this week to fund the government past September 30th, it appears increasingly likely that we are headed for the first shutdown since 2018.

Market Snapshot

	This Week 9/28/23	Last Week 9/21/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.65%	5.66%	-1	-0.18%	18.45%
SOFR	5.32%	5.30%	2	0.38%	23.72%
2-year US Treasury	5.08%	5.15%	-7	-1.36%	14.67%
5-year US Treasury	4.65%	4.62%	3	0.65%	15.96%
10-yr US Treasury	4.61%	4.50%	11	2.44%	18.81%
2s-10s UST Spread	-47.00	-65.00	18.00	-27.69%	-14.55%
DJIA	33,665	34,070	-405	-1.19%	1.56%
S&P 500	4,305	4,330	-25	-0.58%	12.11%
Spot Gold	1,881	1,940	-59	-3.04%	3.01%
WTI (Oil) Current Contract	91.59	89.63	1.96	2.19%	14.12%
1-year Brokered CD	5.50%	5.50%	0	0.00%	19.57%
5-year Brokered CD	4.75%	4.75%	0	0.00%	18.75%
5-year Bullet US Agency	4.74%	4.67%	7	1.50%	16.18%
5-year/NC1yr Callable US Agcy.	5.93%	5.90%	3	0.51%	9.81%
CDX IG Spread Index	73.77	72.79	0.98	1.35%	-10.06%
CDX High Yield Index Spread	101.00	102.07	-1.07	-1.05%	0.38%
15-yr UMBS	5.79%	5.70%	9	1.58%	24.25%
30-yr UMBS	6.28%	6.19%	9	1.45%	17.82%

Source: Bloomberg data as of 2:30 p.m. 9/28/2023 and 5:00 pm ET 9/22/2023

In the end, without approved spending appropriations or an agreed upon CR, the government will ultimately face a funding gap that will trigger the shutdown of 'non-essential' federal functions and the furlough of hundreds of thousands of government workers, while those that provide essential services like law enforcement, military, postal delivery, air traffic control, and public safety will remain on the job without pay.

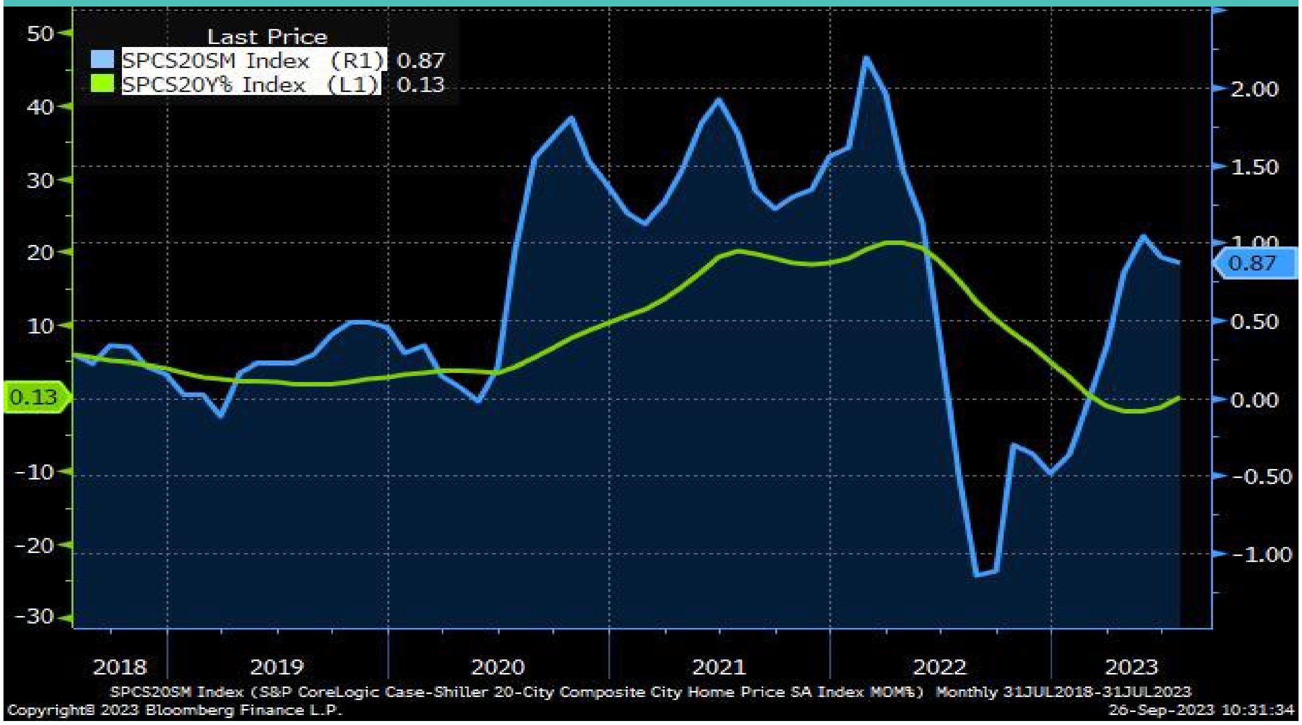
While it might seem that government shutdowns are rare given their last-resort billing, budgetary disagreements that lead to outright furloughs have become more common lately, with four shutdowns over the past decade and 14 since the early 1980s, ranging from one day to a 35-day shutdown in 2018-2019. That said, what is not common this time around is the rapidly deteriorating fiscal landscape and massive expansion of the federal debt since the last shutdown, along with Fitch's downgrade of the sovereign debt rating of the United States government from AAA to AA+ last month – the second such move in history, matching the downgrade by Standard and Poor's (S&P) in 2011. Citing repeated debt-limit battles, last-minute solutions, and rapidly mounting debt burden, Fitch lamented that eroding confidence in the country's fiscal management and worsening estimates of prospective deficits have increased America's vulnerability to future economic shocks. Accordingly, the last rating agency to maintain a AAA rating for U.S. debt, Moody's, announced earlier this week that the current budgetary standoff and potential government shutdown could hasten a downgrade below their highest rating. As with Fitch, Moody's reiterated that Congressional dysfunction could trigger a credit watch negative or outright downgrade, stating that a shutdown "would demonstrate the significant constraints that intensifying political polarization put on fiscal policymaking at a time of declining fiscal strength, driven by widening fiscal deficits and deteriorating debt affordability." While Moody's and most investors agree that any shutdown would likely be short lived and have both limited and localized negative economic effects, notably in the nation's capital and for spending by affected federal workers and contractors, any negative action (watch and/or downgrade) by the rating agency would likely serve to extend the recent rise in longer-term U.S. Treasury note yields and hasten more bear steepening in the bond market during the fourth quarter.

On the fiscal front, the big news this week has been the rapidly rising specter of a government shutdown given the lack of substantive progress on final spending appropriations and, in lieu of those, a CR that can pass both houses of Congress. Away from that, we anticipate an appeal to the Supreme Court by the New Civil Liberties Alliance (NCLA), the group that sued the Biden Administration in August over the President's latest proposed plan to forgive student loan debt. 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.

S&P CL Case-Shiller 20 City Comp Home Price Index MOM/YOY% Change – Monthly – 5 Yrs

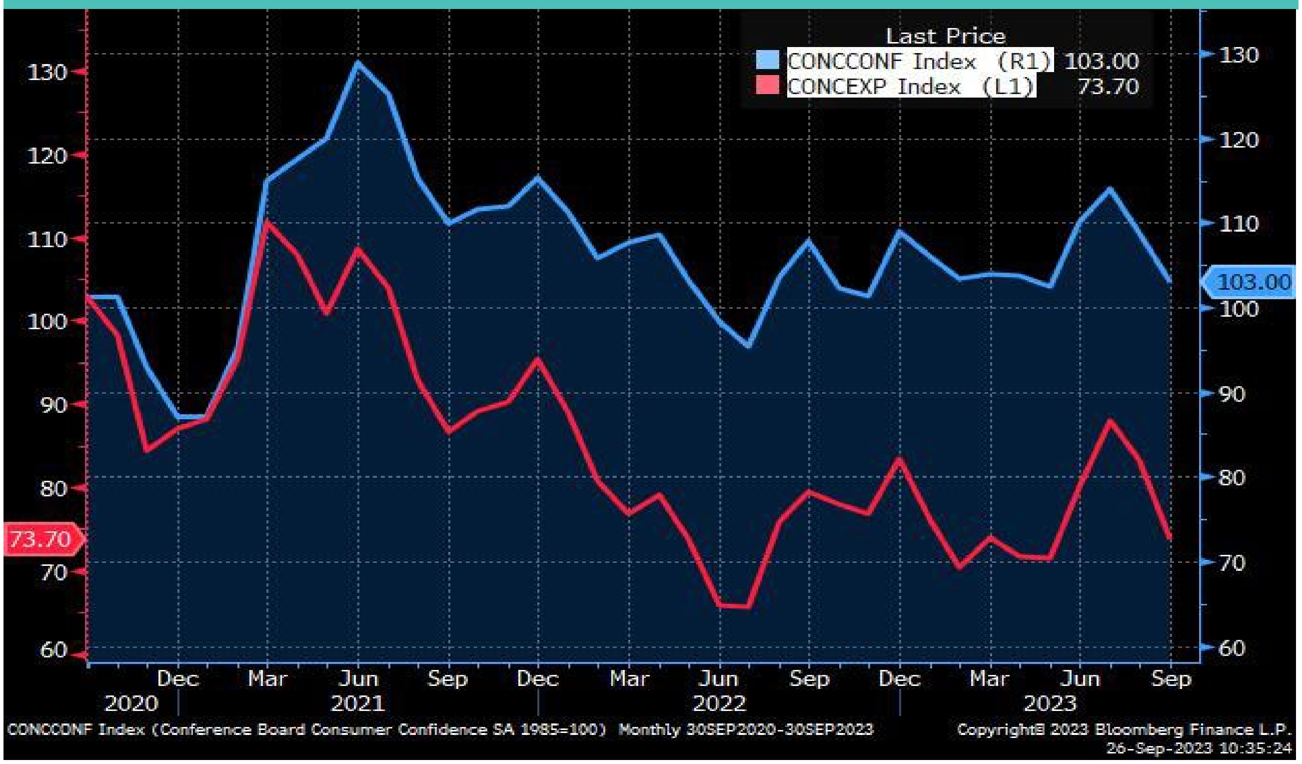


Source: Bloomberg as of 9/28/2023

The S&P CoreLogic Case-Shiller 20-city home price index rose +0.87% in July (+0.70% est./+0.13% YOY), the fifth consecutive monthly gain and largest three-month advance since last June, as the headwinds of record low affordability and higher mortgage rates have been more than offset by historically light inventories and durably resilient demand. While slower gains were widely expected given the sharp rise in prices from mid-2020, housing market technicals continue to be favorable as supply remains tight in many areas (3.3 months in Aug./record low 1.8), listings continue to sell quickly (20 days on market in August/record low 14), and the rental market remains strong. Regarding inventories, August's existing home sales data revealed that there were just 1.10 million previously owned homes for sale, down more than 14% since last August (cycle low 850,000, Jan. 2022), providing a substantial tailwind for home prices as we close in on 2024. In total, 12 of the 20 cities continued to show annual price gains, albeit well-off of their cycle highs last year, with Chicago (+4.4%), Cleveland (+4.0%), and New York (+3.8%) posting the largest annual gains, with Las Vegas (-7.2%), Phoenix (-6.6%), and San Francisco (-6.3%) rounding out the bottom three. On a national basis, the housing price index rose +1.0% for the year ended July, the largest annual advance since February and a sharp reversal from last March's 20.8% record high (1988 index inception). Looking at the text of the report, a director of the survey stated that, "We have previously noted that home prices peaked in June 2022 and fell through January of 2023, declining by 5.0% in those seven months. The increase in prices that began in January has now erased the earlier decline, so that July represents a new all-time high for the National Composite. Moreover, this recovery in home prices is broadly based. As was the case last month, 10 of the 20 cities in our sample have reached all-time high levels. In July, prices rose in all 20 cities after seasonal adjustment," and that "Regional differences continue to be striking.

On a year-over-year basis, the Revenge of the Rust Belt continues. The three best-performing metropolitan areas in July were Chicago, Cleveland, and New York, repeating the ranking we saw in May and June." All in all, while many expected lower home prices given the sharp rise in mortgage rates and record setting price appreciation during the pandemic, the combination of rock-bottom inventories and chronically resilient demand have erased last year's soft patch and pushed prices higher since the first quarter of this year.

Consumer Confidence & Expectations – Monthly – 3 Years

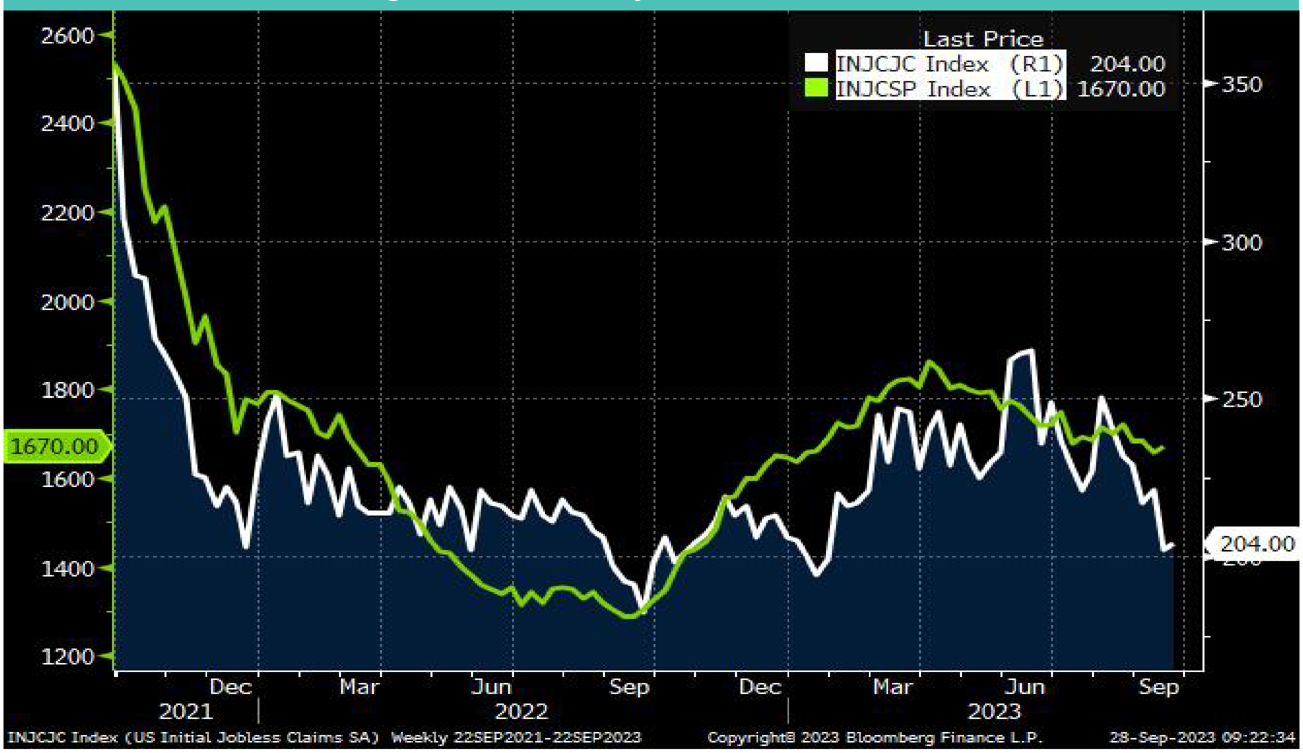


Source: Bloomberg as of 9/28/2023

Consumer confidence weakened again during September and came in below consensus at 103.0 (105.5 est./108.7 August), the lowest level since May, driven by further weakness in labor market expectations, another leg-up in market interest rates and higher gasoline prices, and a union that threatens to derail this summer's strength in consumer spending. Leading this month's decline was the expectations component, a measure of consumers' six-month outlook, which slid to 73.7 (83.3 Aug./83.4 Dec.), representing a two-month plunge of more than 14 points and once again above the recessionary reading (80), as more respondents expect business conditions to worsen (18.4% vs. 17.3% Aug.) and a greater share see lower income (14.4% vs. 11.9% Aug.). Adding to this month's lackluster data was the present situation component, which was essentially unchanged at 147.1 (146.7 Aug./147.4 Dec.), nearly matching the lowest level since last November and driven by fewer respondents stating that business conditions were good (20.9% vs. 21.5% Aug.) and more stating that jobs were hard to get (13.6% vs. 13.2% Aug.).

Looking at the text of the report, the chief economist of the survey stated, "Write-in responses showed that consumers continued to be preoccupied with rising prices in general, and for groceries and gasoline in particular," and that, "Consumers also expressed concerns about the political situation and higher interest rates." On the jobs front, labor market conditions appear to have retained much of the loosening observed during August as the Labor Index metric, which measures the labor differential of jobs plentiful less those hard to get, came in at 27.3% (26.7% Aug./36.5% Mar.), the second lowest level since April 2021. All in all, the weight of higher interest rates and surging gasoline prices have reversed the summer's run-up in confidence, with further deterioration in consumer spending expected during this fall as job creation slows, pandemic-era excess savings deplete, consumer debt mounts, and more than 37 million borrowers resume student loan payments next month after a three-year moratorium.

Initial Jobless & Continuing Claims – Monthly – 2 Years



Source: Bloomberg as of 9/28/2023

Initial unemployment claims again came in lower than expected during the week ended September 23rd at 204,000 (215k est./202k last), the lowest level since January and reflective of chronic strength in demand for labor and employer propensity to hold onto hard-to-find workers. Additionally, the four-week moving average of initial claims, which smooths out outsized observations in the data, continued this month's downtrend to 211,000, the lowest level since mid-February and more in line with pre-pandemic averages observed during 2019. Additionally, continuing unemployment claims have tracked this summer's downward trend seen with initials, which came in at 1.670 million (1.645 million on Dec 30th) and include people who have already received unemployment benefits for a week, the lowest level since January and near pre-pandemic averages as employers stretch to fill nearly 9 million open positions forecasted by the latest JOLTS survey. All in all, another strong report that revealed still-muted layoffs and tight labor markets despite recent moderation in job creation, data supportive of the FOMC's policy stance of 'higher for longer' regarding short-term interest rates.

The Week Ahead

The data calendar picks up over the coming week, headlined by the PCE Deflator, JOLTS Job Openings, and ISM Services. Looking ahead, markets remain focused on inflation, employment data, and further signs of weaker economic activity. On the new issue front, ABS slowed dramatically after a jam-packed, first three weeks of September with just three deals totaling $789.5 billion priced through the 27th and $223.2 billion year to date ($221.2 billion over same period last year; $276.7 billion for 2022). IG corporate issuance remained on the lighter side with $18.4 billion priced through the 27th and $981.9 billion year to date ($1.05 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 normalized 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 9/29
PCE Deflator

Monday 10/2
ISM Manufacturing

Tuesday 10/3
JOLTS Job Openings

Wednesday 10/4
ISM Services; Factory Orders

Thursday 10/5
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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