Fixed Income Market Insights

April 20, 2023

Key takeaways

Bond yields were higher this week, with GT2s up 19 basis points and GT10s higher by 8 basis points and 2s/10s more inverted by 11 basis points (-63), as concerns of a larger, banking contagion ebbed, and rising energy prices elevated the likelihood of another 25-basis point rate hike at the May 3rd FOMC meeting. On the data front, the University of Michigan Consumer Sentiment Index came in fractionally higher than expected at 63.5 in April, as durably high inflation continues to weigh on consumer optimism despite tight labor markets, higher nominal wages and a five-decade low in unemployment. Sales of existing homes during March came in fractionally lower than expected to an annualized rate of 4.44 million homes, again rebounding from this January's pandemic era low (4.0 million/lowest since 2010), but still well below pre-pandemic averages given rock bottom affordability via higher mortgage rates and elevated prices. Initial unemployment claims ticked up again during the week ended April 15th to 245,000, the second consecutive weekly jump, revealing some loosening of chronically tight labor market conditions despite still muted layoffs and persistent worker shortages.

We suggest

We continue to prefer playing rate defense given relatively low market rates, accelerating 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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Bad Moon Rising?

While we have heard from both sides of the economic pendulum, with some adamant that the U.S. economy is destined for recession and others, albeit a minority, equally committed to soft-landing scenarios, the reality is that we don't know what we don't know, yet. Only data can solve this difference of opinion, which generally matriculates out in a lagged fashion, with fewer, real-time indicators useful enough to sway the most ardent of detractors. While the jury is still out regarding the ultimate destination of domestic economic activity, we are starting to see some of the fallout of monetary policy excesses during the Great Financial Crisis (GFC) of 2008 and the sluggish FOMC response to inflationary pressures of the post-COVID era. To recap, the inexplicably reckless policies of the Federal Reserve post the GFC, in part, landed us where we are today - a near-zero Federal Funds rate for over 8 years and an equally misguided Quantitative Easing (QE) program, where the Federal Reserve crowded out private investors and scarfed up much of the mortgage-backed security (MBS) production backstopped by the U.S. government, which served to artificially depress market rates and encourage more leverage in the housing and financial markets.

Market Snapshot

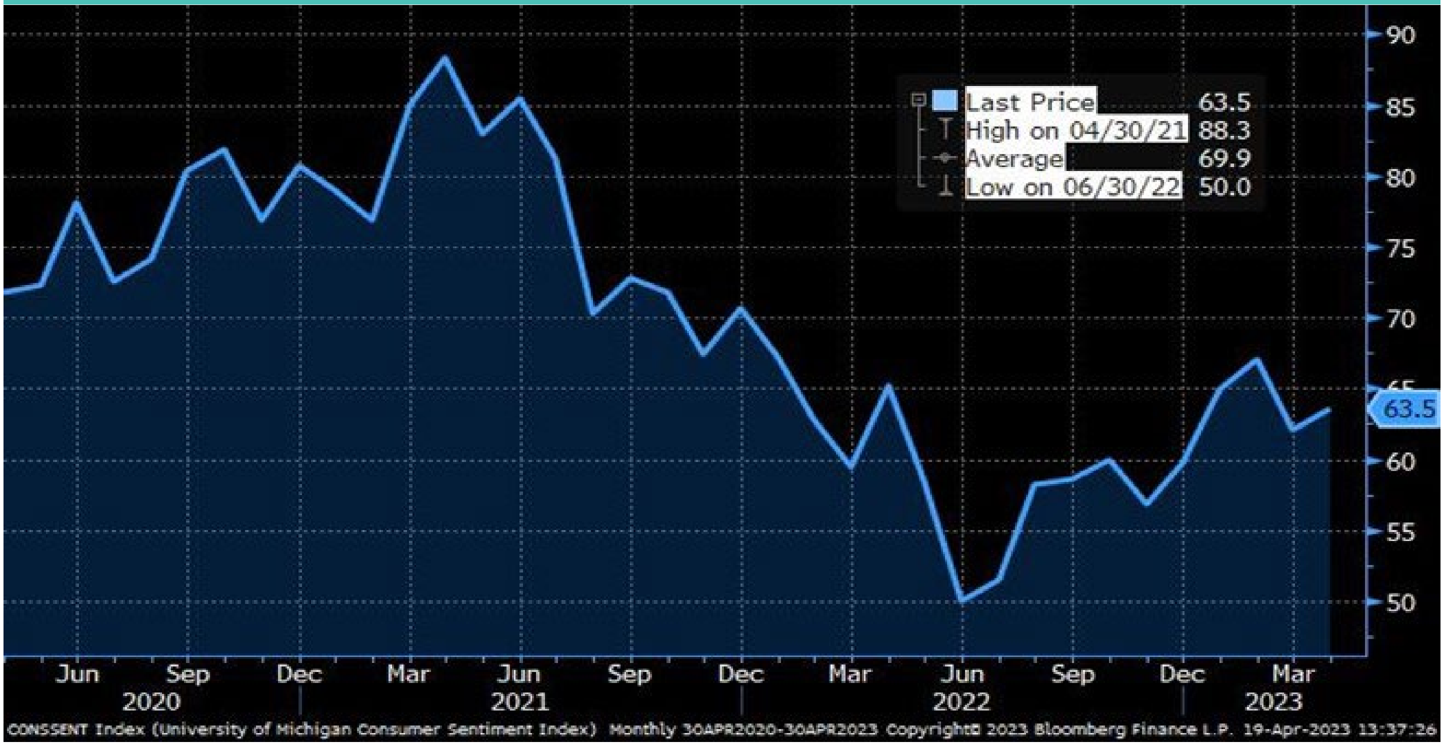
	This week 4/20/23	Last week 4/13/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.26%	5.26%	0	0.00%	10.27%
SOFR	4.80%	4.80%	0	0.00%	11.63%
2-year US Treasury	4.17%	3.98%	19	4.77%	-5.87%
5-year US Treasury	3.63%	3.51%	12	3.42%	-9.48%
10-yr US Treasury	3.54%	3.46%	8	2.31%	-8.76%
2s-10s UST Spread	-63.00	-52.00	-11.00	21.15%	14.55%
DJIA	33,850	34,021	-171.00	-0.50%	2.12%
S&P 500	4,138	4,143	-5.00	-0.12%	7.76%
Spot Gold	2,015	2,053	-38.00	-1.85%	10.35%
WTI (Oil) Current Contract	77.54	82.20	-4.66	-5.67%	-3.39%
1-year Brokered CD	4.95%	4.80%	15	3.13%	7.61%
5-year Brokered CD	4.25%	4.25%	0	0.00%	6.25%
5-year Bullet US Agency	3.79%	3.69%	10	2.71%	-7.11%
5-year/NC1yr Callable US Agcy	5.15%	4.87%	28	5.75%	-4.63%
CDX IG Spread Index	76.94	74.72	2.22	2.97%	-6.19%
CDX High Yield Index Spread	101.09	101.55	-46.00	-0.45%	0.47%
15-yr UMBS	4.70%	4.48%	22	4.91%	0.86%
30-yr UMBS	5.18%	4.99%	19	3.81%	-2.81%

Source: Bloomberg data as of 11:00am ET 4/20/2023 and 2:45pm ET 4/13/2023

Sound crazy? We wouldn't disagree, and more importantly, markets today are also coming around to the realization that these were meaningful policy errors with few historical rivals, until today. Indeed, the same ex-Federal Reserve Chairman during the GFC is now running the U.S. Treasury, and Secretary Yellen, along with Federal Reserve Chairman Powell, went all in on the 'transitory' narrative regarding inflation for too long, resulting again in overstaying unduly stimulative monetary policy which, when paired with massive fiscal stimulus, seeded much of the broad-based, inflationary pressures still with us today. Away from stubbornly high inflation, a veritable witches brew of rising real estate delinquencies, both in commercial and residential properties, has started to percolate, with the potential to inflict meaningful damage to the economies at home and abroad. On the residential front, recent data compiled by real estate data analytics firm ATTOM revealed that foreclosure filings jumped 22% during the year ended March 31st, the 23rd consecutive month of year-over-year increases, driven largely by economic hardships germinated by chronically high inflation, still-depressed labor participation and the lifting of government interventions that artificially held down foreclosures during the darkest days of the pandemic. While foreclosures are still running below pre-COVID levels, the trend is sobering and likely to worsen in the months to come as the cumulative impact of 475 basis points of monetary policy tightening takes full effect, likely to further dampen economic activity, accelerate the recent trend of higher layoffs and, as a consequence, trigger an outright slowdown in hiring across most industries. Judging by longer-dated U.S Treasury yields and indicators of forward rates later this year, the bond market appears to be poised for additional economic fallout. While Federal Funds futures imply nearly a 90% chance of another 25 basis points in tightening at the May 3rd meeting, the picture changes dramatically after that, with the market predicting nearly 75 basis points in rate cuts by the end of January 2024. Stay tuned!

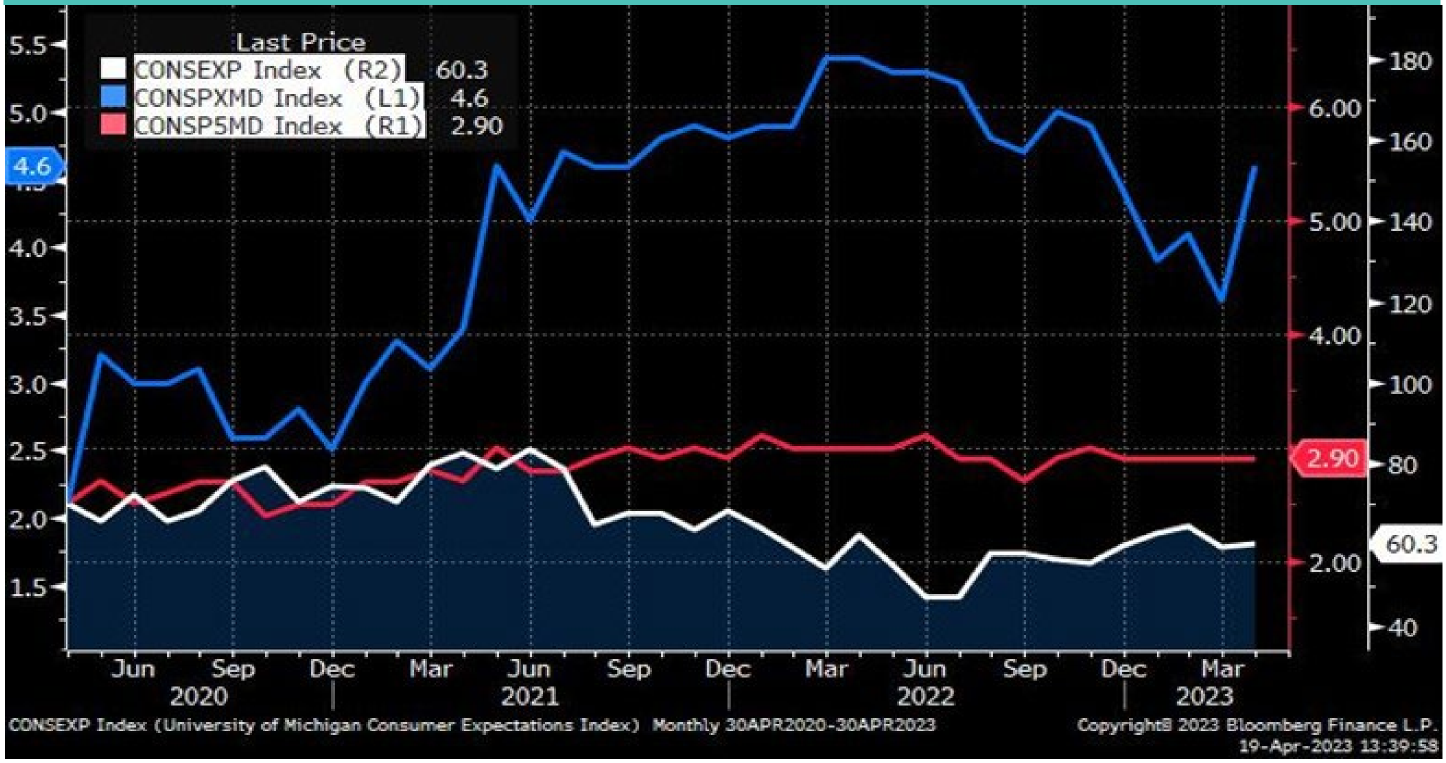
Still quiet on the fiscal front as extended breaks and additional House hearings continue to populate the congressional calendar. Among several legislative initiatives, negotiations regarding the debt ceiling will take center stage in the weeks to come. Also look for mounting calls for tighter bank regulation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

U of Michigan Consumer Sentiment – Monthly – 3 Years



Source: Bloomberg as of 4/20/2023

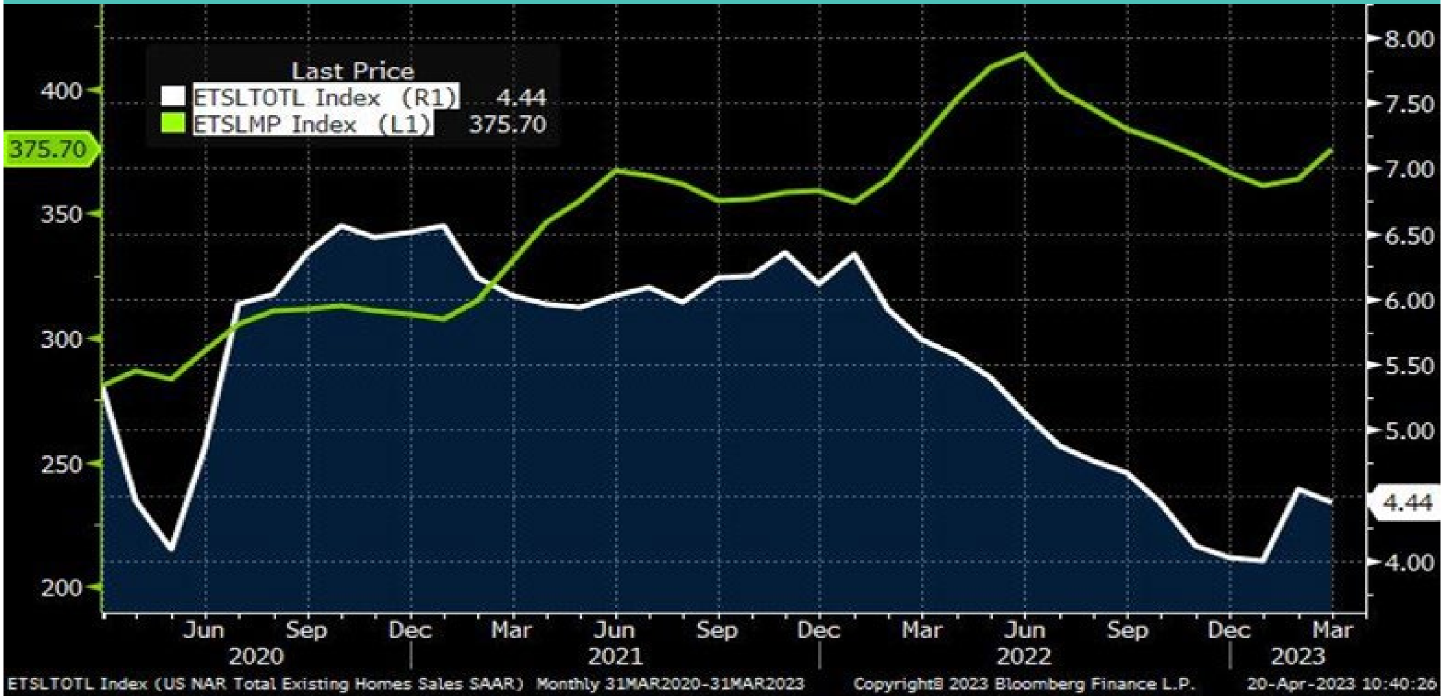
U of Michigan Consumer Expectations, 1yr and 5-10yr Inflation – Monthly – 3 Years



Source: Bloomberg as of 4/20/2023

The University of Michigan Consumer Sentiment Index came in fractionally higher than expected at 63.5 in April (62.1 est.; 62.0 Mar.), as durably high inflation continues to weigh on consumer optimism despite tight labor markets, higher nominal wages and a five-decade low in unemployment. Indeed, over 42% of consumers attributed their negative views regarding personal finances to inflation (38% Mar.; 42% in Sept.), just shy of the all-time high during the 2008 financial crisis (49%) and driven by the recent jump in gas (oil) prices, and a mere 17% expect their incomes to rise more than inflation, a slight improvement from June's 13% cycle low. Additionally, a paltry 26% of consumers expect good economic times over the next year (versus July 2022 cycle low: 13%) as higher interest rates, broad-based inflation and geopolitical risks continue to weigh on consumer optimism about their near-term financial well-being. A deeper dive into the survey revealed that both components of headline sentiment improved fractionally, with current conditions up to 68.6 (66.3 Mar.; 65.6 Oct. 2022) and expectations edged up to 60.3 (59.2 Mar.; 56.2 Oct. 2022), both near their highest levels in over a year, but still historically weak. On the price front, near-term inflationary expectations jumped 100 basis points over the past month to 4.6%, the highest level since last November, driven by higher gasoline prices and remain historically elevated over the near (1yr. 4.6%; cycle high 5.4% Mar. 2022) and longer terms (5+ yrs. 2.9%; cycle high 3.1% Jun. 2022), well above of the FOMC's target of 2%. Looking at the text of the report, the director of the survey stated that "Concerns over gas prices are starting to grow again, with nearly 20% of consumers spontaneously mentioning gas, fuel, or energy prices, up from 14% last month. One-year gas price expectations reached their highest level in six months, and five-year expectations reached their highest level in almost a year," and that "These patterns reveal that consumers are fully aware that inflation has softened from its peak, but that high prices continue to make them feel less financially secure," All in all, inflation and higher interest rates continue to weigh on consumer optimism, conditions likely to persist in the near term, particularly given heightened concerns about the safety of community banks, and threaten to upend consumer spending during the second half of this year when the cumulative effects of FOMC tightening take full effect.

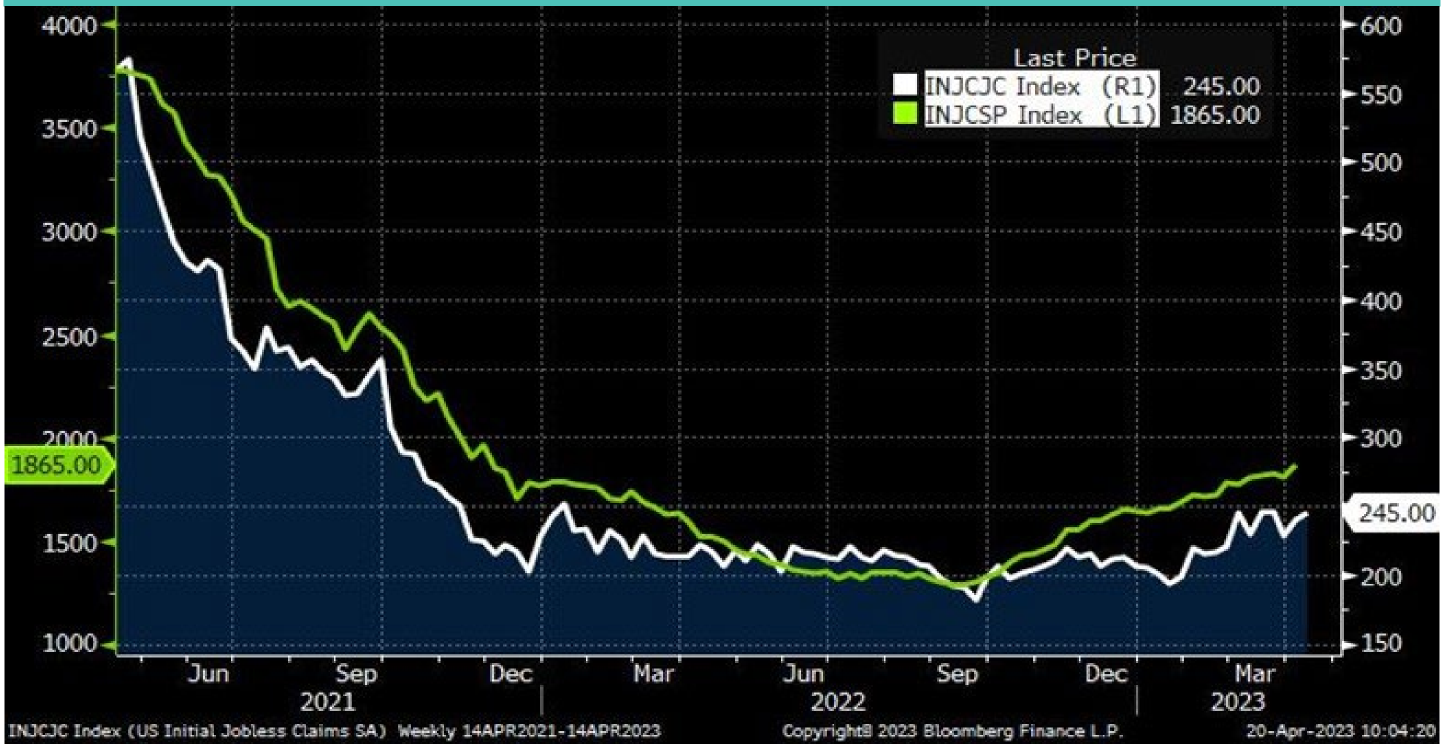
U.S. Existing Home Sales (Annualized) & Median Home Sales Price – Monthly – 3 Years



Source: Bloomberg as of 4/20/2023

Sales of existing homes during March came in fractionally lower than expected to an annualized rate of 4.44 million homes (4.50 est.), again rebounding from this January's pandemic era low (4.0 million/lowest since 2010), but still well below pre-pandemic averages given rock bottom affordability via higher mortgage rates and elevated prices. On the supply front, there were 980,000 previously owned homes for sale last month, reversing last year's upward trend and only fractionally higher than March 2022 inventory levels (930,000). Notwithstanding last year's increase in supply from the January 2022 cycle low (850,000), housing inventories are still historically low as higher rates and still elevated prices have discouraged mobility. The magnitude of this tighter supply is revealed in the months of supply and days on the market metrics for March, which came in at 2.6 months (record low 1.8 months) and 29 days (record low 14 days) respectively, maintaining some of the recent trend higher, but still historically low. As a consequence, existing home prices have risen sharply and maintained most of these pandemic era gains with median selling prices coming in at $375,700 last month, a decline from June's all-time high of $413,800 and down -.9% during the last year, the second, consecutive monthly year-over-year decline in eleven years, but still historically steamy. Looking at the text of the report, the survey's Chief Economist stated that "Home sales are trying to recover and are highly sensitive to changes in mortgage rates," and that "At the same time, multiple offers on starter homes are quite common, implying more supply is needed to fully satisfy demand." Indeed, while rising home prices and higher mortgage rates have crimped affordability, another negative effect has been the run up in national median rents, which came in at $1,937 during March, unchanged from February and off just $113 from August 2022's all-time high, and down -.40% over the last twelve months, the first year-over-year decline since March 2020. While elevated prices and higher mortgage rates will likely dampen home sales further this year, we expect demand for housing to remain solid and prices to remain elevated in the near term given historically tight inventories and increased likelihood of mortgage rate relief post FOMC tightening.

Initial Jobless & Continuing Claims – Monthly – 2 Years



Source: Bloomberg as of 4/20/2023

Initial unemployment claims ticked up again during the week ended April 15th to 245,000 (240,000 last), the second consecutive weekly jump, revealing some loosening of chronically tight labor market conditions despite still muted layoffs and persistent worker shortages. Notwithstanding this year's run of historically low initial claims, this series is likely to continue to trend higher over the next few months as the recent uptick in layoff announcements may presage a broader economic slowdown, triggering more layoffs and slower hiring. The four-week moving average of initial claims, which smooths out outsized observations in the data, remains near year-to-date highs, coming in at 239,800 (versus 209,300 on Dec 30th), though still near pre-pandemic levels as job vacancies continue to be plentiful. That said, some initial signs of cooling appear to be brewing given the recent rise in continuing unemployment claims, which increased to 1.865 million (1.645 million on Dec 30th) and include people who have already received unemployment benefits for a week, the highest level since November 2021 but still near pre-pandemic averages as employers push to absorb the nearly 10 million open positions estimated by the latest JOLTS survey. While total employment has finally exceeded pre-pandemic levels (2+ million jobs), labor participation continues to lag as expanded government assistance, elevated retirements and skill mismatches have weighed on employer efforts to attract and retain workers. All in all, the job market remains tight, and the claims data still portend a relatively slow path to restore better balance between the supply of and demand for labor, which will likely encourage policymakers at the FOMC to reiterate their 'higher for longer' stance regarding short term interest rates.

The Week Ahead

The data calendar slows over the next week, headlined by GDP (1st Quarter), Consumer Confidence, Durable Goods Orders and Weekly Jobless Claims. Looking ahead, markets remain focused on inflation, employment data and more signs of slowing economic activity. On the new issue front, ABS volumes picked up this week, with 13 deals totaling $9.9 billion priced through the 19th and $84.9 billion year to date ($90.4 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance also picked up with $28.9 billion priced as of the 19th and $443.7 billion year to date ($552.3 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 breadth of ABS and corporate issuers as investor demand remains robust, with the caveat that additional fallout from the SVB/SBNY failures will trigger issuance furloughs like those observed over the past month.

Friday 4/21

S&P Manufacturing/Services

Monday 4/24

Dallas Fed Manufacturing Activity

Tuesday 4/25

Consumer Confidence; New Home Sales; S&P CoreLogic HPI

Wednesday 4/26

MBA Mortgage Applications; Durable Goods Orders

Thursday 4/27

GDP (1st Qtr. Advance); 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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