Fixed Income Market Insights

June 8, 2023

Key takeaways

Bond yields were higher this week, with GT2s up 17 basis points and GT10s higher by 11 basis points respectively, and 2s/10s more inverted by 6 basis points (-79), driven by still-robust headline payroll gains and surprise rate hike by the Bank of Canada. On the data front, headline Non-Farm Payrolls again came in stronger than expected with 339,000 new jobs added in May, driven by durability in services employment, including persistent strength in professional and business services, healthcare, leisure & hospitality, and government. The ISM Services PMI index came in much weaker than expected at 50.3 during May, the lowest level since December 2022, as a steep drop in new orders, weaker employment and diminished business activity raised concerns that the durable strength in services demand may be waning given the weight of higher prices, elevated interest rates, and tighter credit conditions. Initial unemployment claims jumped during the week ended June 3rd to 261,000, the highest level since October 2021, suggestive of some loosening of chronically tight labor market conditions given the recent upswing in layoff announcements.

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

CRE Double Trouble

As delinquencies continue to rise and more landlords walk away from financially impaired properties, the specter of looming commercial real estate (CRE) debt maturities – which many estimate to be in excess of $1.5 trillion over the next three years – has been amplified by events other than the precipitous rise in financing rates during the FOMC's current rate-hiking cycle: namely, dried up funding from regional/community banks, the advent of remote working models, and the growing share of consumer spending via e-commerce. Indeed, a growing number of banks have either paused or reduced the amount of credit available for selected CRE lending, particularly offices and shopping malls, as regulators have stepped up pressure on lenders to bolster their capital ratios given the recent SVB/SBNY/FRBK bank failures, mountain of near-term CRE debt maturities, and falling occupancy rates due to structural changes in the labor force. Further compounding maturity concentration are the negative effects of higher interest rates and, to a lesser extent, the very structure of many CRE loans, which are often originated as "Interest Only" (IO) structures, where borrowers make only interest payments during the loan term (typically 5-10 years), with a balloon payment for the entire principal borrowed on the maturity date.

Market Snapshot

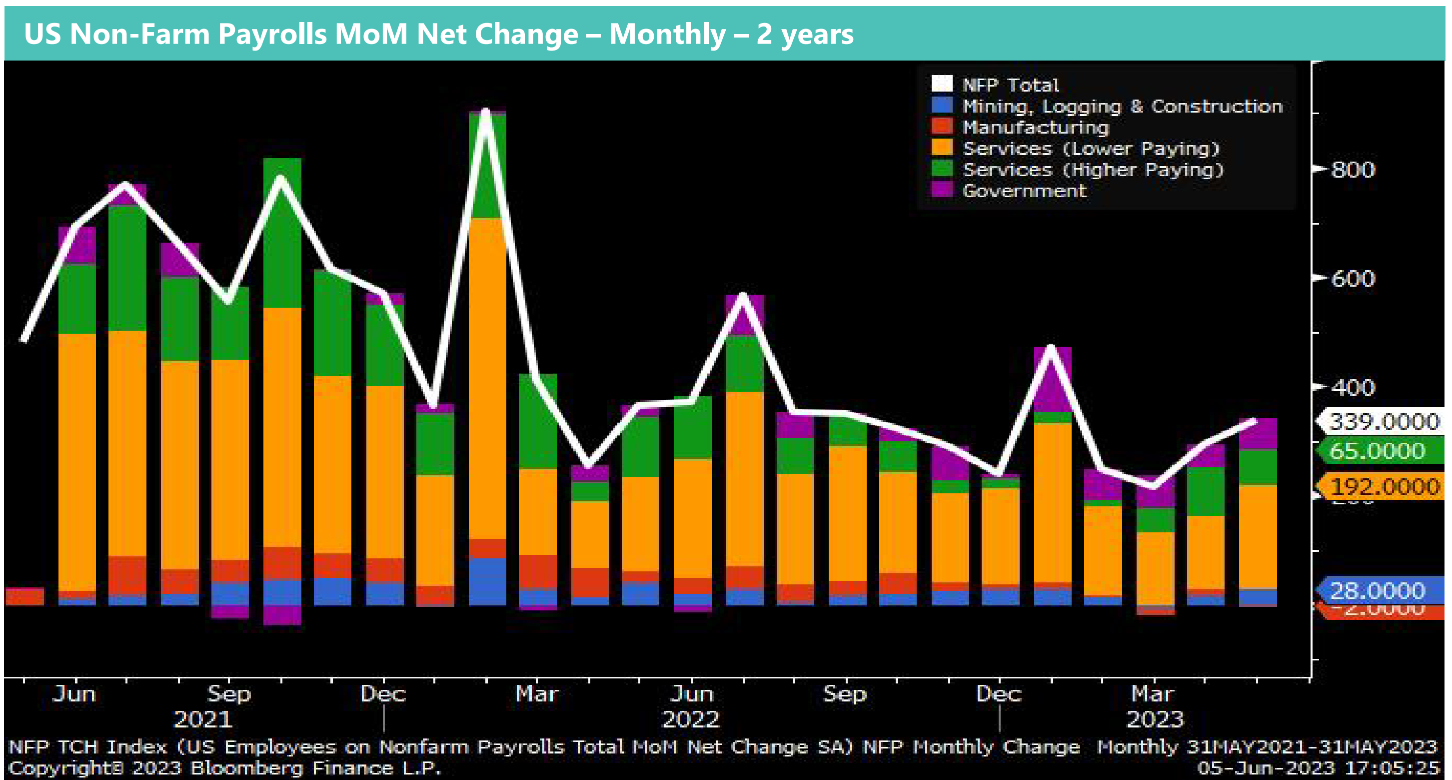
	This Week 6/8/23	Last Week 6/1/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.51%	5.52%	-1	-0.18%	15.51%
SOFR	5.05%	5.08%	-3	-0.59%	17.44%
2-year US Treasury	4.51%	4.34%	17	3.94%	1.81%
5-year US Treasury	3.85%	3.70%	15	4.05%	-3.99%
10-yr US Treasury	3.72%	3.61%	11	3.05%	-4.12%
2s-10s UST Spread	-79.00	-73.00	-6.00	8.22%	43.64%
DJIA	33,819	33,098	721	2.18%	2.03%
S&P 500	4,284	4,231	53	1.25%	11.56%
Spot Gold	1,979	1,996	-17	-0.85%	8.38%
WTI (Oil) Current Contract	71.59	70.09	1.50	2.14%	-10.80%
1-year Brokered CD	5.35%	5.25%	10	1.90%	16.30%
5-year Brokered CD	4.50%	4.50%	0	0.00%	12.50%
5-year Bullet US Agency	3.95%	3.80%	15	3.95%	-3.19%
5-year/NC1yr Callable US Agcy.	5.38%	5.25%	13	2.38%	-0.46%
CDX IG Spread Index	71.09	73.43	-2.34	-3.19%	-13.33%
CDX High Yield Index Spread	102.21	101.42	0.79	0.78%	1.58%
15-yr UMBS	4.93%	4.87%	6	1.23%	5.79%
30-yr UMBS	5.38%	5.34%	4	0.75%	0.94%

Source: Bloomberg data as of 2:00pm ET 6/8/2023 and 3:00pm ET 6/1/2023

According to CRE data provider Trepp, IO loan share of new, commercial mortgage- backed securities (CMBS) issuance has soared to nearly 90% for 2021, a sharp increase from nearly 50% in 2013, rendering progressively larger balances due at maturity this time around, creating a near perfect storm for more defaults given much higher interest rates, reduced availability of credit to refinance and lower property valuations that expose lenders to outright losses should properties have to be sold to pay off the loans. While CRE defaults have been rare post the Great Financial Crisis (GFC) of 2008, delinquencies are on the rise, particularly for office properties, where late payments jumped to more than 4% in May from 2.8% in April, the highest level since 2018 and source of mounting concerns for both lenders and investors alike. Of course, these problems are not unique to office buildings, with recent research by Fitch ratings revealed estimates of 35% of all CRE mortgages pooled in CMBS and set to mature between April and December of 2023 won't be able to refinance based upon today's interest rates and operating income and current market value of the specific properties. While much of the risk of CRE defaults are spread across thousands of banks and private investors, a large jump in defaults this year and next would force more distressed asset sales and likely push CRE valuations much lower from here, exposing lenders to losses and, perhaps more importantly, triggering write downs of performing CRE mortgages on bank balance sheets. To be sure, these write downs would further depress capital levels and force more acute credit contraction that would negatively affect the entire economy and surely spark a deeper economic downturn that would rival the GFC recession of 2008, or worse. More to follow!

The President signed the debt ceiling bill last Saturday, known as the "Fiscal Responsibility Act of 2023," averting a potential U.S. debt default and subsequent rating agency downgrades. Additionally, the President vetoed a bipartisan bill yesterday that would have suspended the Executive Order regarding student loan forgiveness, which aims to cancel up to $20,000 per borrower and sports a price tag of at least $400 billion (with some scoring upwards of $1 trillion), with the looming Supreme Court decision regarding the legality of the Executive order expected as early as today. Stay tuned!

US Non-Farm Payrolls MoM Net Change – Monthly – 2 years



Source: Bloomberg as of 6/8/2023

Unemployment Rate and Average Hourly Earnings % YOY Change – Monthly – 2 years

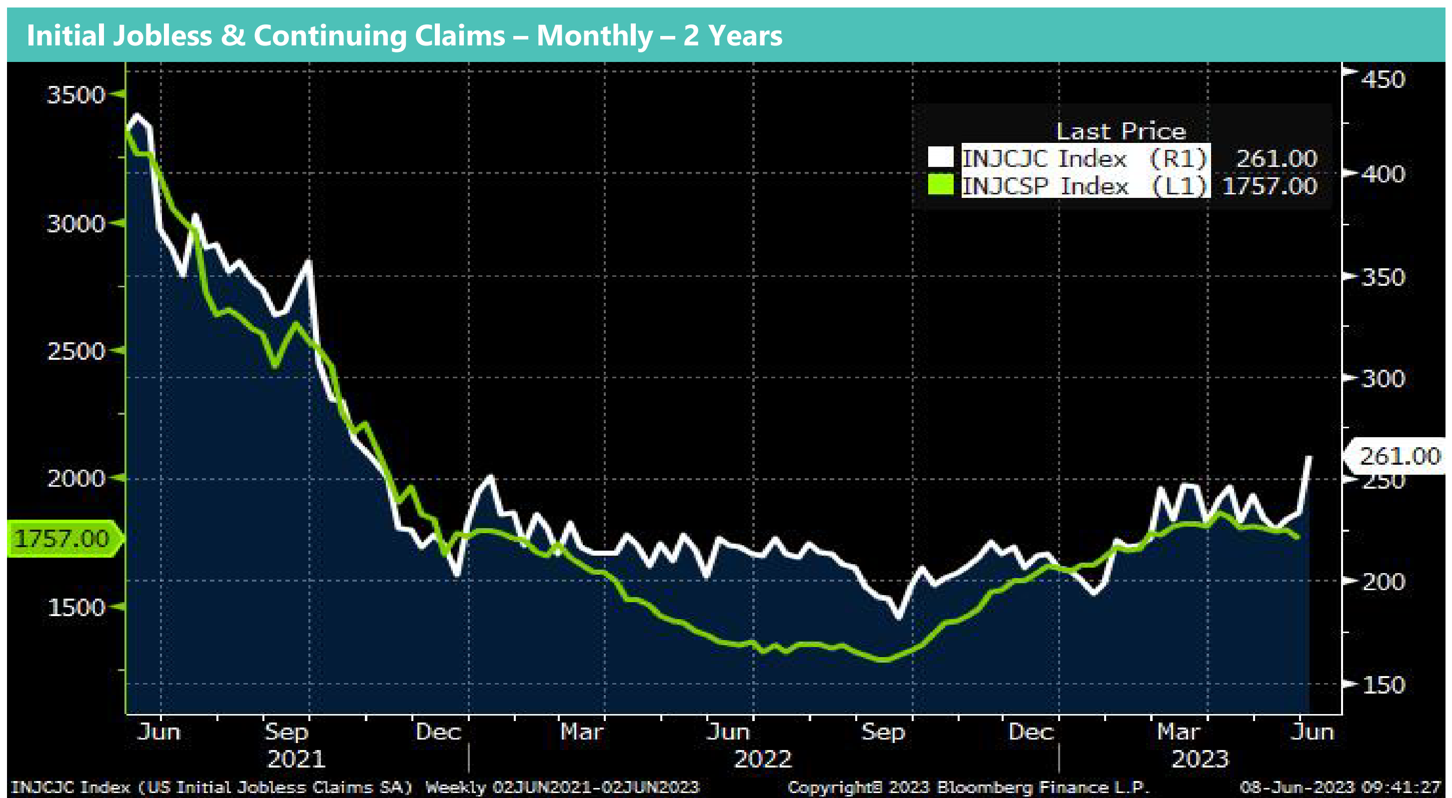
Source: Bloomberg as of 6/8/2023

Headline Non-Farm Payrolls again came in stronger than expected with 339,000 new jobs added in May (195,000 est.), driven by durability in services employment, including persistent strength in professional and business services, healthcare, leisure and hospitality, and government. Taken together with revisions that added 93,000 jobs in the prior two months, job creation remains healthy with average monthly gains of 283,000 during the last 90 days, a deceleration from the first quarter's 312,000 pace (vs. 284,000 Q4 2022). Looking by industry revealed broad based strength, led by gains in education/health (+97k), professional/business services (+64k), government (+23k), leisure and hospitality (+48k), construction (+25k), and transportation/warehousing (+24k). Beyond the headline number, the big takeaways were the large jump in the unemployment rate (UER 3.7%/3.4% Apr.) and the moderation of average hourly earnings (+.3% vs. +.4% Apr./+4.3% YOY vs. 4.4% YOY Apr.), with the UER advance driven by a divergence between the establishment (NFP Headline) and household (base for UER calculation) surveys, with the latter showing a 310,00 drop in overall employment. Regarding the labor market, last week's JOLTS job openings (10.1 million), the number of available positions per unemployed worker (1.8x) and quits rate (2.4% or 3.8 million jobs) remain historically elevated, suggesting that wage inflation will remain sticky in the coming months. Additionally, labor participation remains nearly a percentage point lower than the 2019, pre-pandemic high as elevated retirement rates, skill mismatches and increased entrepreneurship have stunted employer efforts to fill millions of job openings. This lower participation has driven down the unemployment rate, which jumped to 3.7% from last month's cycle low of 3.4% (lowest since 1969), and supported elevated average hourly earnings (4.3% YOY), both conditions expected to persist in the near term. All in all, another strong employment report that revealed little fallout from recent banking sector woes, with some silver linings regarding average hourly earnings moderation and slower pace of job creation versus the first quarter.

ISM Services PMI– Monthly – 3 years

Source: Bloomberg as of 6/8/2023

The ISM Services PMI index came in much weaker than expected at 50.3 during May (est. 52.4/51.9 Apr.), the lowest level since December 2022, as a steep drop in new orders, weaker employment and diminished business activity raised concerns that the durable strength in services demand may be waning given the weight of higher prices, elevated interest rates and tighter credit conditions. A deeper dive into the survey revealed relatively broad-based gains across industries (11 of 18 reporting growth), albeit with new orders down 3 points (52.9/56.1 Apr.), the third lowest level since May 2020, employment lower by 2 points (49.2/50.8 Apr.), and delivery times continued to decline (47.7/53.9 Sep.), the third lowest level since June 2009, indicative of improved supply chain logistics. Additionally, the data also revealed that prices paid by service providers fell for the sixth time in seven months during May (56.2/68.1 Dec.), the lowest level since May 2020 and more in-line with historical averages. Looking at the text of the report, the Chairman of the survey committee stated that, "The majority of respondents indicates that business conditions are currently stable; however, there are concerns relative to the slowing economy," and that "Right now I'm not seeing the words of recession in the comments. I'm seeing things such as uncertainty and maybe a little bit of slowdown, but again, it varies by industry and by company within those industries." All in all, a demonstrably weaker report suggesting that demand for services is starting to cool given the cumulative effects of FOMC rate hikes, durably high inflation and tightening credit conditions.



Source: Bloomberg as of 6/8/2023

Initial unemployment claims jumped during the week ended June 3rd to 261,000 (233,000 last), the highest level since October 2021, suggestive of some loosening of chronically tight labor market conditions given the recent upswing in layoff announcements. Indeed, claims have trended higher since March over the next few months given the acceleration of WARN notices during the first quarter and may portend a broader economic slowdown, triggering more layoffs and slower hiring. To review, the Worker Adjustment and Retraining Notification (WARN) Act of 1988 requires companies with more than 100 full-time employees to file with state labor departments and notify workers of layoffs with a 60-day lead if they plan to lay off at least 50 people at a single site, and to workers who have their hours cut by half or more in any six-month period. Additionally, the four-week moving average of initial claims, which smooths out outsized observations in the data, ticked up to 237,250 and remains near 2023 highs (versus 209,300 on Dec 31st), though still near pre-pandemic levels as job vacancies continue to be plentiful. That said, some further signs of labor market cooling appear to be brewing given continuing unemployment claims, which came in at 1.757 million (1.645 million on Dec 30th) and include people who have already received unemployment benefits for a week, just shy of 2023 highs but still near pre-pandemic averages as employers push to absorb the 10.1 million open positions estimated by the latest JOLTS survey. All in all, a weak report suggestive that the pickup in layoff announcements may be starting to translate into outright job cuts, notwithstanding the durability of labor market tightness seen post the darkest days of the pandemic.

The Week Ahead

The data calendar picks up over the next week, headlined by the FOMC Rate Decision, CPI, PPI and Retail Sales. Looking ahead, markets remain focused on inflation, employment data and a potential pause in the FOMC's current tightening cycle. On the new issue front, ABS volumes were muted during the first week in June post May's surge, with 5 deals totaling $3.9 billion priced through the 7th and $122.3 billion year to date ($137.4 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance remained robust to kick off June, with $43.2 billion priced through the 7th and $655 billion year to date ($723 billion over same period last year; $1.26 trillion for 2022). While new issue supply has slowed this year given FOMC rate hikes and elevated volatility, market conditions have improved post SVB/SBNY/FRBK bank failures and the new deal landscape remains favorable for a wider array of ABS and corporate issuers as investor demand remains strong.

Friday 6/9

No data

Monday 6/12

Monthly Budget Statement

Tuesday 6/13

CPI; NFIB Small Business Optimism

Wednesday 6/14

FOMC Rate Decision; PPI

Thursday 6/15

Weekly Jobless Claims; Retail Sales; Industrial Production

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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