Fixed Income Market Insights

March 23, 2023

Key takeaways

Bond yields were again lower this week, with GT2s down 38 basis points and GT10s lower by 18 basis points and 2s/10s less inverted by 20 basis points (-39), driven by the continued fallout from the SVB/SBNY bank failures and concerns that this week's FOMC rate hike will edge the economy closer to recession. On the data front, the University of Michigan Consumer Sentiment Index came in weaker than expected at 63.4 in March, the first decline since November, as chronically high inflation continues to dampen consumer optimism despite tight labor markets, higher nominal wages and a five-decade low in unemployment. Sales of existing homes during February came in stronger than expected to an annualized rate of 4.58 million homes, the first increase in a year and largest one month change since 2020, rebounding from January's pandemic era low (4.0 million/lowest since 2010) driven by rock bottom affordability given higher mortgage rates and elevated prices. As expected, the FOMC raised the Federal Funds rate by 25 basis points to 5.00% on Wednesday afternoon with a unanimous vote of 12-0, the highest level since August 2007.

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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Insperex

The FED Fighters

The turmoil triggered by the recent failures of Silicon Valley and Signature banks and, more importantly, the specter that more regional/community banks would either endure the same fate or, at a minimum, reduce credit extension to shore up their balance sheets has led many market participants to predict a pause by the FOMC at this week's highly anticipated meeting. After all, some said, the rapidity of Federal Funds rate increases during the past year was a key driver in depressing asset values and, by extension, the SVB and SBNY closures, implying that more monetary policy tightening would hasten a broader contraction in traditional bank lending, which would trigger a recession and hobble inflation along the way, obviating the need for additional rate hikes. According to a recent study by Goldman Sachs, regional and community banks (up to $250 billion in assets) extend as much as 50% of all consumer and industrial loans in the United States, and, as a consequence, any meaningful pull back by these institutions would surely slow economic activity and increase unemployment, conditions that would favor not only a pause, but ultimately rate cuts prior to the end of 2023.

Market Snapshot

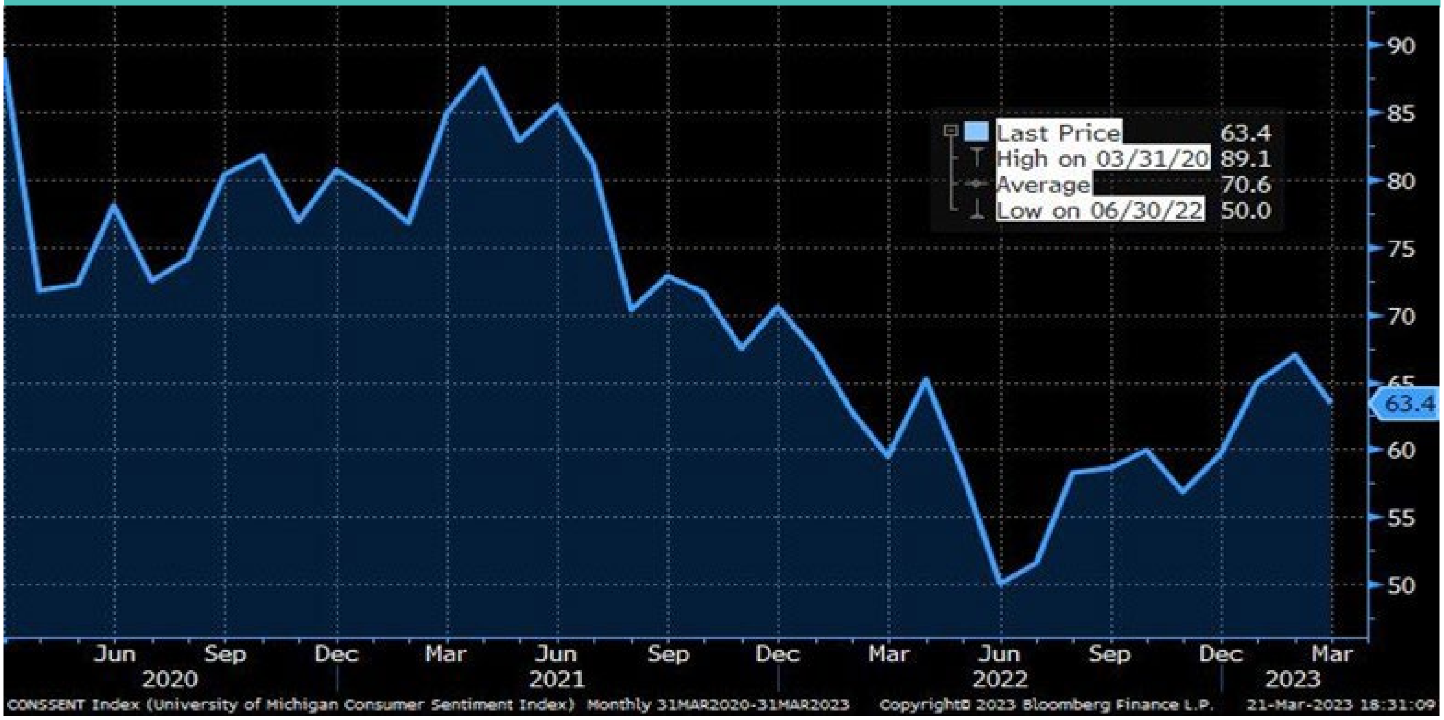
	This week 3/23/23	Last week 3/16/23	Basis Points Change	Weekly % Change	YTD % Change
3-month USD Libor	5.08%	4.91%	17	3.46%	6.50%
SOFR	4.55%	4.58%	-3	-0.66%	5.81%
2-year US Treasury	3.79%	4.17%	-38	-9.11%	-14.45%
5-year US Treasury	3.41%	3.73%	-32	-8.58%	-14.96%
10-yr US Treasury	3.40%	3.58%	-18	-5.03%	-12.37%
2s-10s UST Spread	-39.00	-59.00	20.00	-33.90%	-29.09%
DJIA	32,016	32,220	-204.00	-0.63%	-3.41%
S&P 500	3,929	3,956	-27.00	-0.68%	2.32%
Spot Gold	2,015	1,924	91.00	4.73%	10.35%
WTI (Oil) Current Contract	69.38	68.20	1.18	1.73%	-13.56%
1-year Brokered CD	5.15%	5.35%	-20	-3.74%	11.96%
5-year Brokered CD	4.75%	5.00%	-25	-5.00%	18.75%
5-year Bullet US Agency	3.64%	3.93%	-29	-7.38%	-10.78%
5-year/NC1yr Callable US Agcy	5.00%	5.25%	-25	-4.76%	-7.41%
CDX IG Spread Index	88.07	83.71	4.36	5.21%	7.38%
CDX High Yield Index Spread	99.04	99.95	-0.91	-0.91%	-1.57%
15-yr UMBS	4.33%	4.65%	-32	-6.88%	-7.08%
30-yr UMBS	4.89%	5.19%	-30	-5.78%	-8.26%

Source: Bloomberg data as of 3:00pm ET 3/23/2023 and 3:30pm ET 3/16/2023

Said differently, those advocating for a pause now see more rate hikes as a bigger risk to the Federal Reserve's dual mandate of maximum employment and stable prices, notwithstanding the durability of today's inflationary run, where prices are still running at 2-3x the FOMC's stated 2% target. Ultimately, the Federal Reserve demonstrated the resolve they have been touting since the start of the current policy tightening campaign and raised the Federal Funds rate by 25 basis points and, in our opinion, nicely bifurcated the two main threats to the economy today – elevated inflation and the potential fallout from duress in the banking industry. Indeed, Chairman Powell likened elevated credit contraction, to the extent it occurs, to additional rate hikes, which would surely suspend further tightening and open the door to potential easing should the reduction of credit extension be something more than transitory. As was customary during the fourth quarter of last year, the market resumed its skepticism of the 'higher for longer' posture by the FOMC, which the Chairman reiterated by stating that rate cuts weren't likely this year, as Federal Funds futures continue to show nearly 100 basis points in rate cuts by January 2024. While the extent of credit contraction will take months to quantify, suffice it to say that the economic landscape has changed over the past two weeks, with financial conditions likely to tighten further, which should force price gains closer to a sustainable path towards 2%, the magic bullet to end the most aggressive monetary policy tightening in over 40 years. Stay tuned!

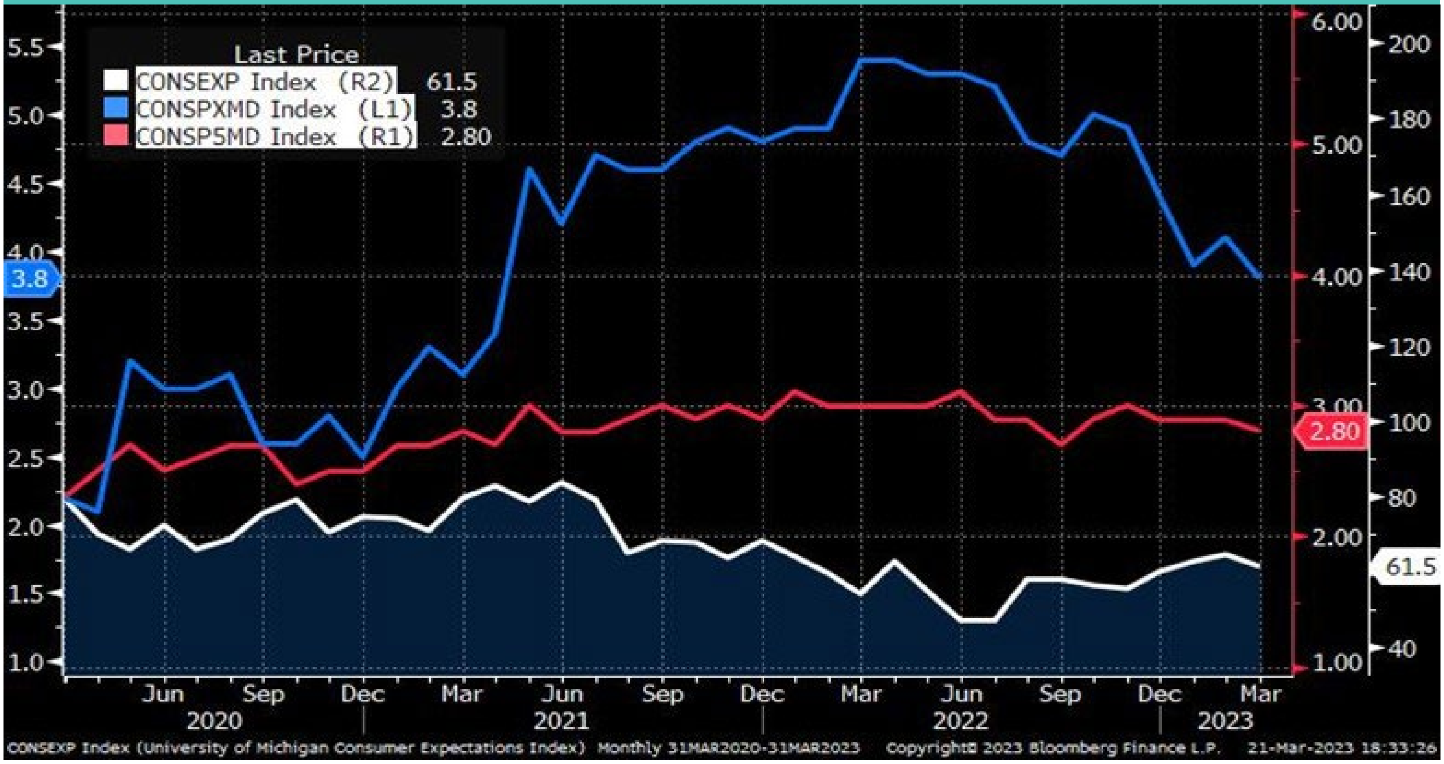
Still quiet on the fiscal front as extended breaks and additional House hearings continue to populate the congressional calendar. Among several legislative initiatives, negotiations regarding the debt ceiling will take center stage in the weeks to come. Also look for mounting calls for tighter bank regulation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

U of Michigan Consumer Sentiment – Monthly – 3 Years



Source: Bloomberg as of 3/23/2023

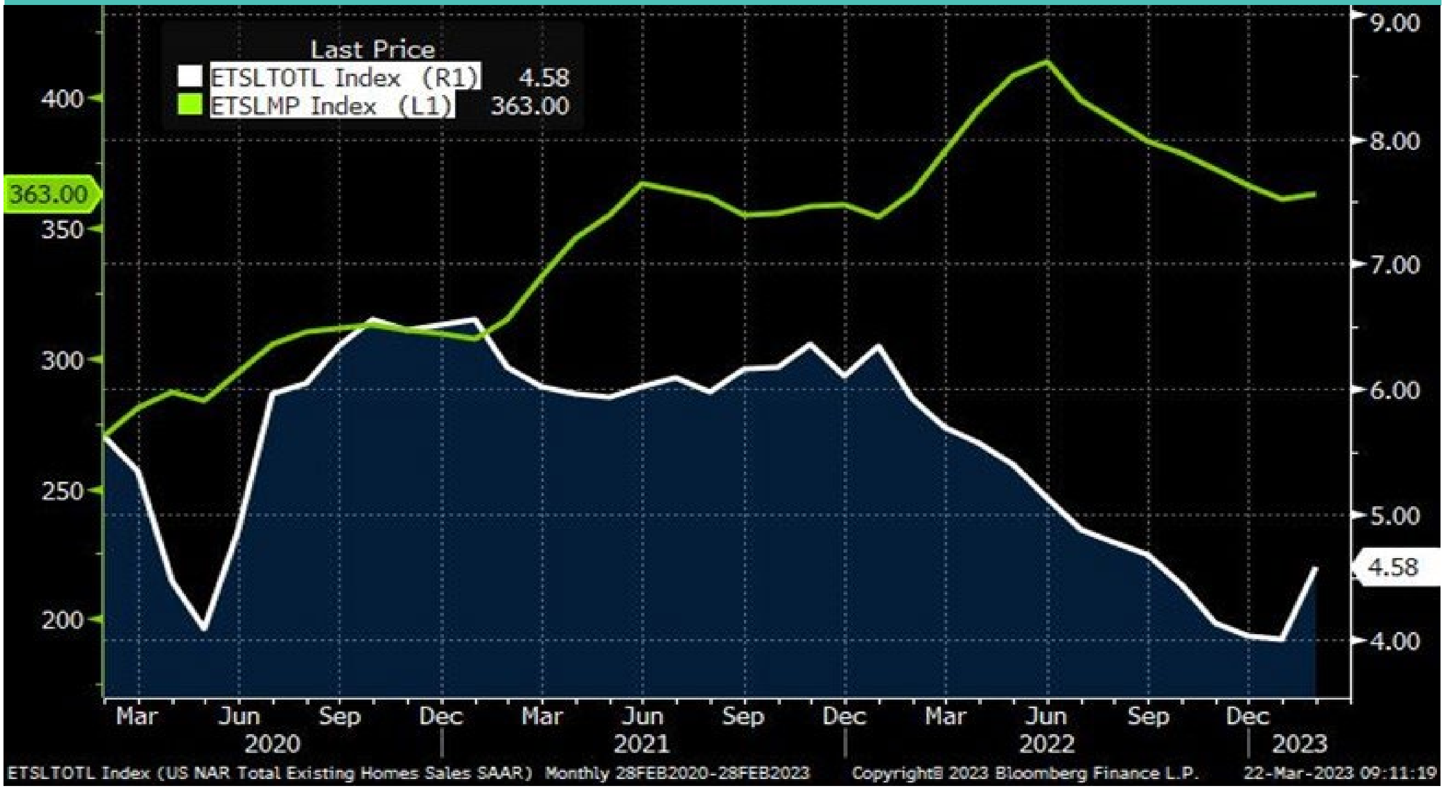
U of Michigan Consumer Expectations, 1yr and 5-10yr Inflation– Monthly – 3 Years



Source: Bloomberg as of 3/23/2023

The University of Michigan Consumer Sentiment Index came in weaker than expected at 63.4 in March (67.0 est.; 67.0 Mar.), the first decline since November, as chronically high inflation continues to dampen consumer optimism despite tight labor markets, higher nominal wages and a five-decade low in unemployment. Indeed, over 38% of consumers attributed their negative views regarding personal finances to inflation (42% in Sept.), shy of the all-time high during the 2008 financial crisis (49%) but still historically high, and a mere 16% expect their incomes to rise more than inflation, a negligible improvement from June's 13% cycle low. Additionally, a paltry 27% 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 dampen consumer optimism about their near-term financial well-being. A deeper dive into the survey revealed that both components of headline sentiment declined, with current conditions lower to 66.4 (70.7 Feb.; 65.6 Oct. 2022) and expectations down to 61.5 (64.7 Feb.; Oct. 2022), both near their highest levels in over a year, but still historically weak. On the price front, near-term inflationary expectations moderated again to 3.8%, the lowest level since April 2021, due largely to lower energy prices, but remain historically elevated over the near (1yr. 3.8%; cycle high 5.4% Mar. 2022) and longer terms (5+ yrs. 2.8%; cycle high 3.1% Jun. 2022), well above of the FOMC's target of 2%. Looking at the text of the report, which was largely compiled before the failure of Silicon Valley Bank, the director of the survey stated that "This month's decrease was already fully realized prior to the failure of Silicon Valley Bank, at which time about 85% of our interviews for this preliminary release had been completed," and that "Overall, all components of the index worsened relatively evenly, primarily on the basis of persistently high prices, creating downward momentum for sentiment leading into the financial turmoil that began last week. While inflation has eased from its peak last summer and, likewise, sentiment has lifted from its all-time low, high prices continued to be a primary drag on consumer attitudes." All in all, high inflation and elevated interest rates continue to dampen consumer optimism, conditions likely to persist in the near term, particularly given the recent bank failures, and threaten to derail the robust nature of consumer spending seen over the past year, especially 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 3/23/2023

Sales of existing homes during February came in stronger than expected to an annualized rate of 4.58 million homes (4.20 est.), the first increase in a year and largest one month change since 2020, rebounding from January's pandemic era low (4.0 million/lowest since 2010) driven by rock bottom affordability given 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 (960,000). 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 dampened mobility. The magnitude of this tighter supply is apparent in the months of supply and days on the market metrics for February, which came in at 2.6 months (record low 1.8 months) and 34 days (record low 14 days) respectively, continuing 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 $363,000 last month, a decline from June's all-time high of $413,800 and the lowest level since January 2022, and down -.2% during the last year, the first year-over-year decline in eleven years. Looking at the text of the report, the director of the survey stated that "Conscious of changing mortgage rates, home buyers are taking advantage of any rate declines. Moreover, we're seeing stronger sales gains in areas where home prices are decreasing and the local economies are adding jobs," and that "Inventory levels are still at historic lows. Consequently, multiple offers are returning on a good number of properties." 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 February, off a mere $113 from August's all-time high, and up 1.7% over the last twelve months, albeit the slowest year-over-year increase in twenty months. While elevated prices and higher mortgage rates will likely dampen home sales further this year, we expect demand for housing to remain strong and prices to remain elevated in the near term given historically light inventories and increased likelihood of mortgage rate relief post FOMC tightening.

FOMC Rate Decision & Statement Analysis

As expected, the FOMC raised the Federal Funds rate by 25 basis points to 5.00% on Wednesday afternoon with a unanimous vote of 12-0, the highest level since August 2007. As has been customary, Chairman Powell reiterated the Committee's resolve to reduce inflation and advanced slight revisions to their interest rate Dot Plot and Summary of Economic Projections (SEP). Regarding the Dot Plot, which outlines rate projections by 18 FOMC members, the median interest rate forecast now reflects an additional 25 basis points of tightening during 2023, a pause for the balance of the year, followed by 100 basis point rate cuts in 2024 and 2025. Said differently, the FOMC left the terminal Federal Funds rate unchanged at 5.125% during 2023, a departure from the 'higher for longer' posture by the FOMC just prior to the SVB/SBNY bank failures nearly two weeks ago, with 2024 and 2025 rate forecasts little changed from December's projections. Additionally, the SEP data revealed that Core PCE inflation expectations were revised fractionally higher for 2023 and 2024, coming in at 3.6% and 2.6% respectively (versus 3.5% and 2.5% in December), both well above the 2% target. Accordingly, the SEP for 2023 Real GDP growth was fractionally reduced to .4% from .5%, with a larger drop projected for 2024, to 1.2% from 1.6% in December, indicative of FOMC expectations for recessionary conditions. In our view, the big takeaway was the reversal of FOMC intra-meeting talk of a higher terminal rate during 2023, which was underscored during the post-meeting press conference where the Chairman stated that the recent SVB/SBNY bank failures will likely result in tighter credit conditions, offsetting the need for an expanded series of rate hikes this year. This was also reflected in language changes in the FOMC official statement, which shifted to "some additional policy firming may be appropriate" from "ongoing increases in the target range will be appropriate" in December. Additionally, the Chairman reiterated that inflation remains too high and labor markets are extremely tight, stating that "The process of getting inflation back down to 2% has a long way to go and is likely to be bumpy" and that services inflation (ex-housing) have shown little signs of slowing. While Powell again delivered this Committee's party line on inflation, that we understand the hardship and have the tools and resolve to break it, we remain skeptical of the Fed's ability to break inflation without breaking the economy given their constraint of possessing demand side tools only and that rate cuts during 2023 won't happen until a sustainable path towards a 2% inflation rate is achieved. While many continue to see solid consumer and business balance sheets and still elevated real estate valuations as an offset against a meaningful economic downturn, we believe that the likelihood of some form of credit contraction via the SVB/SBNY failures, soaring consumer debt and the cumulative effects of 475 basis points of rate hikes have increased the risk of a larger contraction in consumption and investment later in 2023. Add in this cycle's durable inflation, particularly in food, wages and rents, and mounting geopolitical risks, and you're left with a veritable witch's brew of uncertainty, which are typically the enemies of discretionary consumer spending and a well-bid stock market.

Comparing March and February statements, the major changes centered upon the recognition of recent bank failures and potential for credit contraction, softening of language regarding the prospect for more rate hikes and elimination of references to the war in Ukraine:

"The U.S. banking system is sound and resilient. Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is uncertain.," which replaced December's "Russia's war against Ukraine is causing tremendous human and economic hardship and is contributing to elevated global uncertainty."

"The Committee will closely monitor incoming information and assess the implications for monetary policy. The Committee anticipates that some additional policy firming may be appropriate," which replaced "The Committee anticipates that ongoing increases in the target range will be appropriate."

All and all, Chairman Powell delivered well a very tricky message of acknowledging the potential fallout from SVB/SBNY bank failures, whilst also reiterating that inflation is still too high, future rate increases may be in the offing and rate cuts during 2023 are not in the cards, for now. Judging by Federal Funds futures levels post-meeting, which revealed 100 basis points in rate cuts by the January 2024 rate decision (starting this Summer), the market remains skeptical. Stay tuned!

Date	Target	BN Survey	Survey vs Actual	Direction	Change	Discount	Vote
03/22/23	4.75%-5.00%	4.75%-5.00%	Expected	Tightening	0.25%	5.00%	12-0
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
03/16/22	0.25%-0.50%	0.25%-0.50%	Expected	Tightening	0.25%	0.50%	8-1

Source: Bloomberg as of 3/23/2023

The Week Ahead

The data calendar slows over the next week, headlined by Consumer Confidence, Durable Goods Orders and Weekly Jobless Claims. Looking ahead, markets remain focused on inflation, employment data and more fallout from the SVB/SBNY bank failures. On the new issue front, ABS volumes were again muted given elevated volatility via last week's bank closures and the FOMC this week, with only 2 deals totaling $1.5 billion priced through the 22nd and $57.4 billion year to date ($62.1 billion over same period last year; $276.7 billion for 2022) and IG corporate issuance remained sluggish given banking news and FOMC with a mere $7.4 billion priced as of the 22nd and $364.6 billion year to date ($419.8 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 improved 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 robust, with the caveat that additional fallout from the SVB/SBNY failures will trigger issuance furloughs like observed over the past two weeks.

Friday 3/24

Durable Goods Orders; S&P Manufacturing/Services

Monday 3/27

Dallas Fed Manufacturing Activity

Tuesday 3/28

Consumer Confidence; S&P CoreLogic HPI

Wednesday 3/29

MBA Mortgage Applications; Pending Home Sales

Thursday 3/30

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.