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MARKETS

Rare Bond-Market Inversion Signals Short-Lived Boost to Inflation

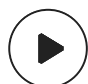
Markets appear to price in a spike of inflation in the medium term that ebbs later on

The Federal Reserve building in Washington.

PHOTO: SAMUEL CORUM/BLOOMBERG NEWS

By Paul J. Davies

Feb. 25, 2021 5:30 am ET



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Markets are signaling that inflation is coming and investors are getting ready. Treasury yields are rising and stock-market investors are starting to shift from high-growth tech companies toward companies like airlines that will benefit from an economic rebound.

But one corner of the Treasury market suggests that a coming bump in U.S. inflation will run out of steam swiftly. This has implications for fans of gold or cryptocurrencies who fret about runaway inflation.

Investors' inflation expectations can be seen in Treasury markets by looking at the difference between the yields on ordinary Treasurys and the yields on inflation protected

Treasurys, known as TIPS. This difference is called the break-even rate.

The difference between five-year Treasury and TIPS yields shows break-even inflation expectations have risen to nearly 2.4% in recent days—the highest level since May 2011, implying inflation is set to pick up.

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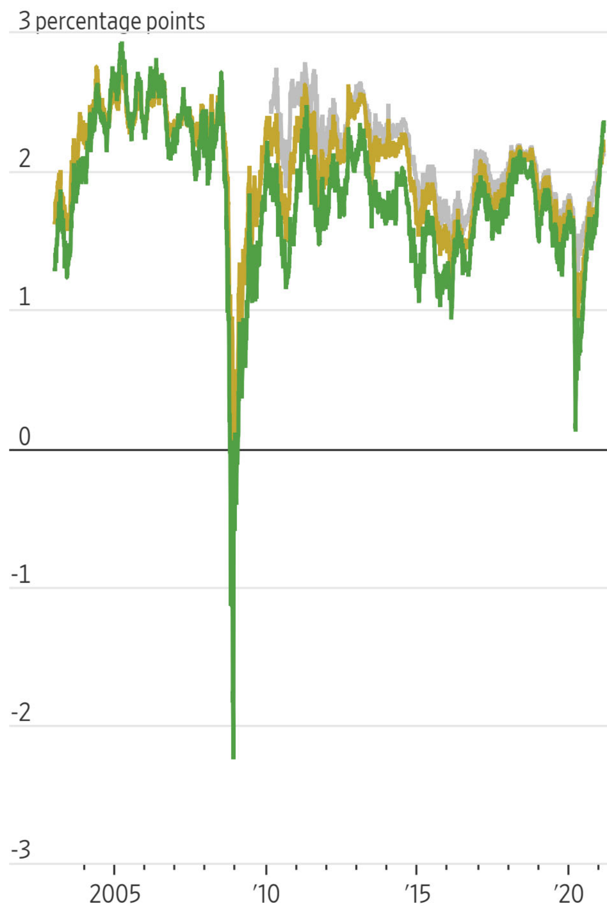
But there is more going on below the surface. Shorter-term break-even rates are higher than longer-term ones, an extremely rare situation—known as an inversion of the break-even curve. This forecasts a spike in inflation that then falls away.

For instance, longer-term inflation expectations are lower: 10-year break-even rates are 2.15% and 30-year rates are 2.1%.



*Real yields are from inflation-protected Treasurys, or TIPS

Source: FactSet

The five-year rate hasn't been above the 10-year since July 2008, according to FactSet, and the gap between the two has never been as great as it was on Wednesday.

Interpretations for the anomaly vary. One possibility is that the $1.9 trillion coronavirus-relief package Washington will vote on this week will bring only short-term benefits—and only a short-lived bump to inflation. More than three-quarters of the funds likely to be approved will be spent on stimulus checks and other income support, according to Goldman Sachs estimates.

Another view is that the inversion in break-even rates might signal expectations that the Federal Reserve—contrary to promises—will react swiftly to cap inflation and keep it close to its 2% target.

"It may signal that we are getting closer to the first test of the Fed's commitment to average inflation targeting...and not tightening policy until they see the whites in the eyes of inflation," said David Riley, chief investment strategist at BlueBay Asset Management.

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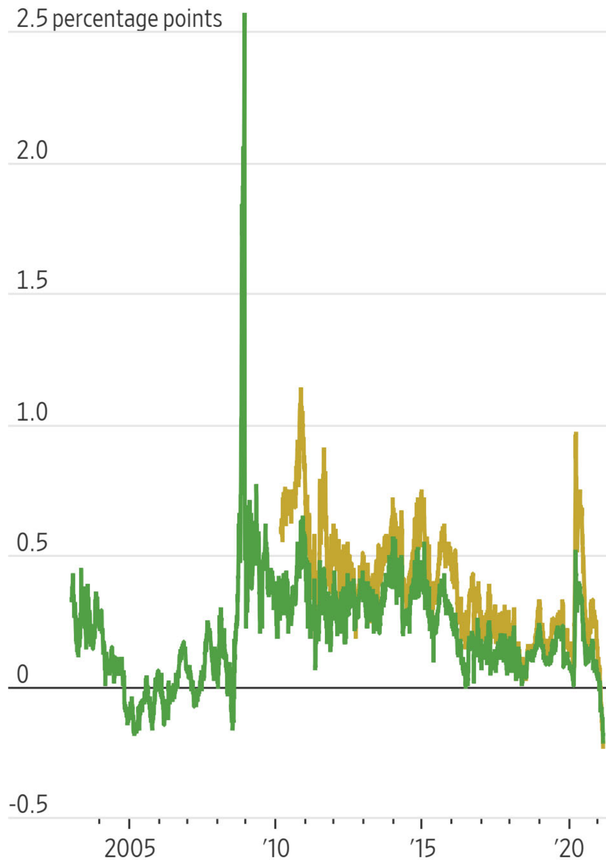
Gap between inflation expectations at different Treasury maturities

- Difference between 10-year and 5-year inflation expectations
- Difference between 30-year and 5-year inflation expectations



Note: A negative reading means inflation will be lower further into the future
Source: FactSet

This idea is supported by the fact that yields on 10-year TIPS—known as “real” yields because they take into account inflation expectations—have risen as 10-year break-even rates have fallen over the past two weeks. That combination, Mr. Riley said, typically signals either a weaker growth outlook, which seems unlikely, or a higher likelihood of rate rises from the Fed.

Another support for this view: Fed-funds futures put an 11% chance on the central bank lifting interest rates by a quarter of a percent in September, up from a zero chance just a month ago.

A third view is that the market is simply getting it wrong and underpricing the effect of government stimulus spending.

That could come in the form of an infrastructure spending package to be agreed upon later this year after the initial coronavirus relief. Alberto Gallo, head of global credit strategies at Algebris Investments, thinks there could be a longer spell of healthy inflation if investments are made in ways that boost U.S. productivity growth. But to truly work, this would also require higher corporate taxes and better antitrust regulation to improve competition in the U.S., he says.

There is also still a lingering concern about the economic pain that a cycle of rising interest rates would cause in a world saddled with even more debt than households, companies and governments were bearing before Covid-19 struck. Higher rates divert more income into debt repayments, slowing spending on other things and hurting economic activity.

The last time there was a series of rate rises from the Fed it ended with a sharp selloff in stocks and riskier debt at the end of 2018 as investors worried the central bank was going to go too far.

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SHARE YOUR THOUGHTS

What do you think will happen with inflation as the economy recovers? Join the conversation below.

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