Bond Market Perspectives

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Disinflation Infatuation

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Highlights

Inflation expectations have fallen sharply in recent weeks, driven by European disinflation, lower energy prices, and overall growth concerns.

The persistence of low inflation expectations may intensify the "lower for longer" theme via lower growth expectations and delays to potential Federal Reserve (Fed) interest rate hikes.

Inflation expectations have dropped sharply and helped to drive bond strength in recent weeks. All else equal, lower inflation, or the expectation of lower future inflation, helps boost bond prices as inflation risks fade. Market-implied inflation expectations, as measured by Treasury Inflation-Protected Securities (TIPS), declined to one of the lowest levels of the past five years [Figure 1].

1 Inflation Expectations Are Below 2% and Near Multiyear Lows

Source: LPL Financial Research, Bloomberg 10/13/14

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A number of factors have worked to push U.S. inflation expectations lower, but the dominant driver has been disinflation in Europe. Eurozone annualized consumer prices are rising only 0.3%, the slowest pace since the end of the Great Recession of 2007–2009. Many countries, Italy being one, are experiencing outright deflation with local prices registering year-over-year declines.

Additional drivers of lower inflation expectations include:

- **Weak economic data in Europe.** Aside from lower prices, Europe is flirting with its third recession of the past six years, raising fears about global economic growth.

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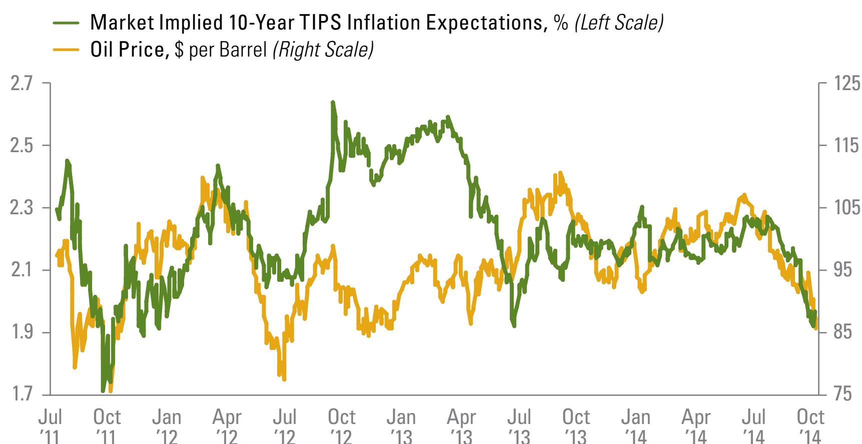
- **Global unrest.** Conflict in the Middle East, protests in Hong Kong, simmering tensions in Ukraine, and concerns over the spread of the Ebola virus are being viewed as potential disrupters to global economic growth.
- **Lower energy prices.** Related to weaker growth expectations, the notable decline in oil prices since the end of June 2014 may reduce a key consumer expenditure.

In the bond market, the decline in oil prices may be having an outsized impact. TIPS' inflation compensation is based on the increase in the overall Consumer Price Index (CPI), of which energy prices represent a significant component. Historically, oil price changes and implied inflation on TIPS have been closely correlated [Figure 2]. When inflation expectations change, TIPS' prices can adjust quickly. Therefore, the path of oil prices can have a heavy influence on TIPS' prices over the short term. In 2013, the two diverged as the taper tantrum sell-off prompted investors to demand a greater inflation-adjusted, or real, yield (essentially a higher risk premium) to compensate for increasing Fed rate hike risks and better economic growth. But the relationship is generally very tight.

2 TIPS and Oil Prices Are Generally Closely Correlated



Source: LPL Financial Research, Bloomberg 10/13/14

Growth Scares

The drop in oil prices and inflation expectations tends to coincide with growth scares — fears of an economic downturn. Aside from 2013, the last two times inflation expectations dropped quickly occurred in mid-2010 and the latter half of 2011, as Figure 1 illustrates. Both of these latter instances coincided with fears over Europe, similar to today's environment. In all three cases, oil prices were hovering near their lows. In mid-2010, oil prices were approximately $75/barrel, and in both 2011 and 2012, they dropped to $80/barrel — briefly coinciding with the drop in inflation expectations. Crude oil closed Monday, October 13, 2014, at $85/barrel.

Therefore, whether the recent increase in high-quality bond prices and drop in yields are sustained depends upon whether economic conditions

deteriorate. Earnings season may provide a clue, and the release of top-tier economic data such as monthly jobs and the Institute for Supply Management's (ISM) Manufacturing Index may provide additional insight during the week of November 3, 2014. We expect fundamental evidence to show that domestic economic expansion continues.

Lower for Longer

Two knock-on effects of low inflation may work in the favor of bonds: lower growth expectations and delays to the timing of Fed interest rate hikes. Declining inflation expectations usually reflect a slower pace of economic growth. Better economic growth generally boosts inflation expectations as strength is reflected in higher prices. The Fed's favorite inflation measure, the personal consumption expenditures, is already running 0.5% below target. Stubbornly, low inflation is likely to restrain the Fed from raising interest rates. The release of minutes of the September Fed meeting reflected Fed officials' concerns over low inflation, which was reinforced by recent U.S. dollar strength.

Not Time for TIPS

The recent underperformance of TIPS, a result of falling inflation expectations, does not warrant exposure to the sector in our view. TIPS may benefit from the ongoing stock market pullback, which is boosting demand for high-quality bonds, but TIPS still share the expensive valuations of their conventional Treasury counterparts. Unless confirmed by deteriorating domestic economic data, the October lift in prices may prove temporary; and TIPS, when purchased in exchanged-traded fund (ETF) or mutual fund form, possess greater interest rate risk than conventional Treasuries or a diversified portfolio of intermediate bonds. ■

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