Bond Market Perspectives

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An Old Nemesis Returns

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Highlights

The rate of inflation remains low, but market awareness about a possible bottom is increasing as bond market measures of inflation expectations have increased.

Inflation is likely to increase only slowly, but current bond yields offer limited protection against rising inflation.

Inflation—one of bond investors' chief enemies—may be making a resurgence. The rate of inflation remains low, but market awareness about a possible bottom is increasing. This week the Federal Reserve's (Fed) preferred measure of inflation—core personal consumption expenditures (PCE)—is expected to increase to 1.4% for April 2014 after a 1.2% annualized rate in March.

Inflation is an important risk to monitor in bond investing. Since most bond interest payments are fixed over the life of the bond, rising inflation can erode the value of those payments and lead to lower bond prices.

The PCE will likely follow the recent increase in the widely followed core Consumer Price Index (CPI), which rose to a greater-than-expected 1.8% in April 2014 after an above-forecast increase in March. Core CPI has accelerated in recent months with the three-month change equating to a 2.3% annualized rate of inflation [Figure 1]. Prices at the producer level, often watched for signs of "pipeline" inflation pressures, have increased as well. Core finished goods prices as measured by the Producer Price Index (PPI) bottomed in late 2013 and have moved steadily higher since.

Several factors point to prices firming up further (for more insights see the *Weekly Market Commentary*: *The Big Bang Theory: Inflating the Stock Market,* 4/21/14):

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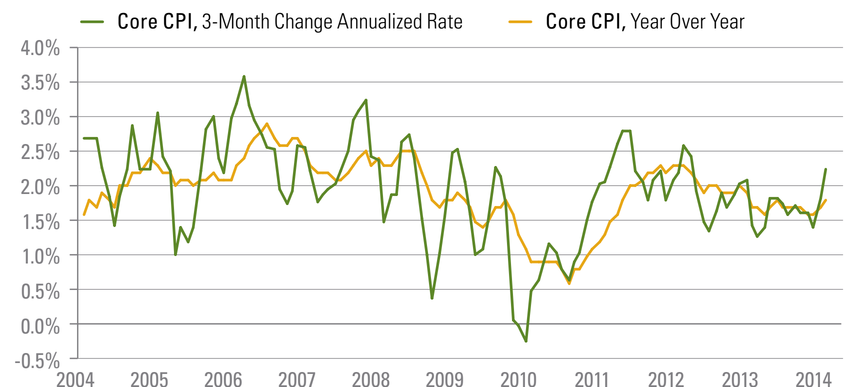
1 Inflation Is Accelerating Over the Short Term



Source: LPL Financial Research, Bureau of Labor Statistics 05/23/14

Past performance is no guarantee of future results. One cannot invest directly in an index.

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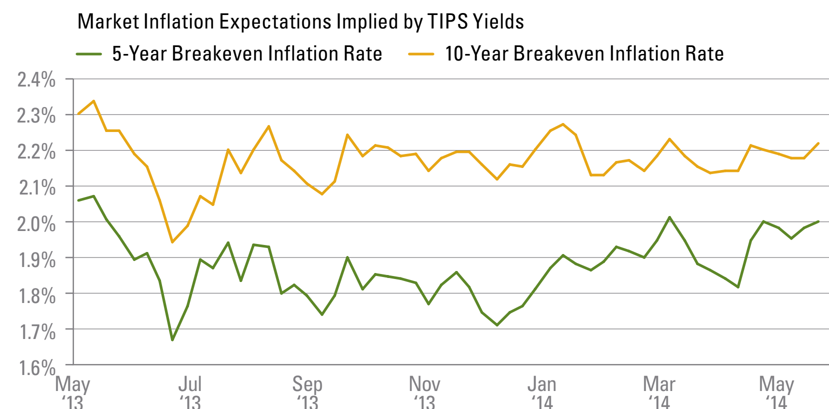
- **Global economic growth.** Second quarter 2014 economic growth in the United States is expected to bounce back from a weak first quarter and is oon pace to expand at a 3.5% rate, according to the Bloomberg consensus forecast, based on a rebound in consumption and industrial production following a snowier and colder winter that depressed economic activity. Overseas, China's Purchasing Managers' Index (PMI)—an important gauge of manufacturing activity in China—showed signs of stabilization after a year of deceleration.
- **Housing rents.** Housing purchases have slowed due to higher interest rates, housing price gains, and still-tight residential mortgage lending standards. But housing rents, a key driver of core CPI, have steadily increased since late 2013 and may likely continue to exert upward pressure on core CPI over the remainder of 2014. Housing rents comprise roughly 25% of core CPI and favorable year-over-year comparisons may boost core CPI.
- **Job growth.** The three-month moving average of monthly private payroll gains is 225,000, the highest since November 2013. Although job growth remains sluggish compared with prior recoveries, continued improvement may lead to price pressures over time.

Since the beginning of May 2014, the yield differential between intermediate- and long-term Treasuries has increased, leading to a steeper yield curve, which often reflects greater, longer-term inflation risks.

Measures of inflation expectations in the bond market have also increased. The breakeven inflation rates implied by Treasury Inflation-Protected Securities (TIPS) are near one-year highs [Figure 2]. In April 2014, the five-year TIPS auction witnessed very strong demand, and demand was again robust at last week's 10-year TIPS auction. Higher implied inflation rates indicate investors are requiring greater inflation protection. Since the beginning of May 2014, the yield differential between intermediate- and long-term Treasuries has increased, leading to a steeper yield curve, which often reflects greater, longer-term inflation risks.

2 Market Implied Inflation Expectations Are Near a One-Year High



Source: LPL Financial Research, Bloomberg 05/23/14

The breakeven inflation rate is obtained from subtracting a TIPS yield from the yield on a corresponding, same maturity, conventional Treasury.

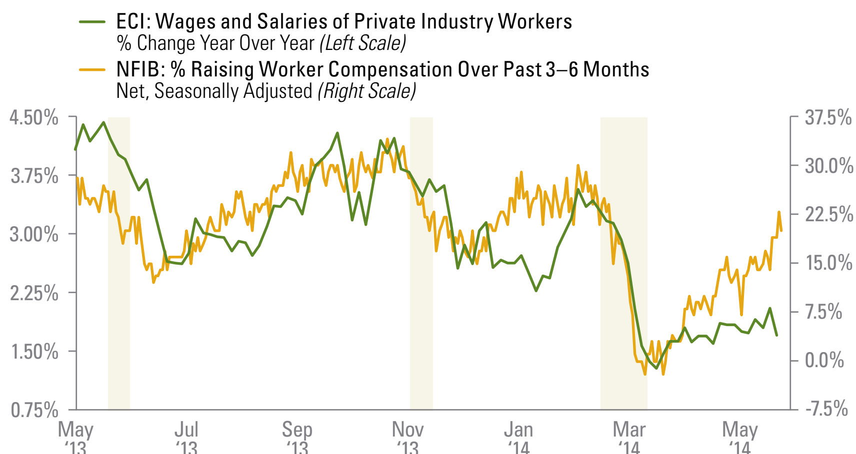
The Fed is projecting a median 1.0% and 2.25% fed funds target rate by year-end 2015 and 2016, respectively, but fed fund futures indicate a 0.6% and 1.6% rate for the same time periods—a significant disparity.

Still Modest

To be sure, the increases in inflation expectations and in the broad price indexes, such as the CPI, are still modest by historical comparison. The 10-year TIPS yield suggests that CPI inflation will average 2.25% over a 10-year horizon—a low level.

The three factors mentioned earlier that may continue to lift inflation will take time to influence prices. Economic growth and job gains will likely need to increase further and remain at higher levels to generate sustained price pressures. Wage pressures, a bigger driver of inflation, remain muted and limit the potential pace of price gains, but signs of wage pressures may be emerging. The most recent Employment Cost Index (ECI) released for the quarter ending March 31, 2014, diverges from the recent trend of small business that intend to increase worker compensation [Figure 3]. The next release of the ECI, in late July 2014, may reflect the stronger compensation plans. We expect this to translate to a gradual increase in the rate of inflation.

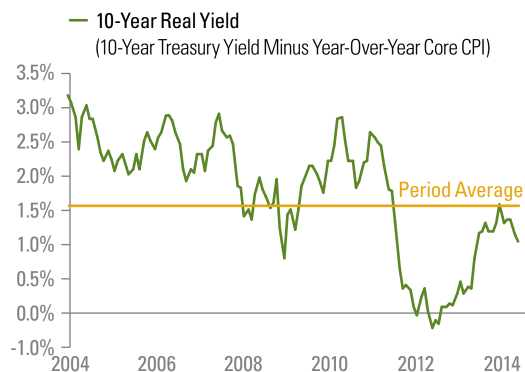
3 Wage Pressures May Be Building



Source: LPL Financial Research, BLS, NFIB, Haver 05/27/14

Past performance is no guarantee of future results.

4 Inflation-Adjusted Yields Still Indicate an Expensive Bond Market



Source: LPL Financial Research, Bloomberg 05/23/14

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Still, any increase in inflation is noteworthy due to the diminished protection offered by high-quality bonds. Subtracting the annualized rate of inflation from the 10-year Treasury yield reveals how high-quality bonds remain expensive. The greater the inflation-adjusted, or real, yield the more attractive bond valuations are and vice versa. The real yield has turned substantially lower in 2014, despite indications of an improvement in economic growth prospects in recent weeks [Figure 4]. Real yields still indicate an expensive bond market and one that is not properly compensating investors for inflation risks even if modest.

We believe inflation is likely to increase only slowly, but current bond yields offer limited protection against rising inflation. Low real yields present

an unattractive investment proposition for bond investors, and renewed weakness in the economy is needed to justify current real yields. Inflation is likely to creep toward the Fed's 2% target over 2014 and into 2015, meaning the Fed is likely on track to raise rates in late 2015/early 2016. The Fed is projecting a median 1.0% and 2.25% fed funds target rate by year-end 2015 and 2016, respectively, but fed fund futures indicate a 0.6% and 1.6% rate for the same time periods—a significant disparity. Fading rate hike expectations indicate pricing could be as good as it gets for high-quality bonds. ■

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