LOOKING OVER THE INFLATION PEAK

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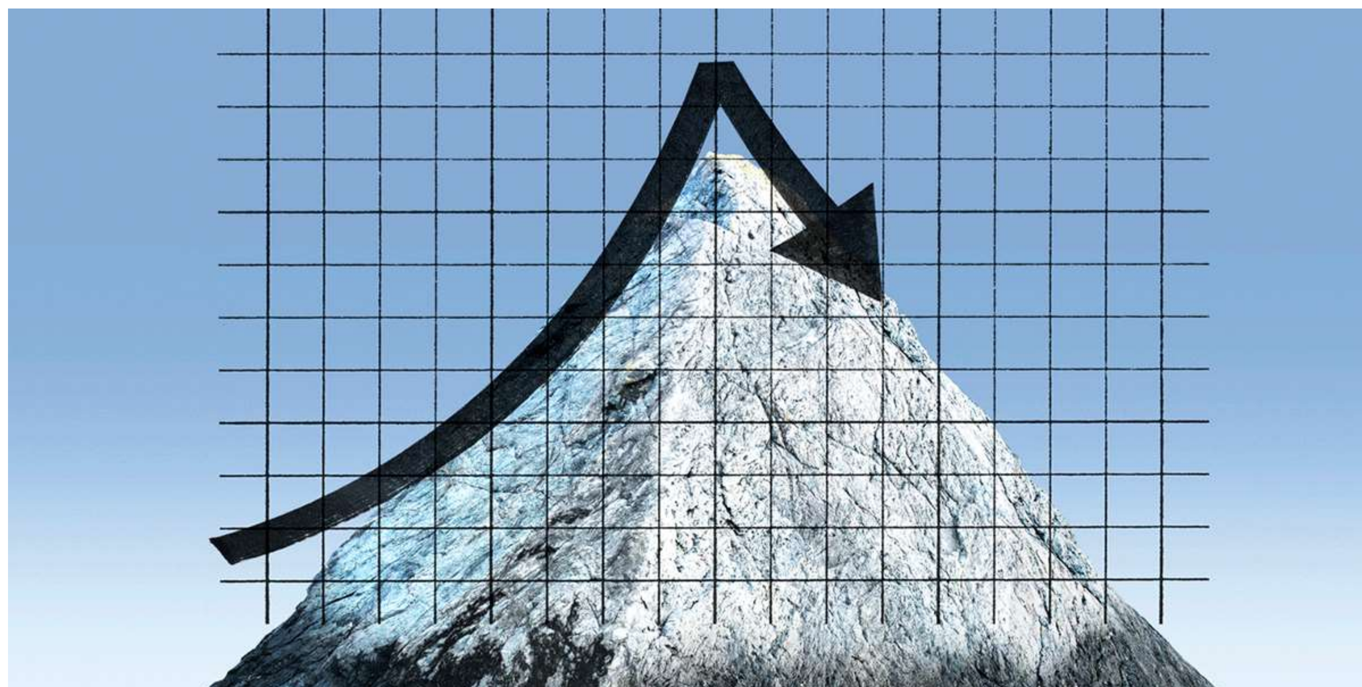

In the same way inflation has roiled financial markets on its way up, it also has the potential to impact them on the way down, should it come down.

Our view is that inflation is nearing a cyclical peak, and we expect it to begin cooling off from here. We're keeping an eye out for that inflection point, monitoring the various inflation survey measures (e.g., CPI, PCE, etc.), wage pressures, and more, all in their various main, core, and trimmed variations. Most of these are readily available and easy enough to track.

But if these measures have a weakness, it is in that they are backward looking, shedding light on what happened over the prior time period. Take the Fed's preferred inflation gauge: the Personal Consumption Expenditures (PCE) Price Index. The report containing PCE inflation data comes out monthly and reflects data for the prior month. In other words, it shares insight on inflation often weeks after the period happened. There are other options.

Market-Based Inflation

Most of what investors think of in terms of inflation are survey-based, observable inflation measures. The bond market also presents various alternative gauges of inflation in what are known as market-based inflation measures. Understanding how those work and what insights they can provide first starts with the distinction between nominal and real rates.

The interest rates you see every day, such as mortgage rates or US Treasury yields, are also known as 'nominal' interest rates. Real interest rates, or real yields, are those nominal rates adjusted for inflation. Real rates are considered a better approximation for financial conditions, and they allow for easier historical comparisons across time periods —such as stretches when inflation is higher (e.g., 1970s) or lower (e.g., 2010s).

There is a relatively clean way to put this understanding to work in bond markets. Fixed income investors can look directly at the US Treasury for nominal interest rates, US Treasury Inflation-Protected Securities (TIPS) for real rates, and then calculate the difference between the two to see inflation expectations, providing a neat view into how economic expectations are filtering through into bond markets.

Inflation Expectations Today

Bond market data largely confirms what investors have been feeling. Inflation expectations have risen remarkably over the past several quarters, and we can observe this in the data. US Treasury rates have climbed rapidly, outpacing the speed with which yields on US TIPS have risen, widening the gap between the two that is reflective of higher inflation expectations. Surging inflation expectations match what we are seeing in the data, even if the data are slower moving.

Additionally, those higher inflation expectations, and the way that they are outpacing real rates, is particularly insightful as well. The sluggishness of real interest rates to adjust higher suggests that financial conditions remain relatively loose. The juxtaposition between surging inflation and accommodative financial conditions implies more runway for the Federal Reserve to tighten policy, by both raising rates and quantitative tightening.

The bond market has more insights to share than yield alone. Real rates and inflation expectations are additional key measures that we are watching for signs that inflation is nearing a peak, helping us skate to where the puck is going to be and shift portfolios accordingly, so that when the data are finally released, your fixed income positioning is already right where is ought to be.

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