Another Piece of the Inflation Puzzle

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There is an increased amount of speculation about inflation, as geopolitical tensions continue to build and disrupt the production and supply of oil. The increase in discussion is focused around both short- and long-term inflation: if inflation is present, is it transitory or is it settling in for the long haul?

At times, it can be difficult to wrap one’s head around all of this inflation talk, especially when consumers are feeling the pain of higher prices at the gas pump and the grocery store. On a related note, have you noticed that cereal boxes have become smaller, or that bags of chips are now lighter? These are simply creative ways of passing higher prices to the consumer without causing sticker shock.

However you look at it, inflation as experienced and measured by the general consumer is at a high point. But is this a sign that persistent price inflation is just around the corner? Not necessarily, or at least not when measured by the gauges that the government uses to analyze inflation. This is why Federal Reserve Chairman Ben Bernanke remains very vocal in his view that inflation is not currently a problem and that the recent increases in oil and commodity prices are likely to prove transitory.

Is Bernanke Bang On?

Maybe Chairman Bernanke has it right. Looking at the Federal Reserve’s (Fed’s) preferred measure of inflation, the U.S. Personal Consumption Expenditures Index (PCE, also referred to as core inflation),¹ the reading remains well within the Fed’s preferred range of 1.6% to 2% annually. Headline inflation, which includes food and energy, came in at 1.6% annualized in February, while core PCE came in at just 0.9%. It is important to note that even though the Fed prefers core data as its inflation gauge, it is just as concerned with the headline number. Indeed, one reason why the Fed utilizes core data is

¹ The Personal Consumption Expenditures Core Price Index (PCE), issued by the Bureau of Economic Analysis (an agency in the United States Department of Commerce), provides an overview of the average increase in prices for personal consumption in the United States, excluding food and energy.
because it is a good indicator of future headline inflation. Therefore, if the core number is low, as February’s was, it implies that future headline inflation could very well trend lower.

In recent comments, Chairman Bernanke has asserted that the current rise in oil and other commodity prices is likely to be transitory. In other words, the fundamentals within the domestic economy (high unemployment, excess production capacity, depressed real estate values, etc.) and the various market and economic pressures emanating from abroad do not support the thesis that a significant and prolonged rise in prices is upon us.

**Breakeven Rates Provide Inflation Clues**

There are multiple indicators used to measure inflationary trends. However, it is rare that all indicators will align and point to either an inflationary or non-inflationary environment. It is also rare to find one indicator that is consistently accurate. This is why it is important to use multiple indicators when making an assessment of future inflation.

One piece of the inflation puzzle that we monitor and analyze is the relationship between the breakeven rate\(^2\) of five-year U.S. Treasury Inflation-Protected Securities (TIPS) and the five-year, five-year forward breakeven rate.\(^3\) These indicators are both gauges of expected five-year inflation, with the primary difference being the actual span of time that each one covers; the cash market rate covers the five-year period starting today, while the forward rate covers the five-year period starting five years from today.

In the cash market, the five-year breakeven rate represented by the red line in

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\(^2\) A breakeven rate is the difference between a nominal and a real (inflation-adjusted) yield. For example, the current five-year breakeven inflation rate is obtained by subtracting the current yield on a five-year TIP security from the current yield on a five-year nominal Treasury security.

\(^3\) This rate is the market’s current assessment of the five-year inflation rate starting five years from today (and thus ending ten years from today). It is calculated the same way as a current breakeven rate, except that it uses yields embedded in five-year forward agreements on TIPS and nominal Treasuries.
Exhibit 1 on page 3 shows that investors currently expect inflation to come in an average annual rate of roughly 2.25% over the next five years. The blue line (the Barclays Capital five-year, five-year forward index) is showing that investors expect inflation starting in five years to be 2.75% over the subsequent five years. A normal relationship in an economy that is poised for growth or expansion is for the five-year, five-year forward to remain above the cash market breakeven rate, creating a positive spread. As shown in Exhibit 2, this spread, although still positive, recently started to converge, narrowing to 49 basis points from a high of just over 143 basis points in late October. This shows that investor sentiment may be starting to align with Chairman Bernanke’s belief that the recent elevation in energy and food prices may be short-lived or transitory in nature. Simply put, the cash market is reflecting near-term inflationary pressures due to elevated oil prices, but the forward market is indicating that inflation starting five years from now won’t be significantly higher. These metrics are helping confirm the Fed’s view.

Our View

Our view is very similar to the Fed’s. While we believe the potential for long-term inflationary pressure exists, it’s an outcome that faces stiff headwinds in the form of an elevated unemployment rate, a labor market that’s improving at only a snail’s pace, and overall sluggishness in the economy. We would only expect to see a substantial rise in the risk of future inflation if the economy and employment were to turn up sharply while policy makers remained overly accommodative. We don’t appear to be at that point today.

Where applicable, we are positioning our portfolios to benefit from short-term inflation pressures arising from volatility in the commodities markets. To achieve this, we are investing in short-term inflation-
linked securities, as they carry a relatively high correlation to energy prices. In addition, we are rotating into sectors and securities that are expected to weather a rise in interest rates. If we see a pickup in economic growth, diminishing sluggishness and significant improvement in the labor market, these allocations may change commensurate with the environment and policymakers’ responses. But for now, apart from certain types of goods such as food and energy, inflation is not today’s problem, and whether it will pose a challenge in the future remains to be seen.
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