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The Bond Market's Inflation Gauge Just Rose Above 2% for the First Time Since 2018

By Alexandra Scaggs Jan. 4, 2021 1:52 pm ET

Dreamstime

For the first time since 2018, bond prices signaled Monday that investors see inflation averaging around 2% over the next decade.

The 10-year break-even inflation rate—the gap between yields on the 10-year Treasury note and comparable Treasury inflation-protected securities—briefly climbed above 2% on Monday morning, Bloomberg data show. The rate indicates that investors in Treasuries want to be compensated for potential inflation around 2% over the next decade. Benchmark 10-year Treasury yields climbed to 0.93% on Monday, even as the S&P 500 slid nearly 2%.

While the bond-market inflation gauge has been climbing for a while, the last time it closed above 2% was in November 2018, according to Federal Reserve data. That shows that investors expect a persistent recovery in inflation as U.S. economic growth rebounds from its steep Covid-19 slowdown.

"The prospect of large shares of some economies' populations being vaccinated in the first half of 2021, supporting a return to some degree of normality, has stoked renewed concerns that inflation could pickup sharply this year," Ben May, Oxford Economics director of global macro research, wrote in a note on Monday.

Investors' main concern about inflation is that it could undermine returns in such safe fixed-income markets as Treasuries and high-grade corporate bonds. In conversation published in a recent year-ahead note, portfolio managers at Neuberger Berman discussed the possibility of inflation and the likelihood of low U.S. interest rates persisting.

"The hunt for yield and depressed spreads will likely be a dominant theme in fixed income for yet another year," said Brad Tank, chief investment office for fixed-income strategies.

"If the expected returns from traditional assets look unpromising... investors are likely to continue to seek out nontraditional strategies," said Erik Knutzen, chief investment officer of the firm's multi-asset class strategies. "That could cover commodities, specifically industrial metals as a potential hedge against inflation and precious metals as a hedge against fiat currency devaluation," along with other nontraditional strategies, he said.

But less than a year after a record-setting investor race into haven markets and cash, the dimmer appeal of safe markets is arguably a positive for central bankers.

And the money-management firm doesn't expect a "substantial" pickup in inflation until 2022.

"Our thesis is pretty simple: inflation is not an issue for the next six months, but people are likely to be talking about it a lot from the middle of next year," Tank said.

Oxford Economics argues that even next year's discussions could be too alarmist. In his note, May says that the economic drivers of inflation aren't signaling a persistent increase any time soon.

First, he wrote, global authorities' unprecedented stimulus efforts have been appropriate given the scale of the downturn. Second, May doesn't see much evidence that global fiscal authorities are pursuing overly aggressive stimulus policies. Third, employment hasn't recovered to levels that would overheat the economy and cause prices to spiral higher. And finally, unless new restrictions go into place, vaccines probably won't be distributed quickly enough that demand for travel and services rises much faster than supply, he wrote.

Consumer prices could appear to rise quickly in the second quarter of 2021, May argued—but only because prices will be compared with the lockdowns and steep decline in travel that occurred in the second quarter of 2020.

"We expect the jump will be temporary and nothing to lose sleep over," he wrote.

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