



UNITED STATES

Towards a rebound in market-based inflation expectations?

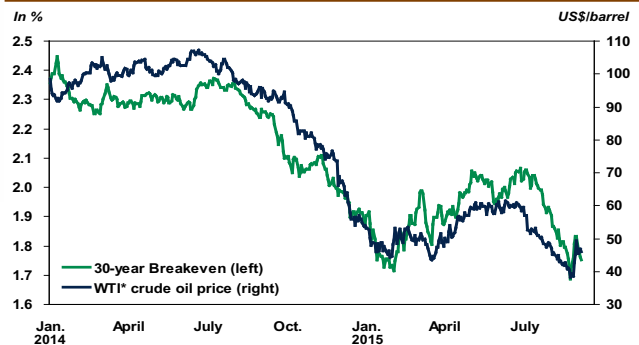
The difference between yields on nominal bonds and those on inflation-protected bonds (breakeven rate) is a commonly-used measure of inflation expectations. In the United States, according to this measure, markets expect an inflation rate of 0.3% over the next 2 years. Over the next 5 years, inflation of merely 1.2% is expected. Even over the next thirty years, investors appear to believe that a rate of only 1.8% will be maintained. In each case, expectations diverge significantly from recent averages. For example, over the 30-year horizon of 30 years, inflation expectations had maintained an average of 2.4% from the beginning of 2011 until mid-2014.

What inspires markets to adopt such a different perspective? It seems the price of oil is the culprit. Indeed, the sensitivity of inflation expectation measures to contemporaneous inflation is a phenomenon that has long been observed, especially at shorter maturities. Since most of the movement in realized inflation has been the result of lower oil prices, a significant decrease in short-term breakeven rates has been observed, in synchronicity with the tumble in energy prices. Although the somewhat more surprising development has been the weakening of longer-term inflation expectations. The 30-year breakeven's recent precipitous decline has been remarkably correlated with the oil price slide.

The Federal Reserve (Fed) has taken notice of these trends but has downplayed them somewhat. Indeed, other gauges of inflation expectations, notably those based on household surveys and those from professional forecasters, indicate no significant deviation from levels of recent years. For example, the monthly survey conducted by the University of Michigan indicates that consumers expect an inflation rate of 2.9% over the next year¹. Private sector forecasters surveyed by the Fed of Philadelphia at the beginning of August were more moderate but still looked for rises in

¹ Note that inflation expectations from this survey are typically elevated relative to observed inflation.

Oil prices have had a significant bearing on long-term inflation expectations



* West Texas Intermediate.
Sources: Bloomberg and Desjardins, Economic Studies

the consumer price index (CPI) in the magnitude of 2.1% in 2016, and 2.3% in 2017. There is little reason to believe that investors inherently expect longer-term inflation to remain as low. Some Fed research has pointed at lower inflation risk premiums to explain the fall in breakeven rates. The inflation risk premium exhibits a tendency to react to current inflation. Thus, this would appear to be the channel through which oil prices affect market-based inflation expectations.

Implications: As measured by the CPI, inflation remains close to zero but we expect it to converge towards the Fed's 2% target at the turn of the year, consistent with a diminishing drag from the fall in energy prices on year-over-year CPI growth calculations. With realized inflation soon returning to more normal levels, the inflation risk premium may normalize, with an upside effect on bond yields, especially those at longer maturities.

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