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Economics

US Economic Perspectives

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Markets sense the inflation "clock is running"

- Almost a year ago, Chair Powell warned that "The clock is kind of running on how long will you remain in a low-inflation regime." Since then, despite persistent elevated inflation, various measures of long-run inflation expectations have generally believed the Fed's commitment to returning price stability was credible. Chief among those metrics were market measures of long-run inflation compensation, at least up until recently.
- Over the past week or so, 5y5y breakevens and inflation swaps have risen, particularly relative to the levels implied by fundamental drivers like oil prices. Our models show the highest positive residuals for these market gauges versus oil – consistent with an inflation premium embedded in the former – in quite some time. Indeed, 5y5y inflation swaps are the furthest above levels implied by oil since 2017.
- Time will tell if this recent relationship is sustained. If it is, it will be a worrying development for the Fed, which has undertaken an aggressive tightening campaign to maintain inflation fighting credibility but had since been positioning to at least skip a rate hike at the June meeting. Along with other key data releases pointing to resilience in the economy, the movements in inflation expectations raise questions about whether a pause would be prudent.

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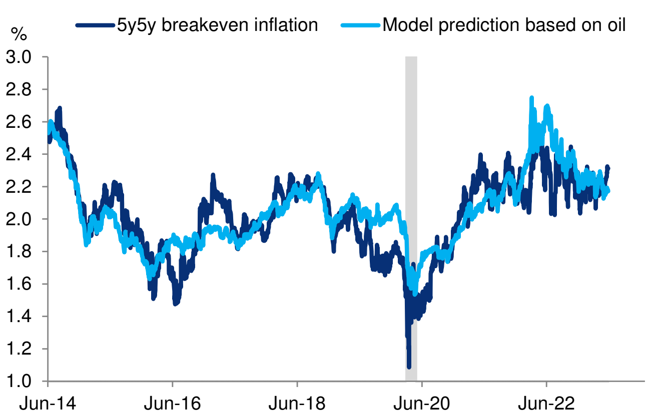
Long-run market inflation expectations losing faith

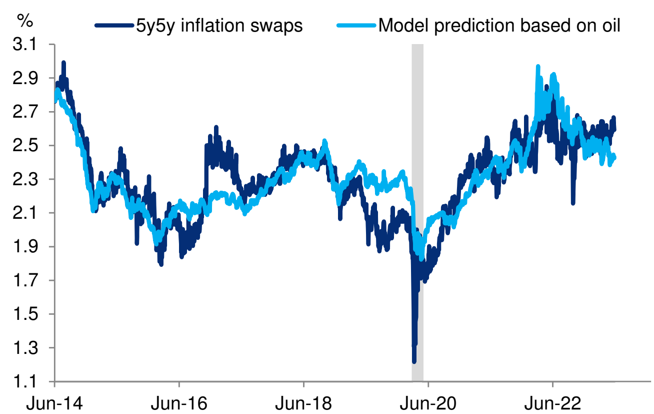
Since the oil price collapse in 2014 we have highlighted the surprisingly high correlation between spot oil prices and long-term market-based measures of inflation expectations. Over this time, Brent oil prices have been about 75-80% contemporaneously correlated with 5y5y breakevens and inflation swaps, a much higher co-movement than prevailed prior to the oil shock. This newly formed relationship has served as one fundamental – albeit simplistic – gauge of where 5y5y breakevens and inflation swaps should be (Figures 1 and 2). Material divergences between the relationship in the past five years have coincided with clear drivers, like the rise in inflation expectations relative to oil following the 2016 election as the Trump reflation trade took hold.

Figure 1: 5y5y breakevens have risen relative to oil



Source : Bloomberg Finance LP, Deutsche Bank

Figure 2: Same for 5y5y inflation swaps



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Prior to and during the early parts of the pandemic, measures of long-run inflation expectations were generally below levels implied by oil prices. That relationship flipped with the results of the 2020 elections which ushered in a period of substantial fiscal stimulus. Following that temporary rise, however, long-run inflation expectations were consistently below levels implied by oil prices, even as actual inflation continued to print at elevated levels throughout 2021 and 2022. Over this period, the Fed appeared to have substantial credibility with the market that they were committed to do what it takes to get inflation back to target over time. No doubt the historically aggressive tightening cycle, including four consecutive 75bps rate increases, played a critical role in earning this support.

More recently, however, market measures of long-run inflation expectations have hit new highs, even as oil prices have remained subdued. Just last week, 5y5y breakevens and inflation swaps both reached the highest levels since last October / November, even though Brent oil prices are about $20 / barrel below the levels that prevailed at that time.

The residuals from a simple linear regression model of long-run inflation expectations on oil prices demonstrates the extent of the current disconnect. Over the past week, 5y5y breakeven and inflation swap residuals relative to oil hit high levels of 17bp and 24bps, respectively. The former is the highest since August 2021, while the latter is the highest in six years.

Figure 3: Model residual suggests 5y5y breakevens well above level implied by oil prices

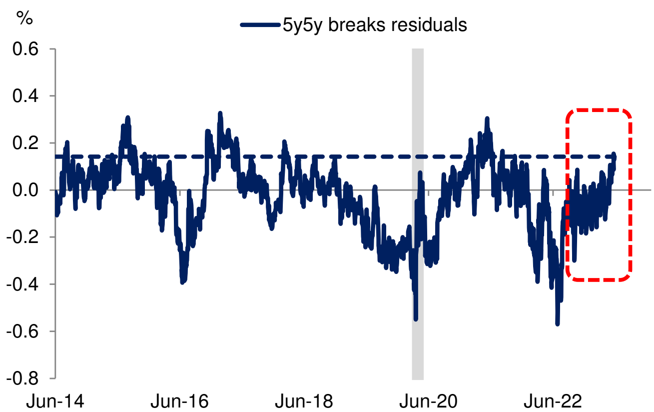

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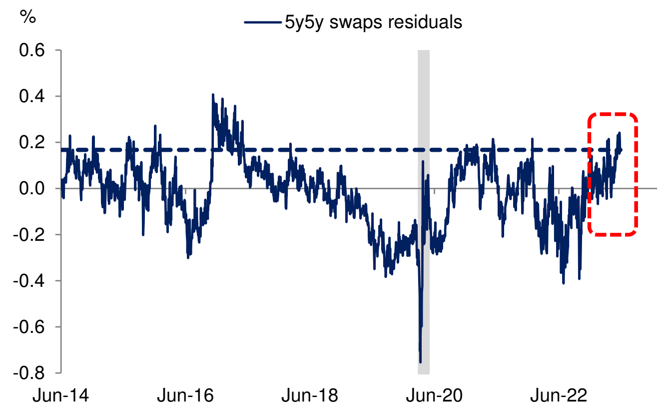
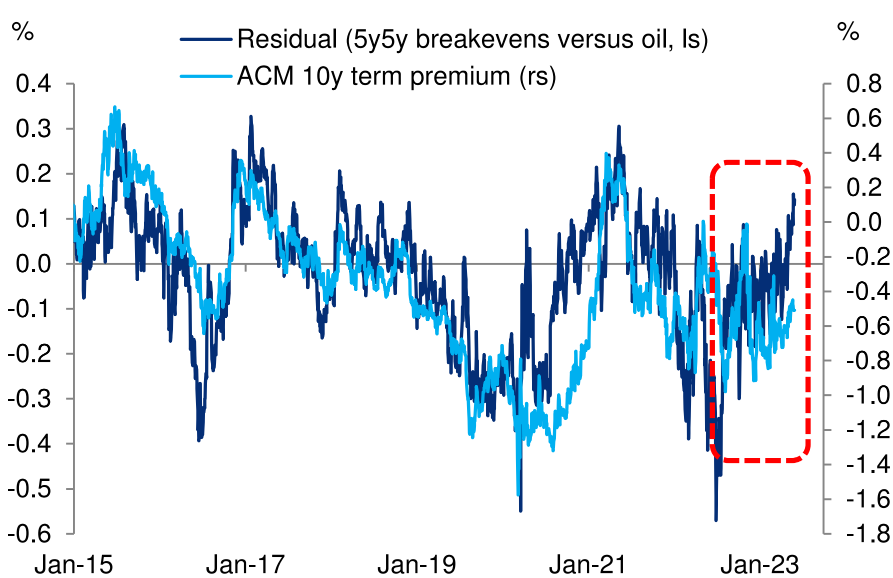
Figure 4: Disconnect between oil and 5y5y inflation swaps is a bit more extreme



Source : Bloomberg Finance LP, Deutsche Bank

In the past, we have found that measures of nominal term premia have often been able to explain the residual of long-term inflation expectations versus oil. When that is the case, we interpreted the movements in market measures of inflation compensation as reflecting changes in risk premia rather than a pure read on inflation expectations. However, this close co-movement has not been present recently. 10-year term premia have remained relatively subdued even as the residuals between inflation compensation and oil have spiked to higher levels. We interpret these developments as signaling a true rise in inflation expectations.

Figure 5: The rise in the breakevens residual not driven by term premium



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Time will tell if this new relationship between oil and long-run measures of market inflation compensation is sustained. If it is, it will be a worrying development for the Fed, which has undertaken an aggressive tightening campaign to maintain inflation fighting credibility but had since been positioning to at least skip a rate hike at the June meeting. Along with other key data releases, the movements in inflation expectations raise questions about whether such a decision would be prudent.

Avik Chattopadhyay is an employee of Acuity Knowledge Partners, a third-party research service provider to Deutsche Bank.

Appendix 1

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