Breakeven Inflation Rates: What’s Beyond the Post Election Bump?
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QUICK TAKE

- We believe the current wider breakeven inflation rates between TIPS (U.S. Treasury Inflation-Protected Securities) and nominal Treasuries reflect expectations for rising inflation under President-elect Trump’s policy agenda. The market reaction supports our thesis that the low breakevens in 2014–2015 reflected low inflation expectations (and not heightened concerns about illiquidity, as some Federal Reserve officials stated).
- A move toward more expansionary U.S. fiscal policy could help keep interest rates away from the zero bound and ease the burden on monetary policy, allowing it to be more effective in the future.
- It remains to be seen whether productivity will increase, especially if protectionist trade policies disrupt the supply chain.
- With unemployment at 5%, there is little spare labor market capacity. This means Trump’s expected policies may have a larger impact on inflation than on real growth.
- We’d expect such an environment to be supportive of TIPS in particular and real assets in general.

The response of inflation-related markets to U.S. President-elect Donald Trump’s potential (if still murky) policy agenda has been dramatic. Breakeven inflation rates (the spread between Treasury Inflation-Protected Securities (TIPS) and nominal Treasuries of equivalent maturities) have risen significantly since Election Day on 8 November.

In our view, the move mostly reflects a sudden rise in the probability of higher inflationary macroeconomic outcomes. We believe the market’s reaction supports our previous assertion that low breakeven inflation rates in 2014–2015 were driven by shifting inflation expectations – and not an increase in the relative liquidity of TIPS, as some Federal Reserve officials have stated.

Overall, we agree with the market-implied view of Trump’s policies: specifically, that fiscal expansion at a point in the business cycle when labor market slack is relatively low, coupled with immigration policies that could slow labor force growth, is a recipe for higher inflation. Of course, we believe the Fed will ultimately push back against any significant and persistent overshoot of its 2% inflation target. Still, these policies plus increasing questions about central bank independence under a Trump
presidency and some potential for a disruptive trade war suggest a bias toward higher inflation among the distribution of possible outcomes, in our view.

**Markets are not fully discounting higher inflationary outcomes**

Expectations are critical: For example, we believe the historically low TIPS breakeven inflation rates in 2014–2015 were mostly a consequence of a change in the distribution of expected inflationary outcomes. The declines in long-term inflation compensation in 2014 and 2015, as measured by five-year forward, five-year breakeven rates, coincided with falling nominal yields and declines in the market-implied probability of materially higher inflation (see charts 1 and 2).

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**Chart 1: Five-year Fed inflation expectations dropped in 2014-2015**

[Graph showing the drop in Fed 5y5y inflation expectations from 2005 to 2015, with a steady decline from 2014 to 2015 and a Fed target line at 2.5%.

Source: Bloomberg and Federal Reserve as of 31 October 2016]
Survey-based measures of the distribution of longer-term inflation expectations realized similar shifts: The University of Michigan survey of five- to 10-year forward inflation expectations recorded a 1 percentage point (ppt) decline in inflation expectations for individuals who were previously expecting the highest inflationary outcomes (see chart 3). This led us to the simple yet elegant conclusion that the explanation for the U.S. inflation market’s behavior was a decline in the short- and long-term probability that realized inflation would overshoot the Fed’s 2% target.
The 2014–2015 collapse in TIPS breakevens also coincided with a prolonged period of elevation of the output gap and choppy real growth in the wake of the 2008 financial crisis. We believe these factors, coupled with the more recent commodity price shock and glaring economic imbalances from Asian trading partners, raised questions about the Fed’s ability to reach its inflation target.

Things began to turn around in 2016, when easy monetary policy finally appeared on track to address labor market slack and deliver some promised realized inflation. Nominal wages were beginning to gradually accelerate, and as the previous commodity shocks faded, realized inflation (and the so-called Phillips curve) started to normalize (see chart 4). Not surprisingly, TIPS breakevens also began to rise off a very low base, and the Fed was preparing to re-engage in a slow but welcome normalization of interest rates.

Then came Donald Trump (and a Republican sweep of Congress), with a policy agenda that has the ability to supercharge inflation markets.
Trump’s expected policies raise the probability of higher inflationary outcomes

Trump’s fiscal and immigration policies are likely to boost the near-term inflation trajectory, in our view.

Proposals for fiscal stimulus amounting to 2%–3% of GDP through a mix of tax cuts and infrastructure spending, if enacted, could boost aggregate demand by 0.3-0.5 ppts on average in the years after implementation. Such stimulus would come at a time when labor markets are very close to potential and could thus result in a somewhat faster acceleration of wage inflation than we would otherwise expect.

Trump’s immigration policies, as currently envisioned, could further accelerate wage pressures by shrinking the U.S. population by 2 million–3 million through deportations of illegal immigrants. These policies could also tighten labor markets by reducing inflows of legal potential workers.
Although the impact Trump’s trade policies may have on real growth is somewhat less clear, we view policies that restrict trade as broadly inflationary. If Trump follows through on expanding import tariffs, U.S. consumers will likely see an increase in the price levels of a range of goods. Meanwhile, if foreign governments place retaliatory tariffs on U.S. goods, the resulting supply chain disruptions could send prices soaring.

Plusses and minuses of higher inflation

From a longer-term perspective, one unambiguous benefit of a shift toward fiscal and away from monetary policy is that it could reduce the odds that the Fed will hit the zero lower interest rate bound in the future. We calculate that accelerating realized inflation and a declining output gap would allow the Fed to hike interest rates several more times over the next several years than it otherwise could. In the medium term, this should reduce the probability of deflationary outcomes, as the Fed would have more room to maneuver in the face of adverse economic shocks.

In addition, a growing amount of literature suggests that a “high pressure” economy could actually repair lingering supply-side damage from the crisis and raise trend growth rates. Higher trend growth rates could also allow the Fed to hike more aggressively, further reducing the probability of longer-term deflationary outcomes resulting from monetary policy exhaustion at the zero lower bound.

The bottom line for growth? We are not convinced that Trump’s specific mix of policies is better suited to boost trend growth than another policy mix that includes fiscal expansion. We believe Trump’s immigration and trade policies could be detrimental to productivity, while the impact of his fiscal policies would be broadly similar to (but perhaps no better than) any number of other reflationary policy mixes that would reduce pressure on the Fed.

TIPS breakevens have room to widen

We think the market reaction since the election is justified, and we see room for a further rise in TIPS breakevens as actual policies roll out (see chart 5). The launch of fiscal stimulus when we are already well into the second half of a business cycle, coupled with an aggressive immigration policy and restrictive trade, should accelerate core inflation and boost the probability of higher inflationary outcomes.

We view this environment as potentially fertile ground for inflation-sensitive assets. Now more than ever, we believe real assets in general and TIPS in particular are an important allocation to a diversified portfolio.
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