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Inflation, Anchoring and Inflation-Linked Bonds

Summary

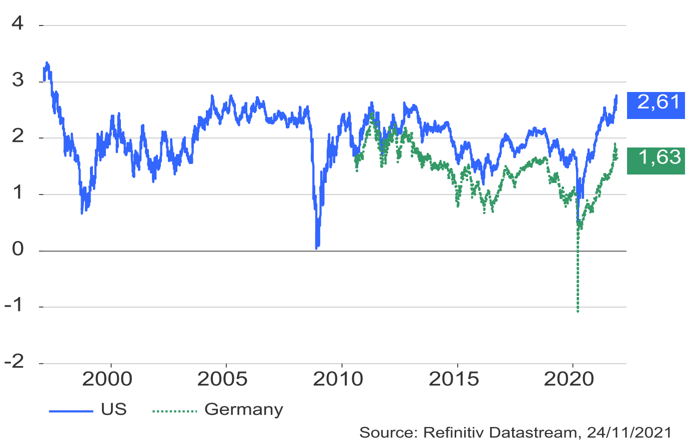
- Inflation and expected inflation are high in the United States and, to a lesser extent, in the euro area.
- While some economists have been warning for months, central bankers are relatively calm.
- Inflation expectations remain fairly well anchored and are not at extreme levels when adjusted for inflation risk premium and liquidity premium. Inflation is expected to remain high but to decelerate in mid-2022.
- Demand for inflation-linked bonds should remain strong due to the ongoing risk, especially in the US.
- However, we have a neutral view on eurozone and US inflation-linked bonds as their upside potential appears limited.

Up and up

Inflation is climbing and becoming more widespread. Furthermore, inflation expectations (measured by opinion polls or market prices, by households or financial professionals) are going up too.

Central bankers are scrutinising these inflation expectations given that a change in perception of inflation can lead to shifts in behaviour. For example, if households anticipate price increases, they will put more pressure on their employers to obtain a raise in salary. And if companies expect price increases, they will hike their prices to cover their costs. So potentially there is a self-fulfilling aspect to this phenomenon.

10-YEAR AVERAGE ANNUAL INFLATION DERIVED FROM MARKET PRICES



Source: BNP Paribas Wealth Management

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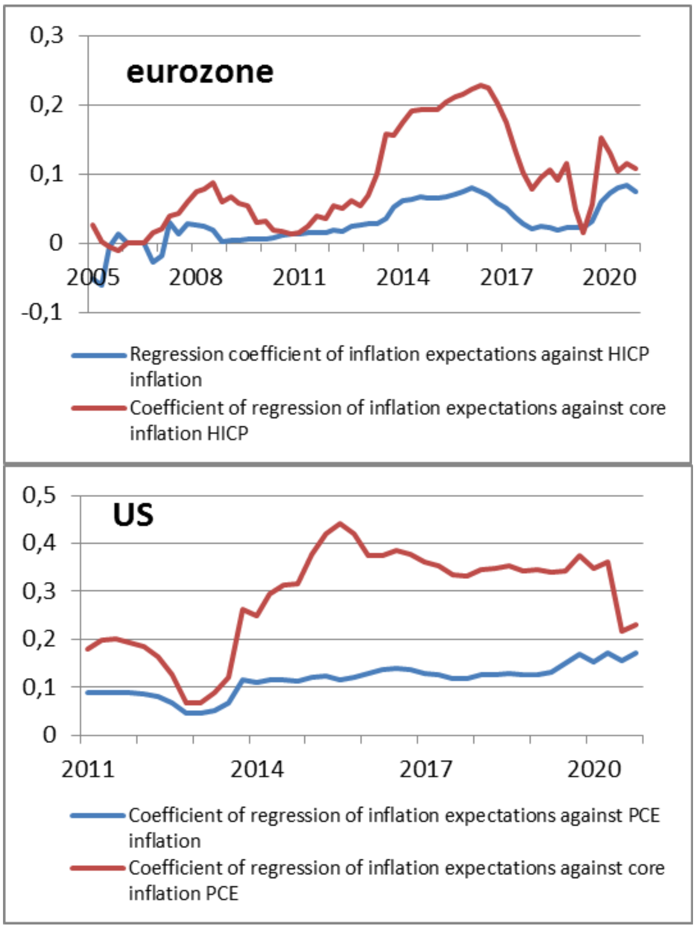
Anchoring

One way to measure this is to assess the extent to which inflation expectations are anchored, i.e. the extent to which inflation expectations react to short-term news. The European Central Bank has a methodology that consists in calculating the 5-year regression coefficient for 5-year inflation forecasts made by financial professionals against realised inflation. Thus, a high coefficient indicates that realised inflation powerfully influences inflation expectations, and thus, the anchoring of inflation expectations is low.

INFLATION EXPECTATIONS ARE FAIRLY WELL ANCHORED IN THE EUROZONE AND IN THE US



Source : BNP Paribas Wealth Management

The charts show that inflation expectations are still fairly well anchored, both in the eurozone and in the United States, thereby explaining the relative serenity of central bankers (resolve not to raise key rates for the moment) while some economists have been warning for several months.

In addition, central bankers are closely monitoring the inflation expectations derived from market prices. For example, the 10-year breakeven inflation rate (calculated as the difference between the yield on a 10-year nominal bond and the real yield on an indexed bond of the same maturity) has increased considerably since March 2020. It shows that the markets expect more inflation on average over the next 10 years, i.e. 2.6% in the US and 1.6% in the eurozone.

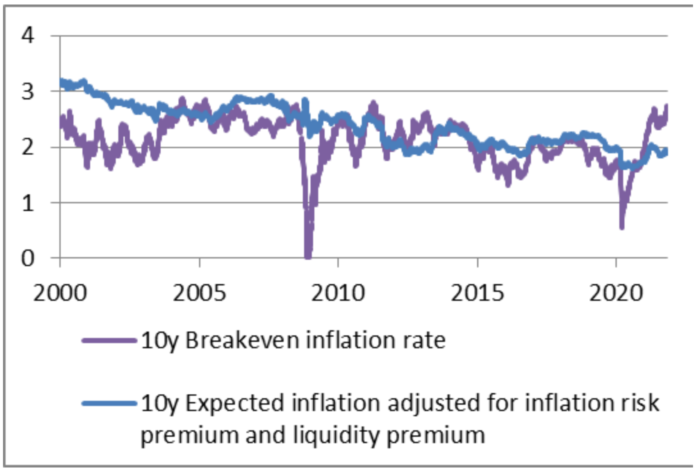
However, this measure is distorted by other factors and, in fact, it does not accurately predict actual future inflation. Indeed, breakeven inflation is not a direct measure of inflation expectations because it has three components: i) expected inflation, ii) inflation risk premium and iii) liquidity premium.

The inflation risk premium reflects the additional remuneration that an investor demands as compensation for the volatility of inflation, for example.

The liquidity premium is linked to the fact that inflation-linked bonds are less numerous and less liquid than nominal bonds, more or less 5 times less liquid, judging by the spread between the buying and selling prices of these two assets over the last 10 years.

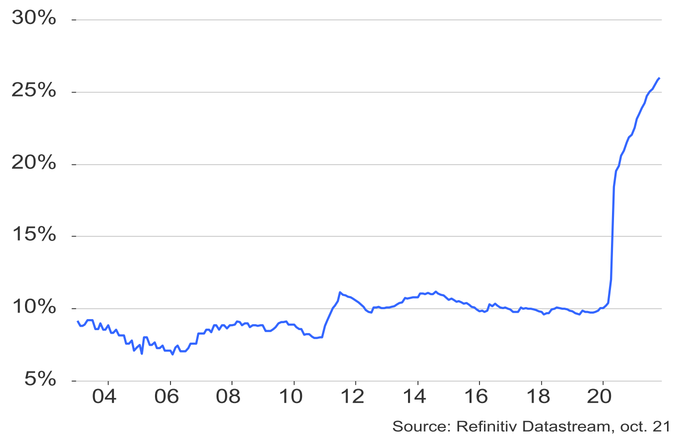
The "expected inflation" component is therefore a more accurate reading of the level of inflation anticipated by the markets. According to the Fed's DKW model, with reference to the works of Stefania D'Amico, Don H. Kim, and Min Wei, 2018, “Tips from TIPS: The Informational Content of Treasury Inflation-Protected Security Prices”, the average expected 10-year inflation was not 2.65% as at 29/10/2021, but rather 1.90% when adjusted for inflation risk and liquidity premia.

THE EXPECTED INFLATION ADJUSTED FOR INFLATION RISK PREMIUM AND LIQUIDITY PREMIUM IS CLOSE TO 2% IN THE US



Source : Fed, BNP Paribas Wealth Management

THE FED ACCOUNTS FOR 26% OF THE TIPS MARKET



Source : BNP Paribas Wealth Management

Inflation-linked bonds

Inflation-linked bonds are the best-performing asset class in the bond universe, with a performance of +6.1% in the eurozone and +5.3% in the United States since the beginning of the year.

Massive amounts of liquidity flowed into these asset classes as investors sought to protect themselves against the risk of inflation. Central banks also massively bought these assets as part of their monetary easing programmes during the health crisis. The Fed, in particular, has disproportionately purchased US inflation-linked bonds (TIPS), which may have led to price distortions, as trade is usually relatively low in this market. The Fed now accounts for 26% of the TIPS market, doubling its share in the space of a year.

Demand for inflation-linked bonds remains strong, as evidenced by the last 10-year US Treasury inflation-linked issue in mid-November. The latter was very successful, especially among foreign investors. Investor attraction to inflation-linked bonds should continue in the coming months as inflation and inflation expectations are likely to remain high, especially in the US, where wages are climbing.

The risk is that real rates will rise as inflation-linked bond prices fall when real rates rise. The risk certainly exists because real rates have fallen to an all-time low on both sides of the Atlantic. In addition, real rates generally recover after a crisis, to keep pace with the economy's new real growth potential. In the United States in particular, the phasing out of the Fed's asset purchases should allow real rates to rise, or at least not sink to fresh lows. Historically, US real rates have risen when the Fed has announced the end of its asset purchases, such as in 2013 ("taper tantrum") and in periods when it has hiked its policy rates. We expect the Fed to make its first rate in mid-2022.

In view of this risk, we prefer to keep a neutral recommendation on eurozone and US inflation-linked bonds, especially as they are already relatively expensive.

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