

SHOULD THE BOND MARKET EXPECT THE UNEXPECTED?

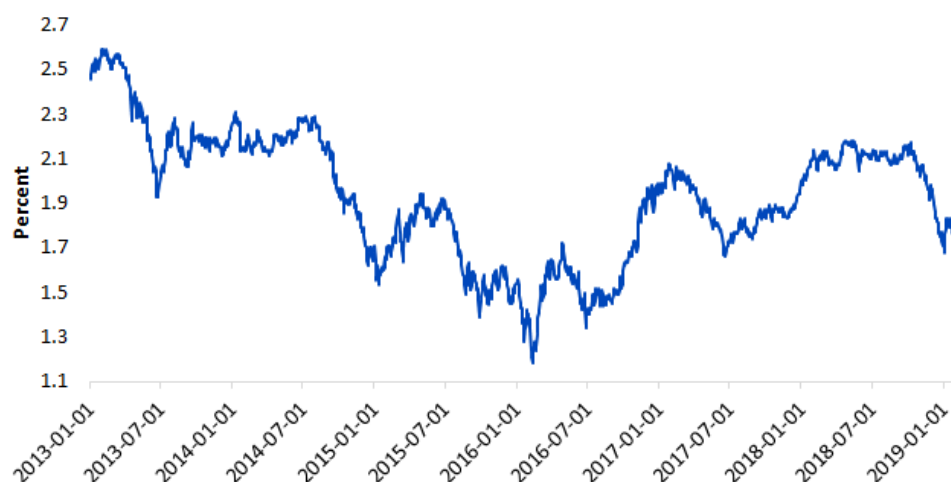
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Quick question: What typical bond market catalyst has received scant attention of late? Obviously, it's not [Federal Reserve \(Fed\)](#) policy, nor is it some of the latest softer-than-expected U.S. economic data, such as retail sales and industrial production. Give up? How about [inflation](#)? While the most recent report on the [Consumer Price Index \(CPI\)](#) was not headline-grabbing, I'm going to pose the following question: Should the bond market expect the unexpected?

CPI is the most closely watched inflation measure on a broader basis. Certainly, the overall number will grab the limelight, but the Fed and the fixed income arena gravitate more toward the core rate, or CPI excluding food and energy. I know we all have to eat and heat or air condition our homes, not to mention put gasoline into our cars, but food and energy prices can be [volatile](#) and affected by other forces that are not really related to the economy, such as weather. Against this backdrop, the preferred gauge to measure underlying demand pressures is core CPI, which will be the topic of this blog post.

10-Year Breakeven Inflation Rate



Source: Bloomberg, as of 2/15/19.

For the record, the government agency that produces the CPI report, the Bureau of Labor Statistics, was open for business during last month's shutdown, so the data-gathering process was essentially business as usual. In January, core CPI rose +0.2%, or +2.2% on an annualized basis. Interestingly, both overall CPI and CPI minus the food and energy component hit their recent peaks in July of last year—+2.9% and +2.4%, respectively—but due to a plunge in gasoline prices, the headline figure has seen its year-over-year reading drop to +1.6%, while the core reading has held up reasonably well, coming in at +2.2% the last three months.

What could the future hold? As the accompanying graph highlights, market expectations are not looking for any uptick in

inflation pressures. The 10-year breakeven inflation rate measures the difference between the [yield](#) on a nominal bond ([U. S. Treasury 10-Year note](#)) and an inflation-linked or real yield bond with the same [maturity](#) ([10-Year Treasury Inflation-Protected Securities, or TIPS](#)). This [spread](#) reflects the markets expected inflation rate—a wide spread equates to a market expectation of higher inflation, and vice versa. As you can see, expectations sunk into early this year in response to the [risk-off](#) trade and have bounced a bit over the last month, but the level is still well below where it resided in early October.

Conclusion

If core CPI manages to continue registering gains in the area of +0.2% on a monthly basis going forward, the year-over-year reading has the potential to move back up toward the aforementioned peak of +2.4%. In fact, over the last three months, the annualized reading has crept up over the +2.5% threshold. While I'm certainly not going to invoke the "inflation boogeyman," one has to wonder if the bond market has become too complacent on this front.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Inflation : Characterized by rising price levels.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

U.S. 10 Year Treasury Note : A debt obligation issued by the United States government that matures in 10 years.

Maturity : The amount of time until a loan is repaid.

Treasury Inflation-Protected Securities (TIPS) : Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.