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08/03/2016

The last month or so has certainly given the money and bond markets a lot of divergent news headlines to digest. Not surprisingly, the focus has been on negative rates abroad, geopolitical events and, a bit more recently, some better-than-expected employment news juxtaposed with a softer-than-expected GDP report. That begs the question: What about inflation? Isn't that a key ingredient in the bond market mix? Without a doubt, U.S. inflation data has taken a backseat for fixed income investors, and for good reason; there just haven't been any fresh developments lately. Certainly, the conversation has shifted from a year ago, when deflation concerns were permeating market psychology. But the latest figures don't elicit concerns that price pressures will be rearing their ugly head anytime soon, or at least that's what the collective thinking is in the fixed income markets.

Breakeven Inflation Rate

Source: Bloomberg, as of 7/22/2016.

So, what does the inflation backdrop look like? According to the widely followed Consumer Price Index (CPI), the year-over-year inflation rate came in at +1.0% in June[1]—very little changed from the readings posted over the last four months, but definitely higher than the +0.1% for the same month in 2015. The core gauge, which excludes food and energy, rose at a +2.3% annual clip and has been residing in a range last seen in 2012. There continues to be a large dichotomy between core goods (-0.6%) and core services (+3.2%).[2] As part of its dual mandate, the Federal Reserve (Fed) addresses inflation trends and its outlook in its FOMC meeting policy statements as well as focusing on expectations. In fact, inflation expectations play a pivotal role in the voting members' deliberative process, because once a certain sentiment becomes embedded, it can become difficult to reverse. A primary way to gauge these expectations lies in what is known as "breakeven inflation rate." This measure is the difference between the yield on a nominal bond (such as the U.S.Treasury 10-Year note) and an inflation-linked or real yield bond with the same maturity (such as the 10-Year U.S. Treasury Inflation-Protected Securities, or TIPS). This difference, or spread, is viewed as representing the expected rate of inflation. Utilizing our graph as a guide, the breakeven rate between

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the UST 10-Year yield (1.55%) and the UST 10-Year TIPS (0.05%) is 1.50%, not too far removed from the five-year low of 1.20% posted during this year's peak "risk-off period," and considerably below the high point of 2.64% registered in September 2012. In other words, expectations are for an inflation rate of roughly 1.5%, another factor that not only provides the Fed with no urgency to raise rates but also gives it time to continue to "closely monitor … global economic and financial developments."[3] **Conclusion** Looking ahead, it seems more than likely that increasing price pressures are not building on the horizon. The effects of the prior strength in the U.S. dollar tend to lag and could continue to pass through and act as a drag on inflation. General economic slowing abroad, especially in China, may also weigh on prices in the goods sector. The Fed's preferred gauge, the core PCE price index, has been running at a +1.6%[4] annual rate the prior four months and does not look poised to hit the policy makers' +2% threshold in 2016. [1]Source: Bureau of Labor Statistics, as of 7/15/2016. [2]Source: Bureau of Labor Statistics, as of 7/15/2016.[3]Source: Federal Reserve as of 7/27/2016.[4]Bureau of Economic Analysis as of 8/2/2016.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

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Inflation : Characterized by rising price levels.

Deflation : The opposite of inflation, characterized by falling 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.

Annual Clip : Annual Rate.

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

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

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 repai.

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.

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.