An Inflationary Mulligan Stew

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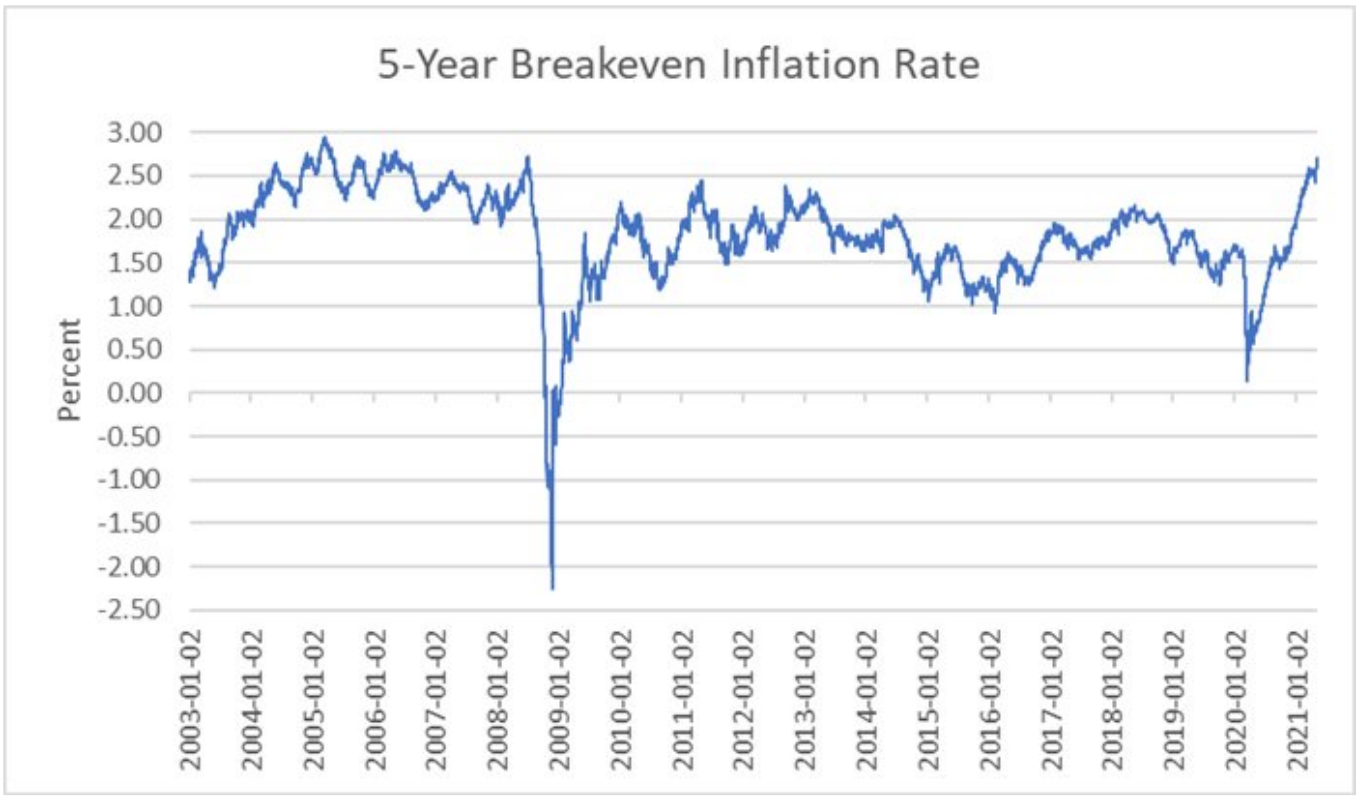
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Treasury Secretary Janet Yellen seemed to forget for a moment that she was in a new role, one that does not set monetary policy. Against that backdrop, let's just say Secretary Yellen got her first mulligan[1].

As a reminder, Yellen said that "it may be that interest rates will have to rise somewhat to make sure our economy doesn't overheat"[2], but quickly pivoted away from that statement later on. The premise of Secretary Yellen's initial comment came from being asked if the current, and proposed, spending from the Biden Administration could create a setting where inflation may need to be reined in.

There is no question the inflation debate is currently gaining momentum in the markets, specifically the fixed income arena. Is inflation looming on the horizon, and will any potential increase prove to be 'transitory' as the Federal Reserve (the Fed) believes, or will it be more sustainable? At this stage, there appears to be four undeniable factors that should push inflation higher in the months ahead:

- Base effects, i.e. year-over-year readings will be compared to very low readings from 2020
- Higher commodity prices
- Disruptions in supply chains and low inventories
- Pent-up demand from Covid-related reopening's



Source: St. Louis Fed, as of 5/7/2021

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So, who is right in this inflation debate? I like to take my cues from the bond market, and as you can see, inflation expectations have been on a rather visible ascending trajectory. Looking at Treasury 5-year breakeven spreads, the latest reading of roughly 2.70% has now gone back into a territory that is rarely visited…in other words between 2.50% to 3.00% In fact, as of writing this, the last time the breakeven rate was this high you have to go back to the pre-financial crisis days of 2006.

[1] Mulligan is a golf term for: getting an extra stroke after a poor shot but it's not counted. The broader meaning is one getting a 'do-over'.

[2] Source: CNBC as of 4 May 2021

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