

PERSPECTIVES

Light at the End of the Inflation Tunnel?

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At some point over the past year, the financial media's inflation coverage transitioned from, "Will this high inflation persist?" to, "Here's how to cope with inflation that's here to stay!" It seems some investors have resigned themselves to a new normal of high inflation following decades of below-average consumer price changes. However, financial market data tells a different story, one of potentially softening inflation.

Breakeven inflation (BEI) rates offer a window into the market's inflation expectations. Defined as the difference between yields on nominal and inflation-protected bonds of the same maturity, BEI represents the inflation rate at which investors would be indifferent between the two. If actual inflation were to exceed BEI rates, investors would be better off with the inflation-protected bond; if inflation were less than BEI, the reverse would be true. BEI is therefore commonly interpreted as the average annual inflation rate expected over a given time horizon.¹

The one-year BEI shows a spike in inflation expectations this year following increasingly high consumer price index (CPI) changes. But the trajectory appears to have changed course over the past couple months (see **Exhibit 1**). Since peaking at 6.3% in late March, the one-year BEI had fallen to 5.2% as of June 10. This might be the market's way of telling us it sees inflation getting under control in the near future.

Exhibit 1**Brighter Horizons**

1-year breakeven inflation rate, January 1, 2021–June 10, 2022



Source: Dimensional, using data from Bloomberg.

It is important to remember that realized inflation can diverge from expectations. For example, the one-year BEI rate as of May 3, 2021, was just 2.7%. Over the next 12 months, CPI grew by 8.3%, meaning a substantial portion of this inflation seemed to have been unexpected by the market. From January 2007 to April 2022, the difference between actual inflation and that “predicted” by BEI varied from –5.59 to 8.43 percentage points.²

While nominal (i.e., not inflation-protected) bond prices reflect expected inflation, investors who opt for Treasury Inflation-Protected Securities (TIPS) or approaches that overlay inflation swaps (“real return” bond strategies) get compensated for actual inflation. Investors who want to reduce uncertainty in the event of higher-than-expected inflation may benefit from these inflation-hedging approaches.

Consumer price index (CPI): A measure of inflation that looks at changes in the price level of a basket of goods and services purchased by households.

Treasury Inflation-Protected Securities (TIPS): Bonds issued by the US Treasury Department that 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, the investor is paid the adjusted principal or original principal, whichever is greater.

Inflation swaps: An inflation-swap agreement is a two-sided contract in which one party receives floating payments tied to the actual inflation rate and pays fixed payments based on expected inflation and the inflation risk premium for a given notional amount and period.

Nominal return: The rate of return on an investment without adjusting for inflation.

Real return: The rate of return on an investment after adjusting for inflation.

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1. More accurately, the difference in yields between nominal and inflation-protected bonds represents both expected inflation and an inflation risk premium borne by holders of nominal bonds.
 2. Based on monthly differences between one-year BEI and subsequent 12-month change in CPI for the period January 1, 2007, through April 30, 2022. CPI data from Bureau of Labor Statistics and is represented by the Consumer Price Index for All Urban Consumer (CPI-U), not seasonally adjusted.

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