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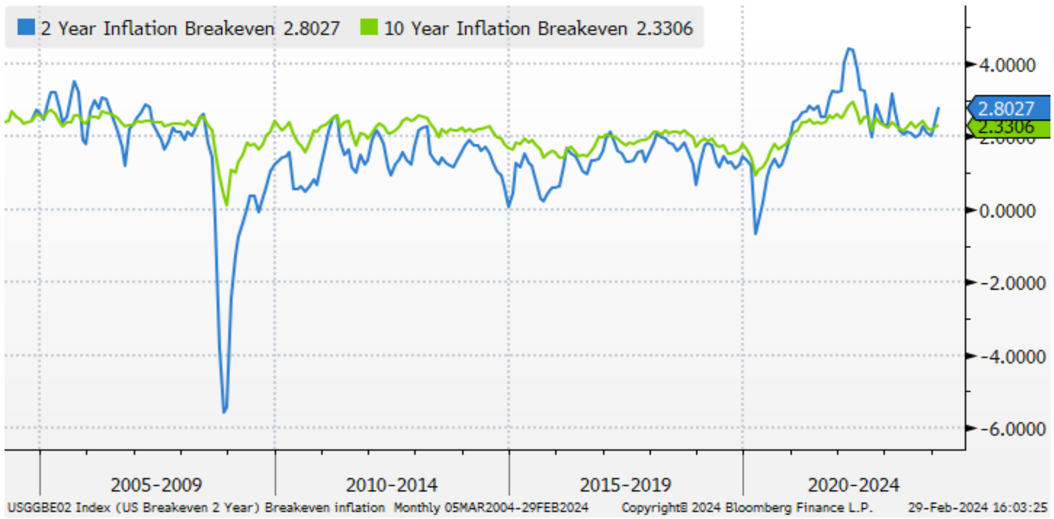
Inflation Expectations – Rising Expectations



- There has been a notable increase in market expectations of near-term inflation since the beginning of the year.
- One market-based measure of inflation expectations is the 'breakeven rate', which is the difference between the nominal yield of a U.S. Treasury bond and the yield on a Treasury Inflation-Protected Security (TIPS) of the same maturity.
- It is called the breakeven inflation rate because it is the rate that inflation needs to average over that time for the total return of the nominal bond and the inflation-linked bond to match.
- Since the start of the year, the breakeven inflation rate for 2 year bonds (blue line) has increased from 2.02% to 2.81%, which is the highest level since last March.
- Interestingly, if you exclude the pandemic and March 2023, inflation expectations (using breakeven inflation rates) for the next 2 year period, are at the highest level since 2007.
- The recent increase has been driven by the confluence of the continued strength of economic activity and labor markets, and higher than expected inflation readings.
- While near-term inflation expectations have risen, longer-term inflation expectations have not. The 10-year breakeven rate (a proxy for what level inflation readings will *average* over the next 10 years (green line)) is in line with its longer-term norm.
- The jump in short-term inflation expectations is the reason why investors over the past two months have shifted from expecting 7 rate cuts in 2024, to now forecasting 3 rate cuts.

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