

Current market inflation expectations are ridiculous

From the Field
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Raise your hand if you thought year-over-year U.S. headline consumer price index (CPI) inflation would peak in June 2022 at 9.1% and stay above 6% into early 2023. I expect to see few hands—forecasts for inflation from 2021 through 2023 were wildly inaccurate. Even many central bankers and most economists got it wrong and were forced to rethink long-standing assumptions about inflation. Put your hand down if you even whispered “transitory.”

Breakeven spreads—the market’s best measure of expected headline inflation—on U.S. Treasury inflation protected securities (TIPS) ranged between 2.44% (five year) and 2.28% (30 year) in mid-March 2024.¹ In the context of the inflation volatility experienced since 2020, this appears utterly ridiculous. You’d expect at least modest variation in inflation expectations across maturities given how much headline CPI inflation has fluctuated over the last few years. Does this mean that market participants have no idea where

inflation will settle? Or are they seeing inflation miraculously disappearing?

Will the downward trend in inflation continue?

Market views on the path of inflation are currently not nearly as divergent as they were in 2021 and early 2022, when outlooks were divided into “transitory” (which included most developed market central banks) and “persistent” camps. Of course, inflation broadly trended downward as 2023 progressed. Most commentators think this will continue through 2024, allowing the Federal Reserve and other central banks to begin cutting interest rates at some point during the year.

But early 2024 has featured signs that the global economy isn’t decelerating nearly as quickly as anticipated, stoking concerns that inflationary forces could build once again. Case in point: Portions of the U.S. CPI numbers for January and February



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¹ Data source: Bloomberg Finance LP.

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were higher than expected, and January's nonfarm payrolls report blew past consensus expectations for jobs added (though the jobs-added number was later revised lower).

Inflation to reaccelerate after nearing Fed target

My view is that core inflation will fall to around 2%, which is the target for several central banks, including the Fed and the European Central Bank. My longer-term outlook is not as sanguine, however, as I think inflation will reaccelerate.

Artificial intelligence (AI) is a productivity miracle, at least in the longer run. But implementing AI into corporate processes across the manufacturing and services sectors will take time and more labor, imposing higher costs. As a result, I see AI being inflationary in the short term before the economy can realize its longer-term productivity benefits. Much of the anecdotal evidence our analysts pick up in their hundreds of company meetings confirm this view.

China is another wild card for inflation. Faltering Chinese domestic demand has meant that the country has been exporting goods disinflation (or even deflation, in some cases) through global trade. This has been a major contributor to decelerating price pressures worldwide.

However, an increase in demand within China—potentially triggered by fiscal stimulus funded by the country's recently announced special issue of new long-term government bonds—would reverse that factor and drive export prices higher. While this probably isn't a baseline scenario, the main point here is that sentiment toward China is skewed to the downside. A surprise would likely be to the upside. Then consider the potential inflationary impact of any additional tariffs that may result from the developing U.S. political theater, and you have clear inflationary risk.

Collaboration among colleagues with different views is a hallmark of TRPA's² investment process. While I am wary of the risks that inflation could reaccelerate, there is research that serves to temper these expectations. Blerina Uruçi, our chief U.S. economist in the Fixed Income Division, has a more benign outlook for longer-run inflation.

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Tempered expectations: The potential for a more benign inflation outlook

Historically, it has been impossible to bring inflation down rapidly without a recession or a large negative shock to the labor market, which is why I expect that the road toward 2% inflation will be long and winding. Nevertheless, demand for workers has slowed significantly from last year, and I expect that this will continue to ease some of the labor market pressures on inflation and help in bringing it down to the Fed's target, likely by early 2025.

Focus on shelter inflation and its lagged effects

Shelter (or housing costs) is a large component of inflation, making up around 30% of the consumer price index, and further progress in bringing down rent inflation will be necessary to ensure that U.S. inflation continues to move closer to the Fed's target. CPI measures of shelter respond with long lags to more timely measures of home prices and market rents. Research suggests these lags can be longer than a year. If you look at private sector data on rents and home prices, they signal that rent inflation should decline further.

The real question is the speed at which this will occur. This, of course, is difficult to answer. Some models using private sector home value and rent indexes suggest we could see sticky shelter inflation holding above 4% for 2024, which would imply a much slower glide down to 2% for overall inflation.

– Blerina Uruçi, Chief U.S. Economist

While I think that the environment is conducive to a reacceleration in inflation, I'm keeping Blerina's inflation outlook in mind and continuing to monitor the potential for inflation to maintain its downward course. I'm confident that this type of collaboration and consideration of differing views can lead to better investment decisions from our portfolio managers.

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