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MORE SUPPORTIVE BACKDROP FOR INFLATION-LINKED DEBT DESPITE HEADWINDS

KEY TAKEAWAYS

- U.S. inflation has normalized, with the consumer price index rising and breakevens at multiyear high levels as the Federal Reserve continues down the path of gradual tightening of policy rates.
- The Fed has noted inflation's rise and become more confident about its path of tightening policy rates, which may counter a further increase in TIPS breakevens; the central bank could be more likely to react if inflation rises with additional tightening measures.
- Some upside risk remains in TIPS breakevens, particularly if oil prices remain elevated, but it is important to remember that the secular forces of technology and demographics remain in place—keeping the prospect for runaway inflation at bay.
- With oil prices rising steadily since last June, inflation-linked debt in Europe has reacted in a similar fashion to U.S. TIPS.

As the Federal Reserve continues down the path of gradual tightening of policy rates, U.S. inflation has normalized, with the consumer price index (CPI) rising and breakevens at multiyear high levels. Breakevens, which measure market inflation expectations, are the difference between nominal and real yields for a given maturity. While the potential for inflation accelerating further is limited, modest upside risks remain, which could translate into opportunities in U.S. Treasury inflation protected securities (TIPS) and inflation-linked debt in other developed markets.

HIGHER INFLATION REPRESENTS A NORMALIZATION

In mid-May, the U.S. 10-year inflation break-even rate hit its highest level in four years—signaling improving inflation expectations and growing optimism surrounding domestic economic growth. Among the drivers behind this move higher in breakevens, two of the most significant have been fundamental in nature—the rise and renormalization in core CPI and the increase in oil prices. Core inflation troughed in 2017 and has accelerated over the past six to nine months. At the same time, oil prices rose by about 50% over the last 12 months. While market sentiment has moved from deflation fear in mid-2017 to inflation fear in early 2018, the reality of the situation likely lies somewhere in between.

This recent acceleration in inflation from its 2017 lows has been more akin to a renormalization, coinciding with Fed interest rate hikes, and the prospect for further acceleration from here is somewhat limited by a few factors. For one, continuing monetary policy tightening from the Fed is all but certain as the central bank has been open and transparent about the future path of interest rate hikes. Additionally, shelter prices, which are a large part of CPI, have stabilized at a high level, and the components of inflation largely tied to tightening labor markets have not responded as expected—wage increases from tighter labor markets have been modest and have only moderately contributed to higher inflation.

INFLATION EXPECTATIONS RISE BUT ARE DAMPENED LONG TERM BY FED TIGHTENING

Meanwhile, the Fed has noted inflation's rise and become more confident about its path of tightening policy rates, which may counter a further increase in TIPS breakevens. The Fed could be more likely to react if inflation rises with additional tightening measures.

The relatively flat TIPS break-even curve demonstrates this dynamic between fundamental drivers pushing inflation upward and the Fed acting as a counterweight. U.S. inflation-linked debt at the front end of the curve is trading at similar levels to longer-dated TIPS. Current inflation and rising oil prices affect the short end of the curve, while

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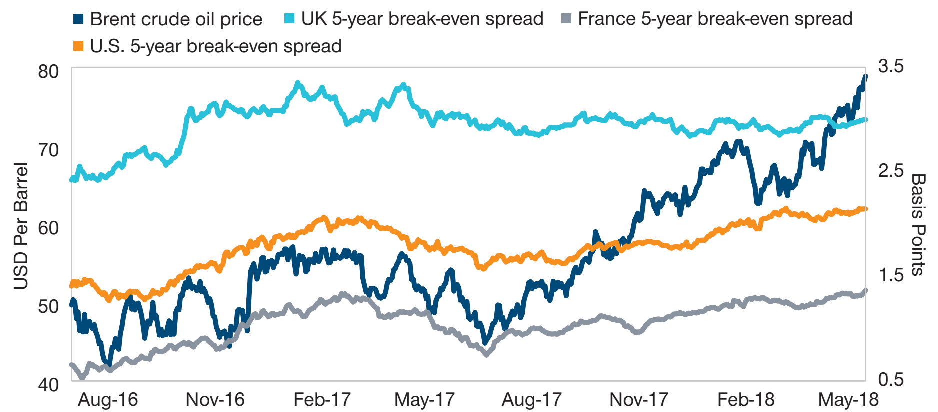
the long end is more influenced by the Fed's reaction to inflation and the central bank's credibility on controlling inflation. As such, the flat TIPS break-even curve is a function of current inflation pushing breakevens higher mixed with the market's belief that the Fed will continue its gradual tightening and work to keep inflation near its target.

MODEST UPSIDE POTENTIAL REMAINS FOR INFLATION DESPITE HEADWINDS

We expect core CPI to print somewhere in the 2.25% to 2.50% range throughout 2018. Traditionally, breakevens would be at or above the current level of core inflation, but the current break-even curve is not reflecting this historically typical behavior. Additionally, breakevens have not overreacted to the spike in energy prices. Some upside risk remains in TIPS breakevens, particularly if oil prices remain elevated, as the rise in inflation has been cyclical. However, it is important to remember that the secular forces of technology and demographics remain in place—keeping the prospect for runaway inflation at bay.

FIGURE 1: Recovery in Oil Supports Most Breakevens



Source: Bloomberg Finance L.P.

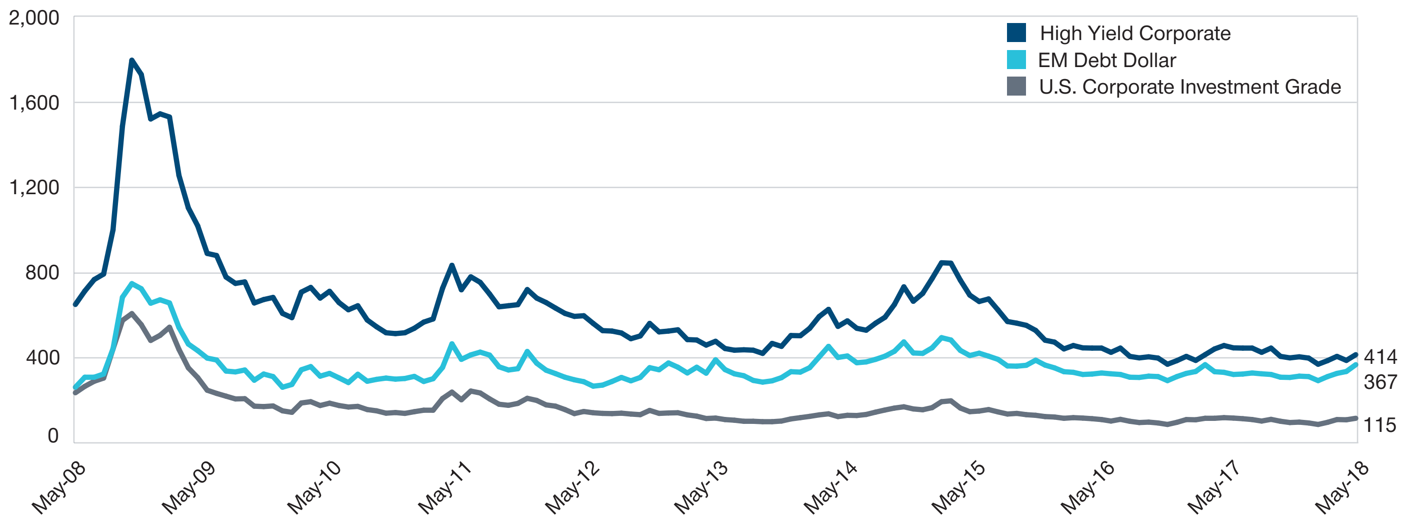
EUROPEAN BREAKEVENS ACTING SIMILARLY

With oil prices rising steadily since last June, inflation-linked debt in Europe has reacted in a similar fashion to U.S. TIPS. As shown in Figure 1, which charts five-year break-evens in the U.S., France, and the UK along with the price of Brent crude oil, French breakevens have trended upward along with oil's rise. Notably, however, overall inflation is considerably lower in France, and the European Central Bank is still taking an accommodative stance while the Fed is tightening.

In contrast, breakevens in the United Kingdom seem less responsive. The inflation pass-through effects have waned from the pound sterling's depreciation after the June 2016 Brexit vote as this time period has rolled out of the headline retail prices index data point used by the UK government. This fact is partly responsible for the diminished impact of higher oil prices on UK breakevens.

Yield Spreads Over Treasuries (basis points)

May 31, 2008–May 31, 2018



Sources: High Yield Corporate—J.P. Morgan Global High Yield Index, EM Debt Dollar—J.P. Morgan Emerging Markets Bond Index Global, U.S. Corporate Investment Grade—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index.*

Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright 2018, Bloomberg Index Services Ltd. Used with permission.

Yield spreads over Treasuries are the calculated spreads between a computed option-adjusted spread index of all bonds in a given rating category and a spot Treasury curve.

*Option-adjusted spread for the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index as of May 31, 2018. Spread-to-worst for the J.P. Morgan Global High Yield Index as of May 31, 2018.

Relative Value Short-Term Outlook

Sector	Driver	Sector Returns (As of May 31, 2018)** One-Mo. Return	YTD Return	One-Yr. Return
U.S. Treasuries	U.S. Treasury yields have continued to move higher as growth remains stable, inflation expectations have increased, and the Fed remains seemingly more confident in the tightening cycle. However, the market is digesting a moderation in growth, impacts from tighter financial conditions, increasing pressure on corporate profit margins, and trade policy uncertainty, which could keep yields contained.	0.90%	-1.10%	-0.83%
U.S. Treasury Inflation Protected Securities (TIPS)	Inflation expectations have increased as oil prices continue to rise, placing upward pressure on breakevens. However, a reversal in oil prices or continued Fed tightening could cap break-even spreads and TIPS performance.	0.43	-0.42	0.74
Global Sovereign ex-U.S.†	German bund yields have remained low as the market digested a deceleration in European economic activity from lofty levels. However, the European Central Bank has communicated its desire to end quantitative easing by year-end, which could put upward pressure on yields. Meanwhile, the Bank of Japan remains highly accommodative amid recent softer growth and inflation data, and in the UK, the Bank of England signaled a diluted commitment to raising interest rates and Brexit uncertainty remains a risk.	-1.87	-0.62	3.40
U.S. Municipals	Municipal yield ratios versus Treasuries are rich in the intermediate part of the curve but are more attractive on the long end. Favorable supply/demand dynamics in the sector are expected to continue, and credit conditions remain broadly stable.	1.15	-0.33	1.11
Mortgage-Backed Securities (MBS)	Despite solid fundamentals, there is uncertainty in the sector due to the move higher in U.S. interest rates, a potential shift to a higher range in volatility, as well as technical challenges from increased seasonal supply and reduced Fed reinvestments. Offsetting demand from money managers and banks has also yet to materialize amid increased rate volatility.	0.70	-1.00	-0.30
Commercial Mortgage-Backed Securities (CMBS)	Despite being in the later stages of the current credit cycle, credit fundamentals in the CMBS sector have remained largely healthy, and from a technical perspective, higher yields should increase investor demand and a light new issue calendar should be supportive.	0.80	-1.21	-0.43
Asset-Backed Securities (ABS)	The ABS sector continues to benefit from strong consumer fundamentals and should continue to provide a relative safe haven if interest rate volatility were to increase; however, there is limited spread tightening potential given the flatness of the credit curve.	0.41	-0.02	0.32
Global Investment-Grade Corporate	Elevated volatility, a flatter credit curve, and weaker technicals have caused spreads to reprice wider. Fundamentals remain supportive in the near term, but the potential for earnings to become more challenging in the second half of the year, an increase in mergers and acquisitions, and fading overseas demand could weigh on the asset class.	0.54	-2.70	0.06
Global High Yield Corporate	Spreads have retraced after widening earlier in the year due to equity volatility and rising Treasury yields, but valuations remain stretched. Fundamentals remain solid amid a supportive backdrop for employment, corporate earnings growth, and stable oil prices. Potential risks include volatility in commodity prices, outflows, weakness in equities, and corporate credit being late in the cycle.	-0.35	-0.65	2.61
Bank Loans	Bank loans, with their floating rate feature, appeal to investors seeking shelter from rising interest rates. Solid fundamentals, low commodity exposure, low default rate expectations, and continued strong demand lead us to be constructive on the sector, but a reversal in technicals is a key risk.	0.16	2.12	4.40
Emerging Markets (EM) Dollar Sovereigns	Valuations have improved for EM credit as rising U.S. rates, a stronger U.S. dollar, and concerns around specific countries have weighed on performance. Continued volatility in risk assets leave EM markets vulnerable to additional spread widening, but encouragingly, underlying fundamentals look better than in past periods of market stress.	-1.08	-4.27	-1.71
EM Corporates	Some value has been restored to the sector after a 25% correction in spreads. Although recovering fundamentals and resilient oil prices provide tailwinds for the sector, we are cautious in the near term given the recent weakness in the sector, a less favorable liquidity profile, and little buffer for idiosyncratic shocks.	-0.70	-2.46	0.48
EM Local	A stronger U.S. dollar has undermined performance for EM local markets and could pressure yields higher if sustained. We continue to favor countries in interest rate cutting cycles as well as those that offer high real yields or are showing progress on reforms. However, we are cautious as the sector has seen much higher rates in some countries which are feeling pressure that we haven't seen over the recent past.	-4.98	-3.69	1.01

Past performance is not a reliable indicator of future performance.

Sources: T. Rowe Price, Bloomberg Barclays, J.P. Morgan, and S&P/LSTA.

**U.S. Treasuries—Bloomberg Barclays U.S. Treasury Index, U.S. TIPS—Bloomberg Barclays U.S. TIPS Index, Global Sovereign ex-U.S.—Bloomberg Barclays Global Aggregate ex-U.S. Index, U.S. Municipals—Bloomberg Barclays Municipal Bond Index, MBS—Bloomberg Barclays U.S. MBS Index, CMBS—Bloomberg Barclays U.S. CMBS Index: ERISA Eligible, ABS—Bloomberg Barclays Asset Backed Index, Global Investment-Grade Corporate—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index, Global High Yield Corporate—J.P. Morgan Global High Yield Index, Bank Loans—S&P/LSTA Performing Loans Index, EM Dollar Sovereigns—J.P. Morgan Emerging Markets Bond Index Global, EM Corporates—J.P. Morgan CEMBI Broad Diversified, EM Local—J.P. Morgan Global Bond Index—Emerging Market Global Diversified.

†European corporates are included in this sector.

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