HSBC Global Research

29 April 2021

The Major bond letter

#7. Inflation rationality

Free to View
Fixed Income - Rates

Global

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We don't always make rational choices. Our decisions can seem to make perfect sense at the time, yet turn out be irrational. If you ever bought a new shirt or dress in a sale that still sits in your wardrobe, you will have experienced this curious phenomenon, called 'bounded rationality'[1]. Similarly, we often pay for insurance that we don't need. Without being aware of it, we make countless decisions based on deficient information.

'Inflationistas' say inflation is rising, so investors should get some protection. Buy some inflation-linked bonds as insurance against higher inflation.

Granted, inflation is on everyone's mind. And it's not just in the exchange of anecdotes when shopping for groceries. Numerous mentions on company earnings calls bring the threat that increased input costs will be passed on to the consumer. Most people's view of inflation seems to be that prices of the things they buy – for example, food – are rising, so there must be a general increase in the rate of inflation. They are not wrong. The US Commodity Research Bureau's index for foodstuff – which includes butter, wheat, sugar, etc. – has soared to its highest level since 2011 and is up 31% on the year.

This view risks falling victim to our bounded rationality and misses the big picture. It's like a decision made in haste, without a full consideration of the facts. What if the increase is only temporary? Most important of all, perhaps, something fundamental has changed.

When enough investors buy the inflation-linked bonds known as Treasury Inflation-Protected Securities (TIPS) – and all the flow data suggests they have been doing so in droves – the price of them goes up, and the yield falls. As a result, the difference between the yield on the TIPS and that of conventional Treasuries, known as the breakeven yield, will increase, other things being equal.

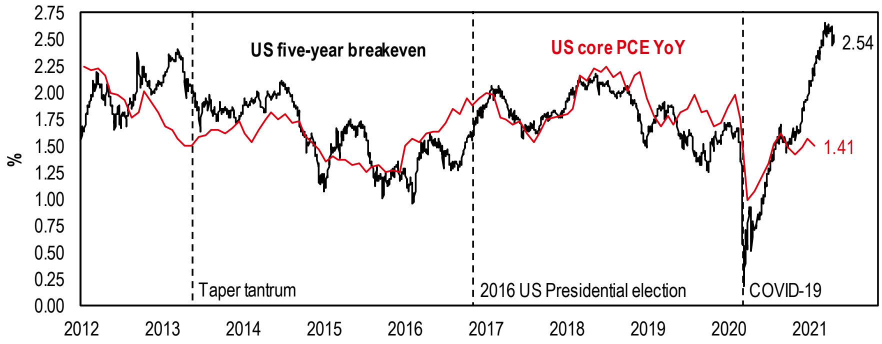
This forms one of the market-based measures of what's going to happen to inflation in the future, which is used alongside survey-based projections. The five-year 'breakeven' spread illustrated in Figure 1 is comfortably projecting levels above the Fed's 2.0% average inflation target. It is also well above recent levels of realised core inflation, the core personal consumption expenditure (PCE) targeted by the Federal Reserve.

When people experience higher prices in the shops, they start to expect a general rise in inflation. Economists, who may claim to be the most rational people of all, know expectations are important determinants of inflation. The Fed is aware of this too, which may somewhat cynically explain why it has bought nearly one-quarter of the available stock of TIPS.

This is a Free-to-View version of a report by the same title published on 29-Apr-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

[1] Simon, H.A. *A behavioural model of rational choice*, February 1955

Figure 1. Market breakevens outpacing inflation prints



Source: HSBC, Bloomberg. *PCE = personal consumption expenditures*

The US core PCE strips out the more volatile components and therefore normally sits below the headline CPI by 20-30bp, but this doesn't explain the huge gap that opened up between the two series. Markets have clearly embraced the information that inflation is going up and positioned themselves accordingly. Today, investors buying inflation-linked bonds risk experiencing something worse than the regret of the shopper described above; they really overpaid for that never-worn dress or shirt. If the purchase of inflation-linked bonds was supposed to be insurance, it may not be money well spent.

A fully rational view should surely take into account the Fed's new average inflation target (AIT) and incorporate the longer-term global and structural drivers of inflation. Taking time to think beyond our bounded rationality requires us to question what has changed and why increased inflation expectations, which are more than fully reflected in the price, could turn out to have been overdone.

The Fed has repeatedly told us that it needs to see the 'whites of the eyes' of inflation. Realised inflation matters more than forecasts, forwards or expectations. Moreover, the Fed is looking at averages. This means that, because inflation has been so low for the last decade, it will have to be persistently above 2.0% to achieve these objectives.

For sure, we will see inflation above 2.0% in the coming months, but it will need to properly stick. If the core PCE were to average 3.0% for the next 12 months – which is not our forecast – it would theoretically pull the moving average of the last three years to 2.0%. But it would not be enough to prompt a change of policy.

Nobody knows for sure what average time frame the Fed is focused on, but our choice of three years is likely too short to address the disinflation of the last decade, in our opinion. Achieving an average of 2.0% would anyway achieve only a minimum of the criteria required to tighten policy because there is also the question of what's happening to employment.

It is by getting it wrong in the past, by tightening too much, that the Fed has learnt its lesson. Having been on track to hike three times in 2019 (at least that is what it projected in December 2018), it had to reverse course shortly after. In fact, it had already overtightened.

This said, now is the time to back the Fed and not the market. The inflationistas might be right for a few months, but when it comes to bonds it is already factored in. Investors would be paying the price of their bounded rationality if they were to overpay for protection they don't need.

Previous 'Free to View' editions of 'The Major bond letter'

#1. *Eurozone common issuance – a long time coming*

#2. *How to spice it up in a dull market*

#3. *New year, old narrative*

#4. *Beneath the surface*

#5. *The bond market sell-off*

#6. *Treasuries and trees*

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Source: HSBC

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Source: HSBC

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