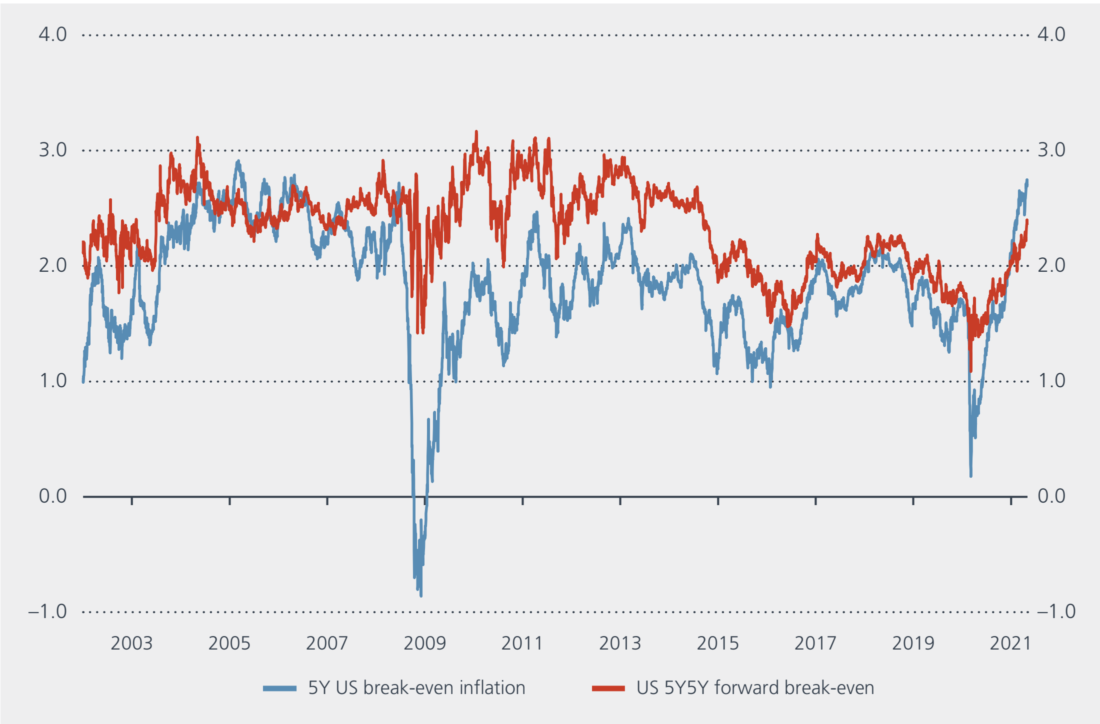
INFLATION EXPECTATIONS AND INTEREST RATES IN THE US

Recently, concerns about rising inflation rates have grown. Yield curves have steepened and interest rate levels have increased. However, the market considers more than a temporary inflationary impulse unlikely, which should limit rises in interest rates. Against this backdrop, USD-denominated bonds appear attractive.

In the first half of 2021, the inflation topic once again made headlines after a break of many years. The electoral victories of the Democrats in January, which gave the party control of both legislative chambers, and the passage of the 1.9-trillion-dollar stimulus package, as well as the prospect of public life reopening as the coronavirus vaccination campaign progresses, have fuelled concerns among many analysts and market participants about an inflationary impulse in the US.

Five-year and five-year forward US break-even inflation rates (in %)



The chart shows five-year break-even inflation rates (lhs) and five-year forward break-even inflation rates (rhs) in per cent for the last 20 years. Source: Bloomberg L.P.

In the wake of these developments, government bond yields have risen and the yield curve has steepened considerably since the beginning of the year. Ten-year US Treasuries increased by 83 basis points to a peak of 1.74 per cent by end of March 2021, where they have since stabilised and the spread between ten-year and two-year government bonds has widened significantly.

Due to base effects from the first coronavirus lockdown last year, inflation rates in the US will be elevated in the second quarter of 2021 with the April number having been published at 4.2 per cent as economic activity picks up, commodity prices have risen sharply and we have seen coronavirus-induced disruptions of supply chains.

However, it is unclear whether there will be a longer-term inflationary impulse beyond mid 2021. It remains to be seen whether a large part of the stimulus payments to private households will flow into the real economy or reach the financial markets as speculative inflows and whether commodity prices will stabilise.

Moreover, many of the deflationary factors that have kept interest rates low for years remain.

The ageing of society and the trend towards more automation have a dampening effect on prices. Capacity utilisation in the US, at 74.9 per cent in April 2021, is still below the ten-year pre-corona-virus average of 76.8 per cent, suggesting continued underutilised resources. The loss of interest income and the absence of a market shake-out among weak companies due to favourable re-financing conditions are also having a deflationary effect.

Looking at market expectations for the US, we see somewhat elevated short-term expectations but no longer-term trend. Figure 1 shows that five-year break-even inflation rates, i.e. the inflation rates at which five-year inflation-hedged US government bonds have the same yield as unhedged bonds, have risen over the past year, reaching its highest level since 2006. However, the five-year forward inflation rate, measuring the expected five-year break-even inflation in five years is at its twenty-year average of 2.35 per cent after recovering from its lowest value of the century in March 2020. This means that there are no inflation concerns in the market beyond an inflationary impulse in the short-term. Inflation expectations remain well anchored.

> Despite a temporary pick-up in prices inflation expectations remain well-anchored.

Regardless of the inflation trend, central bank intervention is another factor in the market that is likely to limit rises in interest rates. In addition to the expansion of quantitative easing measures, the topic of 'yield curve control', i.e. the fixing of certain points on the yield curve by the central bank, has been discussed recently. In view of record-high public debt, political interest in significantly higher interest rates is likely to remain very limited. Against this background, currency-hedged US bonds appear interesting to European investors at current levels.

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