US Macroeconomics

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Will the Collapse in Inflation Expectations Persist?

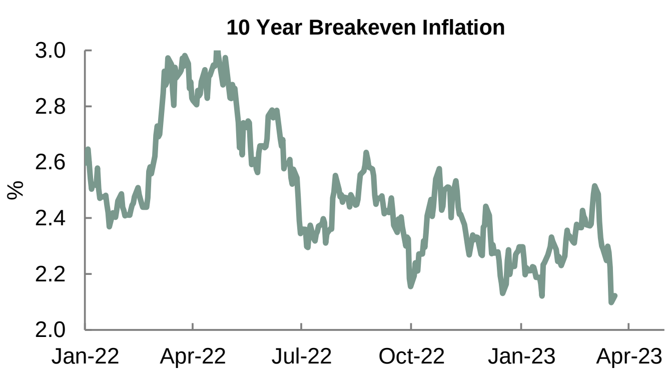
As shown in the lefthand side chart below, **the 10-year inflation breakeven rate has plunged over the past three weeks**, falling from 2.51% to around 2.11% at present. Breakeven inflation is now hovering around its February 2021 level, when both headline and core inflation were under 2% and the fed funds rate was close to zero. We should also note that the decline in breakeven inflation, which can be distorted by seasonality, is being confirmed by a new six-month low in forward 5y5y inflation swaps.

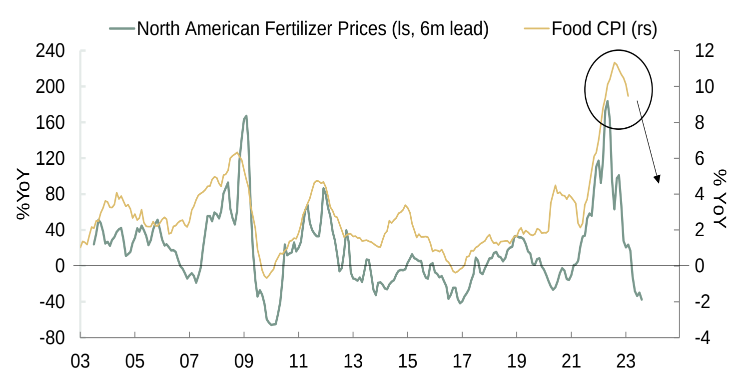
In addition, remember that **a 2.11% breakeven inflation rate is consistent with annual PCE deflator growth of around 1.70% to 1.80%** because the latter tends to run approximately 30 to 40 basis points (bps) below the consumer price index which is used in breakeven construction. Hence, the bond market is discounting price stability. This minimizes the risk of a 1970s price cycle because low inflation expectations are often self-perpetuating. Moreover, there is a good chance that breakeven inflation falls even more. If so, 10-year treasury yields should continue to decline.

Oil prices have declined to well under $70 per barrel and are down about 15% over the past several weeks. As economic activity slows energy demand should weaken more. Retail gasoline prices are down 30% from their June 2022 high, and if the recent decline in oil prices is sustained, falling energy prices will dampen consumer inflation in the months ahead. But there is potentially more good news.

Fertilizer prices lead the trend in food prices by six months. As we can see from the righthand side chart, fertilizer prices have plunged, down about 40% from their year-ago level and still trending lower. Given the drop already seen, food price inflation should moderate to around zero and possibly turn negative. Combined energy (7%) and food (13.5%) prices account for nearly 21% of headline inflation. So, where they trend has an outsized impact on where inflation and inflation expectations trend. But it is not just energy and food prices that are down.

The CRB commodity index recently fell to a new 52-week low, thereby taking the index back to where it was in May 2021. But unlike then, when commodity prices were going up, they are now trending lower, down about 16% from the April 2022 peak. These latest price developments are encouraging and will percolate through into lower retail prices. Hopefully this will be recognized by the Fed. Time will tell.





Sources: Federal Reserve, Bloomberg, BLS, Haver, SMBC Nikko

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