

The return of inflation risk

Paul Brunker | 22 April 2021

Key Points

- The back-up in bond yields represents a risk premium being restored, not an ‘inflation scare’.
- Shifts in structural drivers and policy agendas justify at least the current level of risk premium in bond yields.
- The value style has not fully adjusted to the move in bonds, let alone any further back-up.

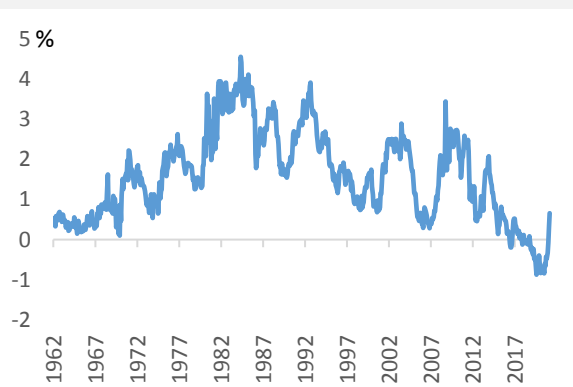
Welcome back, term premium

Bond yields have risen sharply in recent months, underpinning significant outperformance by value exposures in equity markets. Some argue that bonds have already overshot, others see this as an inflection point. Looking at the components of bond yields helps to clarify the debate.

There are two parts to a long bond yield: the expected cash rate over the life of the bond, and a ‘term premium’ (TP) to compensate for duration risk. In principle, without a TP you would simply hold cash or bills.

A commonly cited measure of the US term premium is the ‘ACM’ estimate published by the NY Fed. The TP in US ten-year bonds has trended down since the 1980s (**Figure 1**).

Figure 1: Term premium in US 10-year bonds



Source: NY Fed

This makes sense. The TP reflects uncertainty about inflation and real rates; uncertainty reflects the volatility of the economy, and how predictable and credible policy is.

The late 1960s and the 1970s featured high and volatile inflation, a series of shocks and unpredictable fiscal and monetary responses. From the 1980s policy became more orthodox, and structural forces such as technology and globalisation pushed inflation into narrower channels. This became known as the Great Moderation, and drove a steep fall in the term premium.

‘New normal’ became abnormal

By 2015 the TP was plumbing depths not seen for almost half a century. The usual explanations for low bond yields – subdued inflation, slower growth – can’t directly explain this, because they would be reflected in the market’s expectation of future short rates. The ultra-low term premium was not saying that investors saw a lower trajectory for rates, it said they were (much) more *confident* about that trajectory.

In 2019 the US ten-year TP broke new ground by going negative, falling to a low of -0.8% in July. It then snapped back to reach its highest level in more than 5 years at the end of March.

A negative term premium takes some explaining: why would investors accept a lower expected return on bonds than on cash? Regulatory or prudential requirements could be a factor, so could central bank buying. But these drivers did they evaporate in the last nine months.

A more likely explanation is that momentum created a ‘duration bubble’: investors bought a negative TP on the assumption that it would fall even further. It is telling that the TP explains *all* of the yield back-up from July to March (**Figure 2**). The expected interest rate component has not changed: but investors are now asking, reasonably enough, to be paid for the risk that the base case is wrong.

Figure 2: 10-year US yield and its components, July to March

| | Month end | | Change bp |
|-------------------------------------|-----------|--------|-----------|
| | Jul-20 | Mar-21 | |
| 10-year yield | 0.54% | 1.87% | +133bp |
| Ave exp short rate | 1.38% | 1.21% | -18bp |
| Term premium | -0.84% | 0.66% | +150bp |
| 10-year TIPS | -1.00% | -0.63% | +37bp |
| 10-year inflation break-even | 1.55% | 2.37% | +82bp |

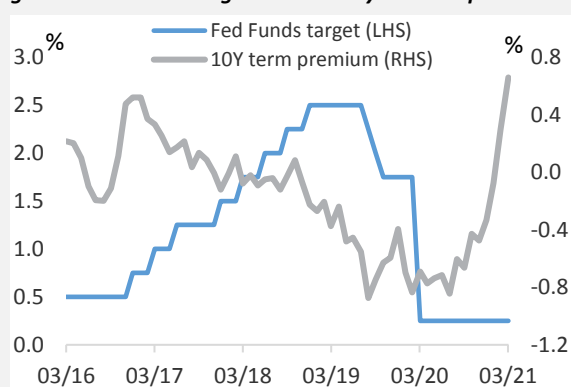
Source: NY Fed, FactSet

The heightened (or more normal) sense of risk mostly revolves around the inflation component of bond yields. Inflation break-evens have moved up sharply during the bond correction, real rates less so.

On this evidence, the bond sell-off is signalling more uncertainty about the pathway for rates, not a higher expected pathway; more inflation risk, not higher inflation.

This analysis contradicts the view that bonds have simply reacted to the prospect of stronger growth post-pandemic. This would push up near-term rate expectations, but would not necessarily change the term premium. Fed vigilance towards inflation could even *lower* the TP – exactly what happened during the 2016-2018 tightening phase (Figure 3).

Figure 3: Fed Funds target and US 10-year term premium



Source: NY Fed, FactSet

Risk is back for a reason

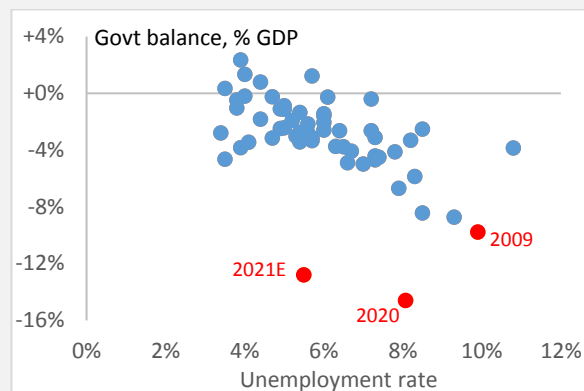
Are bond markets now pricing too much risk? A number of factors argue otherwise.

The sharp move in the term premium reflects an extreme starting point. The 10-year TP is around 50bp at the time of writing, still only a third of the 2000-15 average.

A less deflationary world? Some of the drivers keeping inflation and growth stable in the past three decades may be running out of steam or reversing. Re-shoring and tariffs are throwing sand in the wheels of globalisation; the working population in major economies has started to shrink; deregulation is giving way to intervention. If technology is depressing inflation it should be spurring productivity growth, but there is little evidence of that.

Policy landscape changing. The policy consensus of the 1990s-2000s no longer looks as secure as it did. The GFC was followed by alarm about deficits and debt; the COVID-19 period has seen larger deficits added to higher levels of debt and little talk of fiscal repair. For instance, the 2021 US fiscal boost is a clear outlier relative to the job market (Figure 4).

Figure 4: US Federal budget balance and unemployment rate



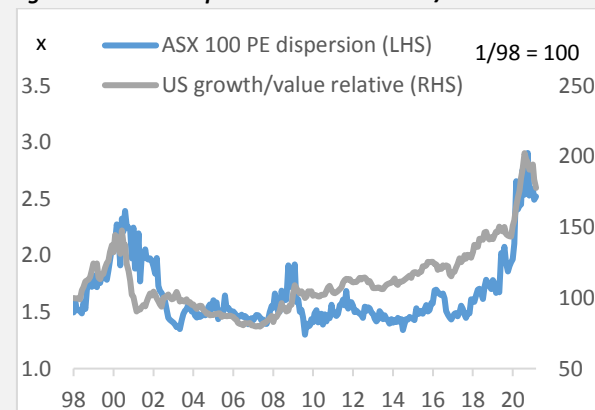
Source: FactSet, CBO forecasts

Returning to the two components of the bond yield: even after the recent correction, the US 10-year term premium is still low by historical standards, and there are also cyclical pressures that could cause investors to revise up the base-case forecast for inflation and rates. In other words it seems premature to conclude that the bond market move has overshot.

What does it mean for equities?

‘Lower forever’ sentiment weighed on value. A negative TP in 2019-20 was mirrored in equity markets. The consensus view was that ultra-low rates were here to stay, which would support high-multiple growth stocks; but feeble growth and inflation would weigh on value and cyclical exposures. PE dispersion (the ratio of high to low stock multiples) blew out beyond tech-bubble highs, as did and growth/value relatives (Figure 5).

Figure 5: ASX PE dispersion and US Growth/Value relative



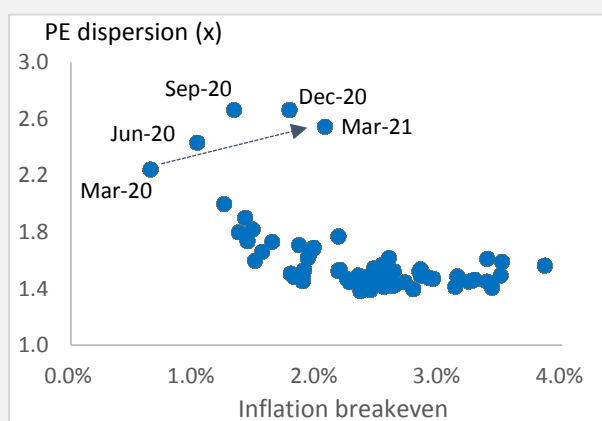
Source: FactSet, UBS, Optar Capital. PE dispersion = ratio of 80th to 20th percentile of forward PEs, ASX100 ex resources

Value stocks are an inflation hedge (and in the money). Equities have a cashflow hedge against inflation, but they are hit by higher discount rates. This double-edged sword is better for value stocks than for growth.

- **Duration:** a rising discount rate weighs more heavily on high-multiple equities because most of their valuation hangs on the outer years.
- **Industrial** stocks need pricing power to support earnings. Low inflation rates are usually associated with excess capacity in economies, which tends to hit the margins of these companies.
- **Financials**, which tend to fall into the value bucket, benefit when rising rates boost lending spreads and the investment earnings of insurers.

PE dispersion in the Australian market has tended to be inversely correlated with inflation expectations (**Figure 6**), supporting the status of value stocks as an inflation hedge. Both metrics were at 14-year extremes by Q120. Bonds then started to price more inflation risk; PE dispersion is still higher than it was a year ago.

Figure 6: ASX PE dispersion and 10-year inflation break-even



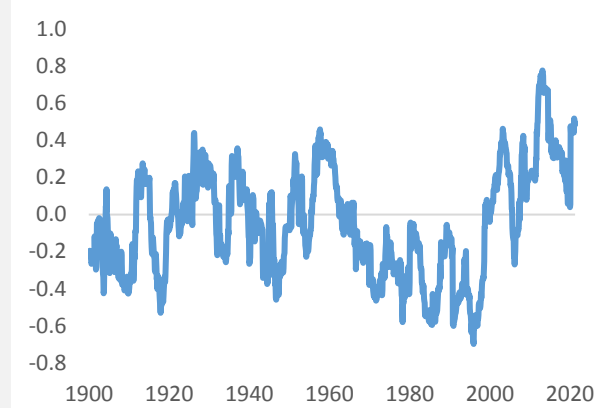
Source: RBA, FactSet, UBS, Optar Capital. 2006-21 quarterly

Could inflation risk threaten stocks?

A historical perspective suggests this concern is premature.

Figure 7 shows the correlation between US bond yields and equities. Before the 2000's, bond yields and the stock market tended to move in opposite directions: falling bond yields flagged a lower risk of tightening, clearing the way for stocks to rise, and vice-versa. During the 'Great Moderation' of the 2000's and the post-GFC period, this dynamic weakened. Markets put inflation on the back burner and focused on economic growth and tail risk. A drop in bond yields implied weak growth or a systemic threat such as a eurozone crisis. Rising yields signalled 'risk on', so stocks could rally. The correlation flipped.

Figure 7: Correlation between S&P500 and US 10-year yield



Source: R. Shiller, FactSet; 5Y correlation of monthly changes

This could change if inflation goes high enough to threaten stability. As **Figure 8** shows, stocks tend to do best when inflation is falling; but returns are reasonable even when it picks up within a low range. High and accelerating inflation is what really hurts equities.

Figure 8: US stocks and bonds, real returns 1950-2021

| | Inflation >3% | | Inflation <3% | |
|---------------|---------------|---------|---------------|---------|
| | Rising | Falling | Rising | Falling |
| Stocks | (7.2%) | 7.7% | 6.0% | 10.2% |
| Bonds | (6.6%) | 3.2% | (1.5%) | (0.7%) |

Source: Shiller, FactSet. Average monthly returns less CPI, annualised, S&P500 and 10-year bond.; 0.5ppt buffer applied to define CPI acceleration/deceleration vs pcp.

If we see a step change in inflation, the relative winners would depend on how policy responds. Value stocks have a stronger earnings hedge to inflation than growth and defensive names, and a less stretched starting-point, but they would be vulnerable if policy intervenes too heavily and threatens growth. It seems premature, however, to speculate about a hypothetical inflation cycle, the hypothetical policy response and what would happen after that.

Bond markets have returned to demanding some compensation for risk. By our reckoning, value stocks have only partly reflected the shift. A diversified asset owner could still look to a value-biased equity exposure as a hedge against further rises in inflation risk, which would hit bonds and other rate-sensitive assets in their portfolio.

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