# Bond Market Convinced Fed Inflation Goal Elusive This Decade



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Richard Fisher, president of the Federal Reserve Bank of Dallas. Photographer: Jim Stem/Bloomberg

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Oct. 14 (Bloomberg) -- When it comes to spurring inflation in the U.S. economy, the bond market is becoming convinced that the Federal Reserve has almost no chance of achieving its 2 percent target before the end of the decade.

Inflation expectations have plummeted in the past three months, with yields of Treasuries implying consumer prices will rise an average 1.5 percent annually through the third quarter of 2019. In the past decade, those predictions have come within 0.1 percentage point of the actual rate of price increases in the following five years, data compiled by Bloomberg show.

Even after the Fed inundated the economy with more than $3.5 trillion since 2008, bond traders are showing little fear of inflation. That may help influence U.S. monetary policy and make it harder for Fed officials to raise interest rates from close to zero as global growth weakens and the International Monetary Fund points to disinflation as a more imminent concern.

“The longer inflation rates stay below their targets, the longer the Fed’s going to stay on hold,” Gregory Whiteley, a money manager at Los Angeles-based DoubleLine Capital LP, which oversees $56 billion, said by telephone yesterday. “The burden of proof is more on the hawks and the people arguing for a rise in rates. They’re the people who have to make the hawks and the people arguing for a rise in rates. They're the people who have to make the case."

As the Fed winds down the most-aggressive stimulus measures in its 100-year history, the debate has intensified over how soon the central bank needs to raise rates and whether the shift will herald the long-awaited bear market in bonds.

## Predictive Power

While Dallas Fed President Richard Fisher and Philadelphia Fed's Charles Plosser dissented at the bank's last meeting and have both warned that keeping rates too low for too long may trigger excessive inflation, the bond market's predictive power helps to explain why U.S. government debt remains in demand.

Instead of falling, as just about every Wall Street prognosticator predicted at the start of the year, Treasuries have returned 5.1 percent in 2014. The gains have outstripped U.S. stocks, gold and commodities this year.

Yields on the 10-year note, the benchmark for trillions of dollars of debt, have plummeted 0.83 percentage point this year to 2.20 percent at 3:52 p.m. in New York. The 30-year bond yield fell below 3 percent for the first time since May 2013.

The rally has accelerated this month as a string of developments from lackluster wage growth to potential deflation in Europe cast doubt on the notion that price pressures will prompt the Fed to raise rates sooner rather than later.

## 'Fundamental Worry'

After the annual inflation rate rose to a two-year high of 2.1 percent in May, consumer-price increases have since slowed for three straight months to 1.7 percent in August.

"There's a fundamental worry that inflation won't be forthcoming," Wan-Chong Kung, a money manager at Nuveen Asset Management, which oversees $225 billion, said by telephone from Minneapolis on Oct. 8.

Kung said she sold her holdings of five-year Treasury Inflation-Protected Securities, or TIPS, which unlike fixed-rate bonds increase in value to compensate for rising living costs.

One of the biggest reasons inflation remains muted is because consistent wage increases that spur consumer spending and demand have yet to materialize. Hourly earnings for U.S. workers, whose spending accounts for 70 percent of the economy, were unchanged last month. They have been flat or increased just 0.1 percent in four of the past seven months.

Weakening global growth has also emerged as a threat. Last week, the Washington-based IMF lowered its growth outlook for next year to 3.8 percent from a July forecast of 4 percent and pointed to the increasing risk of falling prices in Europe.

## Global Drag

Fed Vice Chairman Stanley Fischer said on Oct. 11 at the IMF's annual meetings that if overseas growth is weaker than anticipated, "the consequences for the U.S. economy could lead the Fed to remove accommodation more slowly than otherwise."

His comments echoed those of a number of Fed officials who said the expansion "might be slower than they expected if foreign economic growth came in weaker than anticipated," minutes from the Sept. 16-17 meeting released last week showed.

"The Fed wants to raise rates, but you're not seeing the kind of global growth that would suggest interest rates have to go up any time soon," Jim Kochan, the chief fixed-income strategist at Wells Fargo Funds Management LLC, which oversees $221 billion, said by telephone from Menomonee Falls, Wisconsin.

The consequences for inflation are already being priced into the bond market.

## Collective Wisdom

Based on the gap between yields of government notes and TIPS, traders have scaled back estimates for average inflation through 2019 by a half-percentage point since June to 1.52 percent, Fed data compiled by Bloomberg show.

That decline has significance for policy makers because yields have historically been accurate in predicting the future pace of annual cost-of-living increases.

The market's five-year forecast has understated actual inflation based on the U.S. consumer price index by a median of just 0.04 percentage point since the data began in 2003.

With the Fed's preferred measure averaging 0.34 percentage point less than CPI in that span, traders are signaling prices based on that gauge may rise as little as 1.18 percent. Through August, the personal consumption expenditures deflator has fallen short of the Fed's 2 percent goal for 28 straight months.

Fed officials "need to be paying attention to that because there's a collective wisdom element to the TIPS market," Mitchell Stapley, the chief investment officer for Cincinnati-based ClearArc Capital, which manages $7 billion, said in an Oct. 8 telephone interview.

## Less Confident

Bond traders who are shunning TIPS are underestimating the risk that inflation will pick up as the U.S. economy strengthens and workers are hired at the fastest pace since 1999, according to Pacific Investment Management Co.'s Mirih Worah.

Even as the rest of the world slows, the IMF boosted its forecast for U.S. growth next year to 3.1 percent, which would be the fastest in a decade. In July, the fund predicted the world's largest economy would expand 3 percent in 2015.

"For the next 12 months, headline inflation will be 1.5 percent, but not for the next five years," Worah, one of the co-managers who succeeded Bill Gross in overseeing Pimco's $201 billion Total Return Fund, said by telephone Oct. 9 from Newport Beach, California.

"It's overdone."

Worah said he's been buying five-year TIPS as prices of the securities declined. In September, TIPS of all maturities lost 2.7 percent in the biggest monthly decline since June 2013.

Futures traders are signaling their skepticism over accelerating inflation by pushing back projections for the Fed's first rate increase since 2006.

## 'Disinflationary Cycle'

For the first time in at least six months, they're pricing in the likelihood the Fed won't raise its target rate until after next September, data compiled by Bloomberg show.

When it comes to a rate boost in October 2015, odds based on futures trading have fallen to little more than a coin flip.

Lower commodity prices, coupled with the dollar's strength as traders anticipate looser monetary policy in Europe and Japan, also suggest inflation will remain in check and give the Fed room to maneuver as the U.S. economy grows.

Crude oil prices have fallen 20 percent from a nine-month high in June, entering a bear market last week after closing at $86 a barrel. The Bloomberg Commodity Index, which measures 22 commodities from corn to zinc, tumbled 11.8 percent last quarter in the biggest slump since the financial crisis in 2008.

Most commodities are priced in dollars, which has helped reduce costs for American businesses and consumers as the U.S. currency rallied to a four-year high this month.

"It's becoming increasingly more difficult to be a hawk given what's going on with inflation," Kevin Giddis, the Memphis, Tennessee-based head of fixed-income capital markets at Raymond James & Associates Inc., said in a telephone interview on Oct. 10. "We are in a longer-term disinflationary cycle that is likely to keep rates low for some time."

(An earlier update corrected the size of the yield drop.)

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