Flash note
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Can US inflation become a problem and cause yields to skyrocket?

After an extensive discussion yesterday in the Andbank Global Investment Committee, we were able to reach several conclusions regarding this important subject.

Admittedly, the speed of recovery, the cautious approach to tapering and the rejection of preemptive tightening under the new framework, all create some risk of inflationary pressures. The good news is that the unprecedented increase in growth and inflation expectations over the last 6 months are unlikely to be repeated going forward, and any further rise in yields are likely be more moderate in nature, driven by a different set of catalysts. The wider market appears to be falling in line with the Fed's assessment, and aided by the higher yields on Treasuries we seem to be finding some stability at current levels.

At the moment, US breakeven expectations curve reflects a modest overshoot of inflation over the next 2-4 years, followed by lower levels of inflation. This appears to be exactly what the Fed hopes to deliver. As long as that curve (b.e curve) remains inverted, the market is signaling that inflationary pressure will be transitory, and there is little need for central banks to sharply change tack.

Future move in the UST yield

Looking ahead, a possible future movement on the UST10Y yield, in an environment of 6% -7% growth in the USA for 2021, and a notable growth of 3-4% expected for 2022, it is most likely that we will continue to see a normalization move (rise) in long term yields, but we are clear that it will be a very gradual move controlled by the Fed to avoid destabilizing the markets and the economy. In short, a telegraphed movement that the market can absorb reasonably well. We are thinking of a UST10 yield of 1.8% for this year, which will slowly rise above 2% throughout 2022.

Dissecting inflation:

Core inflation surprised to the upside, increasing 0.3% m/m as the Covid-sensitive sectors increased 1% m/m while the remainder of core increased about 0.2% m/m. Hotel prices and vehicle insurance prices jumped, while travel and recreation prices remain below pre-pandemic levels. We expect strong demand to continue to drive up prices through 2021Q2 and Q3.

Meanwhile, **headline CPI** increased 0.6%--the largest monthly increase since August 2012—due to a 9% m/m spike in March gasoline prices, which have since flattened.