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SYSTEMATIC FIXED INCOME OUTLOOK

Tempting FAIT

BlackRock's quant bond experts tackle some hard questions around the recent inflation data. What is behind the headlines? Are rising prices just temporary or the start of something bigger? What does greater inflation uncertainty mean for bonds and 60/40 portfolios?

In 2020, the U.S. Federal Reserve (Fed) announced a major shift in policy towards inflation management. Under this new policy, called Flexible Average Inflation Targeting or FAIT, the Fed now targets a 2% inflation on average over time, as opposed to preemptively fighting inflation before it shows up.

Critically, FAIT means that following a period of undershooting inflation, the Fed will tolerate overshooting inflation. In the FOMC statement, the Fed characterizes this so-called "make up" strategy as aiming "to achieve inflation moderately above 2% for some time." The policy is not without its critiques, the most colorful came from Federal Reserve Board Vice Chair Randall Quarles, "I come from the American West, and if you're bow-hunting an elk, and you miss one foot to the right, you do not establish your credentials as a hunter by missing one foot to the left."

Yet, the motivation for pursuing such a strategy recognizes a decade worth of failed developed central bank monetary policy to create higher levels of inflation and nominal GDP following the Global Financial Crisis (GFC).

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Treasury Secretary Yellen recently made the point, "We have been fighting inflation that's too low and interest rates that are too low now for a decade…we want them to go back to… a normal interest rate environment…and if this helps a little bit to alleviate things then that's not a bad thing. That's a good thing."

And it's a good thing for the Fed because having interest rates pinned at the zero lower bound renders monetary policy ineffective and the Fed irrelevant. Avoiding that outcome is in the Fed's interest, so its response to inflation will be at first to welcome it.

But with the first signs of price pressures popping up and historic levels of fiscal and monetary support boosting the economy, is the Fed "tempting FAIT" by assuming inflation is just transitory?

Key highlights

Greater short-term inflation uncertainty

The first signs of inflation have bubbled up in the market. It is unclear if inflation will be sustainable, but the risks of entering a new inflationary regime need to be considered.

Putting the Fed to the test

Many see a return to the pre-COVID environment of secular stagnation. But a breakout to higher inflation would put the Fed in a bind between promoting full employment and proactively reigning in inflation.

Bonds may not diversify

History shows bonds can fail to offset equity losses in periods where inflation fears rise. A reflationary reset requires a rethinking of fixed income allocations given that they have been a key beneficiary of long-running deflationary trends.

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Inflation Conflation

The successful reopening of the U.S. economy has reignited economic activity. For markets, the restart pushed inflation expectations up as measured by nominal and TIPS breakeven inflation rates as well as steeper yield curves, and inflationary beneficiaries in the stock market. At the same time, we have seen a rising chorus of debate around the future of inflation, and a flurry of inflationary upside surprises is adding to that discussion. Two major measures of inflation, the Consumer Price Index (CPI) and Core Personal Consumption Expenditures Price Index (Core PCE), have been posting readings well above the 2% Fed target and higher than they have been in decades.

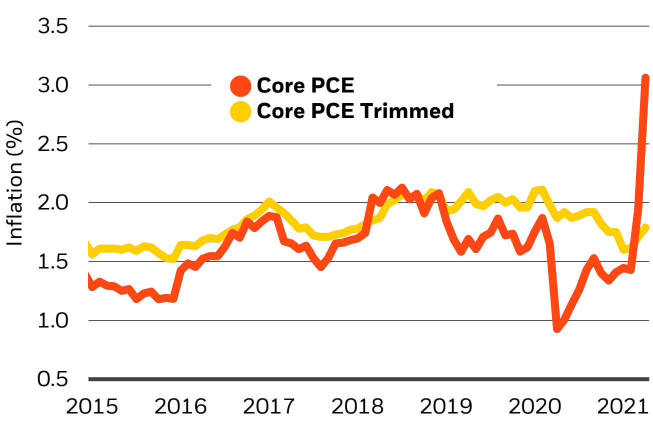
But it's important not to conflate inflation with significant one-time adjustments in prices. Price spikes have been particularly apparent in areas like home building materials, new and used car prices, travel and leisure expenditures, and other areas tied to the economy reopening. Broad-based inflation, in contrast to these headline grabbing increases in prices, is boring. It is persistent and small increases in prices across all categories in the economy that characterize an inflationary increase.

Figure 1 highlights Core PCE, the Fed's preferred basket to measure inflation, and the Dallas Trimmed Mean Core PCE (Core PCE Trimmed), a measure of inflation that takes into account outliers in the inflation basket. As you can see, Core PCE data shows a significant increase in overall prices, but the Core PCE Trimmed shows much more stable prices closer to the 2% level. The key to watch going forward will be broad-based price increases, not attention grabbing headlines. This may be the reason fixed income markets have been held largely in check.

Market views inflation as transitory... for now

TIPS 5-year ahead estimates of 5-year inflation expectations, a measure of what market participants expect inflation to be five years from now, have increased to just over the Fed's target of 2.0%, above the pre-COVID levels of around 1.8%, but below the peak of these measures in May of about 2.5%.

Figure 1: Read between the inflation headlines
Controlling inflation measures for outliers



Source: Bloomberg, as of June 8, 2021. Based on Core Personal Consumption Expenditures Index (Core PCE) and Dallas Trimmed Mean Core PCE Index (Core PCE Trimmed).

These levels reflect market consensus views that agree with the Fed's expectation that the near-term surge in inflation will be transitory.

That likely gives the Fed comfort that its policy of waiting for actual inflation to show up before even talking about tightening policy has not led to any de-anchoring of inflation expectations. But it is still early in the debate to call inflationary concerns unwarranted.

Bond markets overall have been relatively resilient in the face of the onslaught of rising inflation data. This partly reflects the market's confidence in these inflation moves being transitory and may also partly reflect the lingering doubt over the ability of alternative scenarios of higher inflation coming to fruition. Nonetheless, given the current market levels, risks for bond investors clearly skew to the downside. The base case of transitory inflation looks mostly priced in, while the upside inflation scenario would lead to some significant repricing of inflation risks.

Is the Fed tempting FAIT?

For risky assets—credit and stocks—how the Fed would react to the upside inflation scenario remains key. The Fed's June FOMC meeting comments displayed a degree of "risk management." To the surprise of markets, the Fed subtly upgraded its inflation expectations by signaling two hikes by the end of 2023 and acknowledging the beginning of "talking about talking about" tapering.

Despite these shifts, the Fed still appears willing to "tempt FAIT" on inflation, as the benefits of pushing nominal rates further from the zero lower bound helps to restore its ability to operate monetary policy effectively and helps it avoid becoming a permanently less effective central bank that cannot fight off future recessions.

However, the costs of letting the U.S. economy overheat now may prove to be more than the Fed currently anticipates. The Fed cites the recent history of low levels of inflation even with low unemployment as supporting its policy stance of pushing the economy further, overheating labor markets and no longer preempting inflation through policy tightening. The Fed no longer forecasts inflation for making policy decisions; it will wait until that inflation actually shows up, confident in its ability to deal with rising inflation.

Yet the very dynamic that allows for this confident view is also its potential fatal flaw. As Larry Summers pointed out, the low inflation response to labor markets (e.g. the "flat Phillips Curve") can be a double-edged sword—as rising inflation may require substantial increases in unemployment to reign it in. In such a case, the Fed might find itself having to choose between rising inflation or large increases in the unemployment rate. Neither outcome would be popular and would unwind many of the benefits of the Fed's current policy objectives of "broad-based and inclusive" full employment.

A one-time price reset... or the start of inflation?

While the Fed and most economists agree that these price pressures are fleeting, the risks of entering a new inflationary regime cannot be ignored.

Long-term inflation results when the aggregate demand in the economy exceeds the ability of production to keep pace—essentially when demand is greater than supply. The persistent lack of aggregate demand relative to abundant supply in the decades preceding COVID resulted in a prolonged period of disinflation, but several forces may now be shifting the old regime.

A paradigm shift in policy support

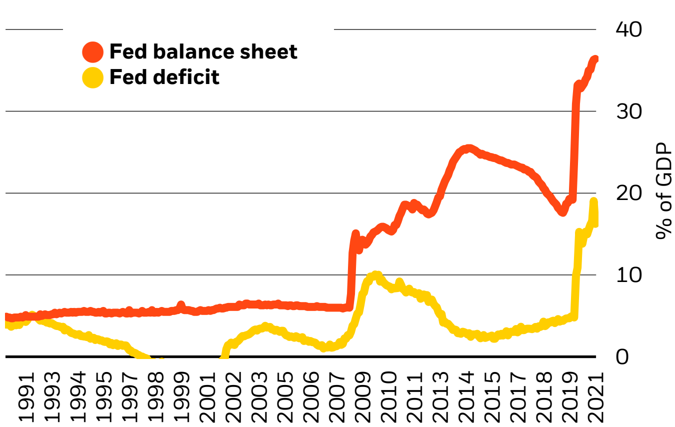
The economic support to COVID has been enormous. First, monetary policy by the U.S. government has provided historic increases to liquidity and money supply in the financial system, in addition to direct credit and financial normalization support to markets. Second, we also have seen equally historic fiscal policy support amounting to over $5 trillion in the form of direct payments, payroll subsidies, extended unemployment insurance, child tax credits and more. That support is likely to rise with negotiations to pass a massive infrastructure bill underway.

Figure 2 highlights the sheer magnitude of the economic stimulus injected into the economy. The chart combines the annual U.S. fiscal deficit with the increase in Fed's balance sheet as a percent of GDP. The amount of both fiscal stimulus (through the expansion of the deficit) and easy monetary policy (through the growth in the U.S. balance sheet) is the highest it has been in the modern era and similar to the levels seen during World War II.

Globally, this impact is largest for the U.S. as its fiscal support response has been larger than in other developed economies. While helping to accelerate the economic restart, this paradigm shift in U.S. policy may have real implications on long-term inflation expectations.

Figure 2: A new paradigm in policy support

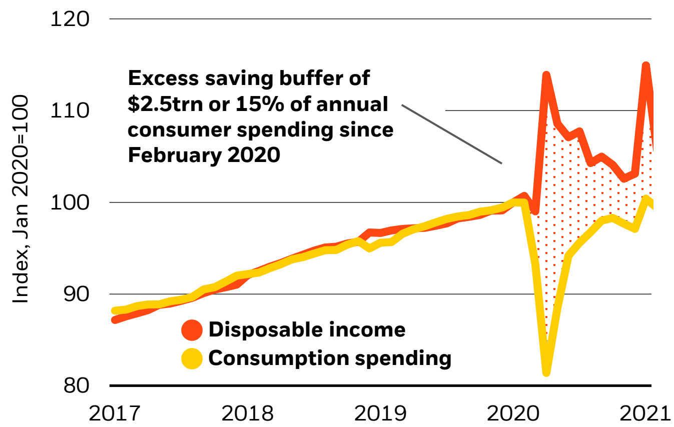
Federal deficit and balance sheet as % of GDP



Source: Bloomberg, as of May 27, 2021.

Figure 3: Pent-up demand and cash burning a hole in consumer's pockets

U.S. disposable income vs. consumer spending



Source: BlackRock Investment Institute, Bureau of Economic Analysis, U.S. Treasury Department, with data from Haver Analytics, April 2021. Chart shows U.S. nominal household disposable income (orange line) and nominal personal consumer spending (yellow line).

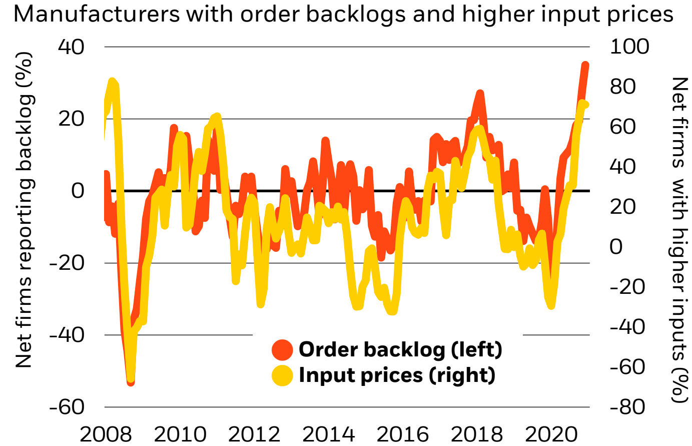
(Sluggish) supply and (pent-up) demand

For some, this level of fiscal support has led to more than 100% replacement rates of lost income during the pandemic. For many consumers who remained employed, they most likely did not spend as much throughout the pandemic given reduced mobility and business shutdowns. The result has been a rapid and epic surge in consumer savings rates alongside surges in consumer spending as the economy has reopened (Figure 3). Since February 2020, the excess savings is likely around $2.5 trillion or about 15% of annual consumer spending.

This surge in demand has corresponded with difficulties reopening the supply side of the economy, leading to bottlenecks. Figure 4 highlights survey results of U.S. manufacturers which shows the net balance of firms reporting order backlogs and increased input prices in the cost of goods. After most firms reported lower or no backlogs and lower input prices after the pandemic first hit, the measures have rebounded significantly and are now at its highest level since the GFC.

Figure 4: Supply-side bottlenecks

Manufacturers with order backlogs and higher input prices



Source: U.S. ISM Manufacturing Survey, as of May 27, 2021.

A potential shift from "demand-pull" to "cost-push" inflation

Of potentially greater concern than restart supply and demand dynamics is the labor market. Despite disappointing headline payrolls reports over the past few months, wage inflation figures surprised to the upside.

This matters because restart economics and supply bottlenecks reflect "demand-pull" inflation. This type of inflation is transitory because the excess demand will eventually wane as pent-up spending behavior and fiscal support normalizes. The risk for more durable inflation runs through a transition to "cost-push" inflation.

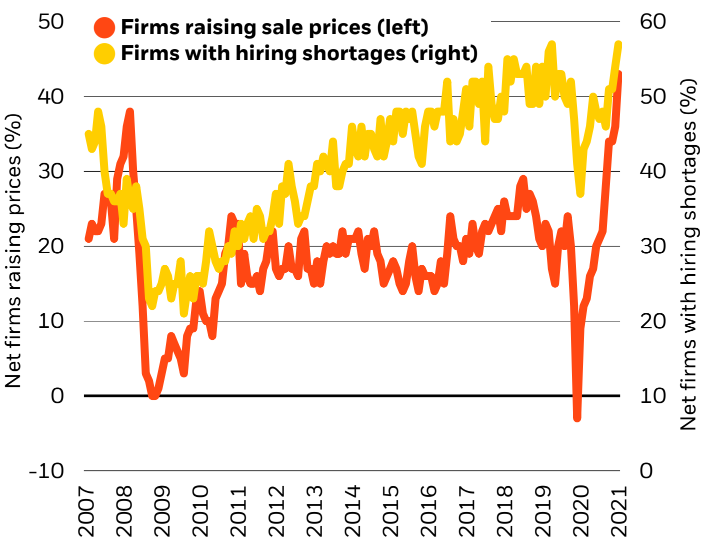
Evidence of this transition is mounting, particularly in the survey data from small businesses which highlights the potential for pricing power pass-through not seen in decades. Figure 5 shows that about half of firms are planning on raising sale prices and roughly 60% are having problems hiring and filling positions.

In this form of "cost-push" inflation, rising wages help bolster the ability of firms to pass on price increases to end consumers, while rising prices and a shortage of labor emboldens workers to demand higher wages.

That is a vicious spiral of de-anchoring inflation expectations that can ultimately lead to persistent—not transitory—pricing pressures.

Figure 5: Start of a "cost-push" inflation cycle?

Firms reporting raising sale prices and hiring shortages



Source: Bloomberg, National Federation of Independent Businesses (NFIB) survey data, as of June 8, 2021.

What about secular deflationary forces?

Underpinning the view that inflation is transitory is the assumption that the global economy will resume certain pre-COVID dynamics such as persistent excess savings (global savings glut), globalization trends supportive of disinflation in input prices, and technological disruption creating scale and pushing down costs.

Substantive change to any these dynamics presents a reasonable case for less disinflation.

- The global excess of savings may be absorbed through the combination of a permanently higher level of government investment demand (global expansionary fiscal policy that doesn't fall off the cliff), private business investment demand fed by a combination of reshoring and restoring resilience to global supply chains.
- The potential for businesses to focus on resilience of supply chains could lead to a change in the level of investment demand. We are also seeing the initial impact of climate change policies on business investment as firms face a growing need to address this long-term threat.
- Technology adoption and productivity may well remain forces to contain the increases in inflation, particularly through the ability to use technology to substitute for labor and hold down wage increases. However, if the best of productivity and inflation suppressing new technological adoption is behind us, this dynamic may no longer contribute as significantly to disinflation as it has in the past.

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What does inflation risk mean for bond ballast?

As questions around inflation have swirled, one of the most frequent inquiries we receive is: "Are bonds still a good hedge to stocks?" Yes, but there is a catch. Based on history, we have found that bonds hedge growth scares, not inflation risks. In fact, of the 25 years with negative equity returns since 1929, U.S. 10-year Treasuries generated positive returns in 22 of those periods (Figure 6). In these cases, the rule of thumb, "Bonds go up when stocks go down," applied.

But what about the other 3 years? Two of the three historical exceptions were unique events. Among the causes in 1931 were the collapse of Austrian bank Credit-Anstalt and the currency crisis that forced Britain to abandon the gold standard. In 1941, it was the U.S. entry into World War II. But the 1969-70 episode stands out. In that period, excessively loose monetary policy coupled with late-cycle fiscal stimulus led to a decade of higher inflation.

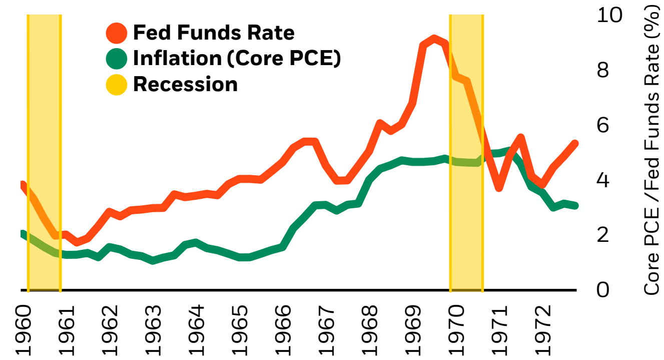
What we can learn from 1969

While the restart from COVID is truly unique, a closer look at the late 1960s reveals some parallels with today's economic backdrop. Inflation was on the rise after a prolonged period of languishing well below the Fed's 2% target. At the same time, the economy was receiving a hefty boost of fiscal stimulus from President Lyndon Johnson's Great Society programs and Vietnam War spending even though the economy was near full employment.

In the mid-1960s, as signs of price increases began to emerge, the Fed quickly shifted from inflation-creating to inflation-fighting mode, contributing to a market downturn (Figure 7). Under such a scenario, bonds were able to provide a hedge to equities eventually, but only after the Fed had sufficiently snuffed out inflation. Unfortunately for investors at the time, inflation kept climbing and peaked only in the mid-1970s. Further policy errors throughout the 1970s contributed to a dreadful experience for markets.

Figure 7: Fed's inflation response leads to 1969-70 recession

Fed Funds Rate, Core PCE, and recessions



Source: Bloomberg, from 3/31/1960 - 12/31/1971.

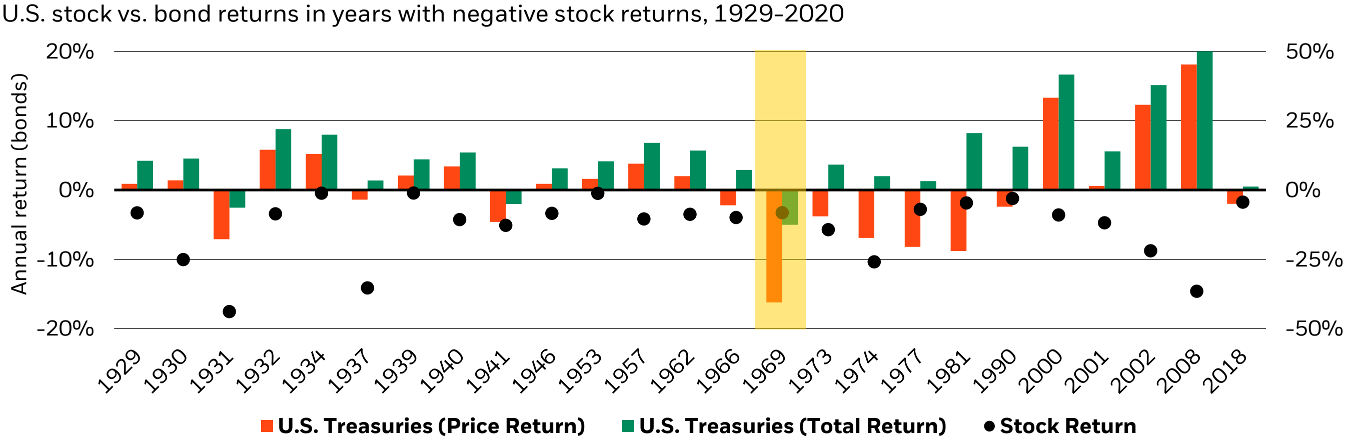
The recession of 1969-70, and the negative stock and bond returns of 1969 that proceeded it, highlight what may happen to bond ballast in an overheating scenario. The key lesson: bonds hedge stocks during downturns when the source of the downturn is a growth shock, which typically leads to declining inflation expectations. But when stocks decline due to rising inflation concerns, bonds suffer as well, undermining their role as equity diversifiers in a 60/40 portfolio. And as seen in Figure 6, negative bond price returns (the orange bars) during high inflation periods ('73, '74, '77) can lead to poor bond returns and stock losses at the same time. Especially—as is the case today—if bond coupon levels do not adequately reflect an inflation risk premium.

Hedging your (inflation) bets

The inflation debate leads investors to search for assets to hedge their current bond allocations in the case of an overheating economy. For fixed income, at today's low levels of yields and tight levels of spreads, the choices are few and far between. TIPS prices already reflect inflation at or above the Fed's targets, making future gains dependent on more persistent inflation than we have already seen.

Figure 6: Bonds hedge growth, not inflation risks

U.S. stock vs. bond returns in years with negative stock returns, 1929-2020



Past performance is not a reliable indicator of future results. Source: Bloomberg, as of December 2020. Notes: The price and total return of bonds are based on the annual return of 10-year U.S. Treasury bonds. Stocks are represented by the S&P 500 Index. Price returns are estimated based on the duration of bonds and the movement of the 10-year rate.

Corporate credit—which can be a natural beneficiary of rising nominal prices because they can pass on the cost of inflation—trades at spread levels that already reflect exceptionally low expected defaults and tight liquidity risk premia. And while inflation may limit default rates, it can eat away at the real interest rate that bond holders receive.

Asset classes outside of fixed income—such as real estate, commodities, gold, and even crypto—have varying degrees of liquidity and predictability (or lack thereof) as an inflation hedge. Many times, the evaluation of inflationary hedging assets is viewed in a vacuum. But as inflation changes, so can the liquidity environment. When evaluating an inflation hedge, investors should ask, "Will the asset perform in a high inflationary scenario while at the same time being met with tightening monetary policy by the Fed?"

Asset inflation, fueled by excess liquidity, can create the perception of inflation hedging characteristics. But those characteristics are more likely fleeting if the assets lack a fundamental link to inflation economics. In this case, the assets may not actually hedge inflation, but rather reflect too much money chasing too few assets—something that can turn quickly if liquidity tightens.

Bottom line on inflation

The uncertainty around inflation expectations is likely to be a reoccurring concern for investors as more data becomes available in the coming months. For investors who don't have the risk appetite to "tempt FAIT," supplementing your traditional bond allocation with alternative diversifiers may be prudent.

Traditional core bond exposures can help to balance equities in the case of a growth shock, but they are vulnerable to exacerbating portfolio losses in the case of an inflation surprise. A complementary allocation to more defensive-oriented alternatives with less inflation vulnerability may help to better balance equity portfolios if the economy shows signs of overheating and inflation proves not to be transitory.

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