Fixed Income Market Commentary

May 2011

Transitory Inflation

Key Points:

- Inflation in focus
- Fuel costs on fire
- The Fed battles misperceptions

Inflation is the hot-button issue that seems to be on everyone's mind lately. The question is, are we poised at the brink of a new bout of spiraling price increases or, as Fed Chairman Ben Bernanke said last week, will the recent spike in prices be brief at best?

While Washington debates trillion dollar deficits, you and I are making increasingly expensive trips to the gas station. It seems as though everything from fuel to food, from education to healthcare, and even our trips to the movies, are going up. Even taxes are rising-or so it seems.

And yet, for bond investors living off the yields our portfolios generate, our rising costs of living are not being matched by a commensurate increase in income. And that's why bond investors care about inflation, because it diminishes our purchasing power, and the value of fixed interest-rate securities.

Much of today's concern over inflation, if not the actual catalyst for rising prices, stems from the stimulus money that has been pumped into the financial system to rescue it and the economy from the 2008-2009 recession.

But are we facing spiraling inflation? The other day Fed Chairman Bernanke used the phrase "transitory inflation" to define the current run-up in prices. If he's right, then the pain we're feeling today should pass. When? I don't know and Bernanke wasn't saying.

You may have noticed that, in the debate over inflation, much of it centers on how you define it. In the economic lexicon there's "headline" inflation, and there's "core" inflation. The headline measure, which is what we experience day-to-day, is more inclusive. The core inflation report removes food and energy costs from measurement because they tend to be more unstable. The core measure is meant to show the longer-term trends in inflation, while the headline rate is what consumers, or businesses are feeling here and now. The whole argument is interesting because not that long ago we heard talk of a possible bout of deflation taking hold.

The government's measures of inflation are important to you and me because everything from cost of living adjustments (COLAs) to Social Security payments to pension payouts, to name a few, is tied to the rate of inflation. And the core rate is often the metric used when adjustments must be made.

One of the Federal Reserve's primary roles is to maintain price stability though, practically speaking, the true goal is to keep inflation from rising much above 2% per year, as well as to keep deflation, when prices spiral downward, from taking hold. From the Fed's perspective, the stickier price movements captured in core inflation measures are more reliable and paint a more accurate picture of longer-term inflation trends. For now, they continue to forecast low inflation (and high unemployment) for the next few years.

As I said, inflation, and expectations for inflation are crucial to the workings of the bond market. In particular, inflation-linked bonds have performed very well of late. As a result they have become expensive as their prices have risen and their already-low yields have fallen further.

I think some investors lack a clear understanding of just how Treasury Inflation-Protected Securities work. The inflation protection protects the principal (face value) of the bonds. When the principal value rises due to inflation, the fixed coupon is paying interest on that adjusted principal value. Of course, the principal value can decline during a deflationary period and, by extension, the income produced would decrease too. However, TIPS prices are market driven and fluctuate just like nominal or regular Treasury bonds. And, given that a significant amount of TIPS were purchased by the Fed in the current round of quantitative easing, not by private investors, the price rally we've seen may, itself, be subject to some irregularities in the marketplace.

Bond investors are clamoring for higher yields. But the combination of politics and government spending, along with the ability of our economy to continue expanding, will influence just when and how far interest rates will rise over the coming year. Given the Fed's expectations for slowing headline inflation, the current high rate of unemployment and recent measures showing economic growth slowing in April, I don't believe the Fed will raise interest rates any time in the immediate future. I expect yields on the benchmark 10-year Treasury bond to remain range-bound between 3% and 4%.

Sector Review

As noted above, investors have put a premium on inflation protection. The inflation-linked Treasury sector (TIPS) put in a solid move higher in April, up 2.5%. This is the top performer in our data box below. The 1.1% gain for nominal Treasuries was the best monthly showing since last August. The municipal bond market is finding renewed interest as well, with the primary index returning 1.8%. A limited new supply pipeline is helping munis overcome the default fears that hurt performance a few months ago. New issue volume is down by more than 50% from last year's levels. In the higher risk areas, high yield continues to deliver positive performance with the Barclay's index up 1.5%. Bonds in many emerging markets also performed well, with an identical 1.3% return in each of the past two months.

Barclays Fixed Income Index Returns Through 4/30/11						
	Duration	Apr	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.31	0.03%	0.08%	0.22%	0.37%	2.44%
US Treasury Index	5.34	1.15	0.99	5.87	-3.57	13.74
US TIPS Index	5.84	2.51	4.65	6.31	11.41	-2.35
US Aggregate Bond Index	5.08	1.27	1.70	6.54	5.93	5.24
US Govt / Credit Index	5.52	1.32	1.60	6.59	4.52	5.70
US Credit Index {A2}	6.43	1.69	2.60	8.47	16.04	-3.08
US High Yield Index {B1}	4.26	1.55	5.49	15.12	58.21	-26.16
Caa component	3.42	1.91	6.89	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.40	1.37	2.96	12.84	34.23	-14.75
Municipal Index	8.41	1.79	2.31	2.38	12.91	-2.47
Municipal Index - 5 Year	3.88	1.28	1.90	3.40	7.40	5.78

Source: Barclays Capital

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