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FLASH NOTE

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INFLATION RISKS, REGIMES AND IMPLICATIONS FOR TREASURY MARKETS

On the tail of hard pandemic lockdowns that imposed the deepest economic contraction on record, the US economy is reopening amid a rapid COVID-19 vaccination roll-out and an avalanche of fiscal spending. So, investors are naturally now contemplating what kind of post-COVID economy will emerge.

The pandemic has brought many issues to the fore – of economic inequality; the risks associated with existing supply chains and production systems; the role of technology; the impact and future of globalization; and humanity's encroachment on the natural world and contribution to climate change. It is clear that the US economy – and indeed those around the world – will not return to business as usual.

In this context, one of the key questions facing fixed-income investors is whether the US economy may be heading towards higher inflation, whether temporary or persistent. The consensus among most US economists is that the increases in prices we will see in 2021 will be purely transitory, reflecting a mix of base effects and temporary supply bottlenecks as the economy reopens. Their argument is that inflation will thereafter return towards target, contained by the stability of inflation expectations, the muted response of wages to labor market pressures and a lack of pricing power in the corporate sector.

This analysis, based on recent experience following the Great Financial Crisis, could well be correct, but I (in my not-impartial position as an inflation-linked bond portfolio manager) think it underestimates the potential for a regime shift in inflation in the coming years. I would argue that, beyond the base effects and temporary bottlenecks, there are cyclical and structural reasons to see a firming of inflation pressures over the next few years, and that a regime shift towards persistently higher inflation is quite plausible.

So why might this time be different?

First, the monetary and fiscal policy response to the pandemic is unprecedented in its scale, coordination and ambition. The sheer size of fiscal intervention poses a risk of overheating the economy, driving unemployment down to levels that will test how flat the Philips curve is at extremes.

Second, the pandemic lockdowns present an economic shock very different to the one that stemmed from the 2008 US housing market debacle, with its attendant damage to financial and household sector balance sheets, allowing for a much faster recovery.

Third, the adoption of an average inflation-targeting framework will ensure that the US Federal Reserve (Fed) is reactive rather than proactive in countering inflation pressures.

Fourth, global supply chains are being reconfigured, and the US-China trade relationship is becoming more adversarial, which looks set to reduce global competition and may strengthen US producers' pricing power.

Fifth, most developed economies, and that of China, are seeing a demographic reversal that will lead to a decline in working age populations. This will reduce global savings rates, drive up real wages and inflation and reduce inequality. Given high levels of corporate and government debt, electorates' refusal to tolerate austerity and the imperative of avoiding a debt sustainability crisis, policymakers will be heavily incentivized to reduce that debt burden through an inflation tax.

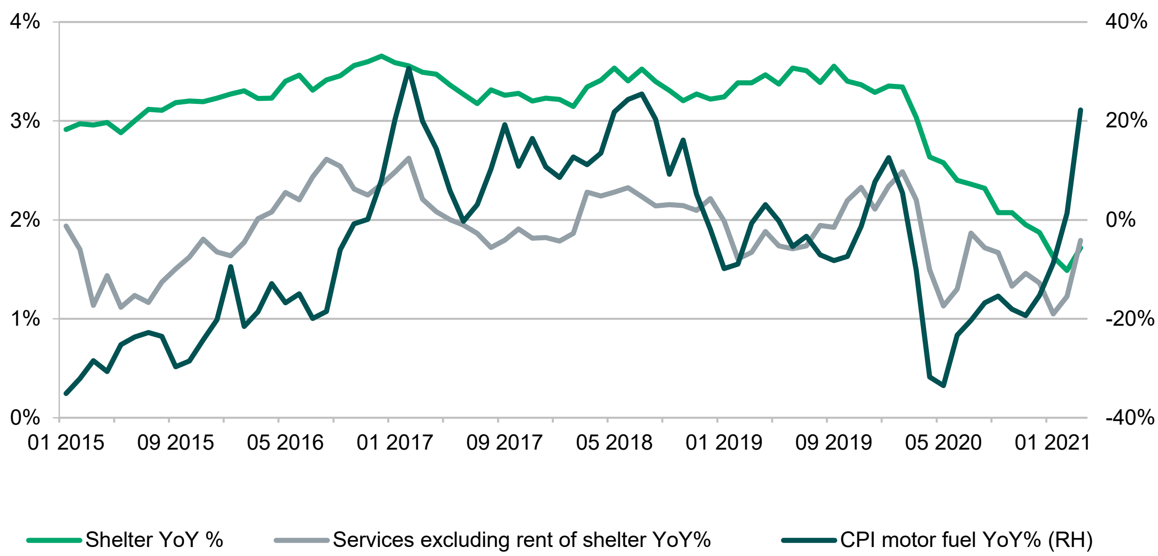
This note concludes by setting out some possible implications of our inflation discussion for Treasury markets. We argue that TIPS (Treasury inflation-protected securities) real yields should remain contained while the Fed is maintaining accommodation, while longer-dated conventional Treasuries remain vulnerable to a further sell-off if investors become concerned about a persistent resurgence in inflation, thereby driving breakeven inflation rates above pre-COVID levels. If inflation expectations are shocked higher by a change in the inflation regime, we should also see a re-emergence of inflation risk premia in Treasury yields.

Where is inflation heading in the near term?

Over the next few months, the outlook for inflation is uncontroversial: consumer price index (CPI) and personal consumption expenditures (PCE) price index inflation will move higher because of (i) base effects and (ii) transitory supply bottlenecks. The sharp declines in commodities prices that accompanied the first lockdowns in March 2020 depressed headline CPI inflation at the time.

To illustrate this, according to the American Automobile Association, the national average price for regular grade gasoline fell from USD 2.58 a gallon in January 2020 to USD 1.78 a gallon in April 2020, but has since recovered to USD 2.90/gallon. Other components of the CPI moderated too, of course, albeit more gradually – notably non-shelter services that were hardest hit by the lockdowns, as well as shelter costs (composed of primary rent, owners' equivalent rent and lodging away from home), where rents fell as tenants initially lost income.

Exhibit 1: Services and motor fuel prices rebounded



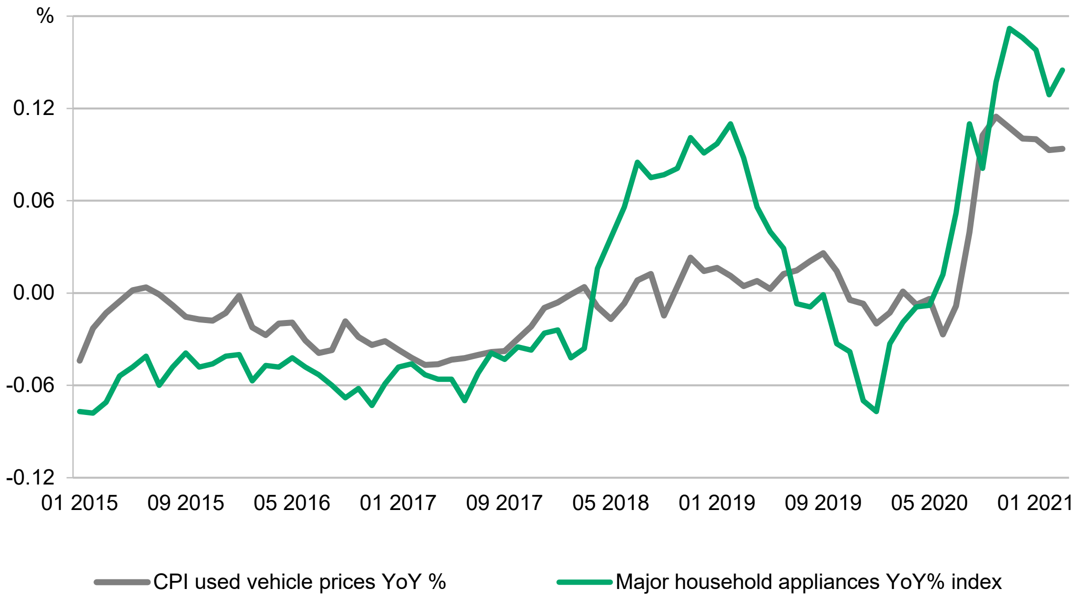
Source: BNP Paribas Asset Management, Bloomberg as of 12/05/2021

As lockdowns ease and in-person services sectors reopen, we are seeing prices of lockdown-sensitive goods and services stabilize. If the summer reopening of 2020 is any guide, we should see prices of CPI categories like airfares, lodging, car rentals and entertainment rise in the coming months.

Already, some goods and services are being impacted by supply bottlenecks, as inventories were in many cases drawn down in 2020, and production problems from disrupted supply chains are preventing restocking. The clearest current example of this is in the shortage of semiconductors, which has slowed production of domestic appliances and new vehicles, and helped drive up the price of major household appliances and used vehicles[1].

[1] Ford sets out escalating impact of chip shortage | Financial Times (ft.com)
To be fair, semiconductor supplies have been impacted by a fire at Renesas's chip production facilities, but the broader point that integrated just-in-time global supply chains are subject to disruption remains valid.

Exhibit 2: CPI used vehicles prices and major household appliances, year-on-year, % since 2015



Source: Federal Reserve Economic Data | FRED | St. Louis Fed (stlouisfed.org) as of 12/05/2021

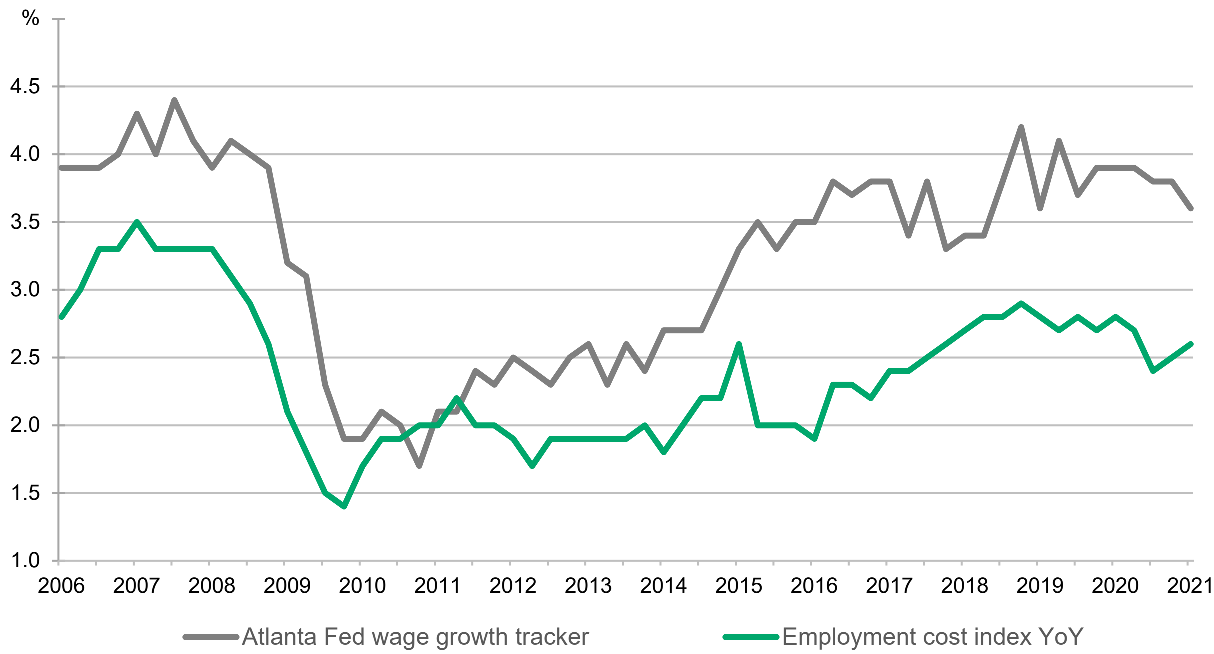
Semiconductors will likely not be the only blockage in the economy in the coming months, though. With businesses of all varieties having drawn down inventories and scaled back production to protect cash flow, and with retailers reporting historically low inventory-to-sales ratios, it is reasonable to anticipate shortages of certain goods and services across a number of sectors. Furthermore, in some sectors, many businesses will have closed permanently during the months of lockdown. That productive capacity will take time to rebuild.

Another potential bottleneck is in staffing. Despite the swollen ranks of the unemployed and furloughed, several services sectors are already reporting difficulties in rehiring qualified staff, and we have seen a number of employers raise wages or offer bonuses pre-emptively to attract and retain workers[2]. The relatively weak April non-farm payrolls report stands in stark contrast to the surge in job openings. The National Federation of Independent Businesses survey also reports that small businesses are increasingly having problems filling open positions and having to raise worker compensation. A reluctance by some workers to return may reflect caution about the ongoing health situation, childcare complications as schools remain disrupted, and/or the extension of enhanced unemployment benefits until September – all temporary factors that will eventually recede. Nevertheless, they could yet cause supply constraints and price increases in the coming months.

Furthermore, it is worth noting that despite massive lay-offs and furloughs, the employment cost index and Atlanta Fed's measure of wages for prime-age workers have not declined in the same fashion as in 2009-10, a revelation that casts doubt on the suggestion that rehired workers will be cheaper.

[2] Businesses encounter hiring challenges as demand surges | TheHill

Exhibit 3: Employment cost index and Atlanta Fed wage growth tracker for prime-age workers



Source: BNP Paribas Asset Management, Bloomberg as of 12/05/2021

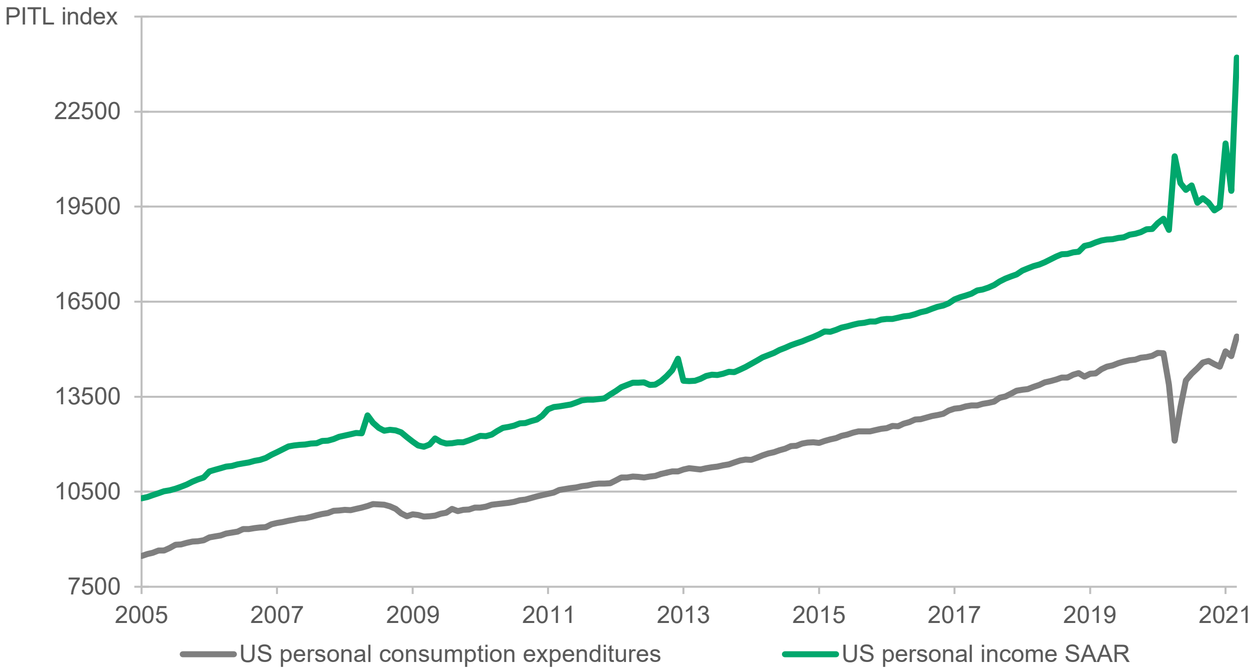
What about cyclical pressures on inflation?

As easing of public health restrictions allows the economy to reopen, we are seeing a combination of robust demand and input supply shortages that is driving up prices.

On the demand side, a mix of improving consumer confidence, sharply higher household disposable income and an estimated USD 1.6 trillion of excess household savings from the pandemic is enabling consumers to ramp up their spending. Although surveys indicate that consumers are choosing to spend perhaps only a third of their stimulus checks, the sheer size of these transfers, along with rising employment earnings, are such that personal incomes grew at the fastest pace on record in the first quarter, and to levels that far exceed the pre-COVID trend-line.

This boost to personal income has permitted personal consumption expenditures to return to the pre-COVID trend-line, even if the spending has been weighted towards goods rather than services. As businesses reopen, staff are rehired and opportunities for spending are once again available, we anticipate that personal spending will accelerate further, a thesis confirmed by March retail sales, which grew at an astonishing 9.8% month over month.

Exhibit 4: Personal income and consumption expenditures, USD billion



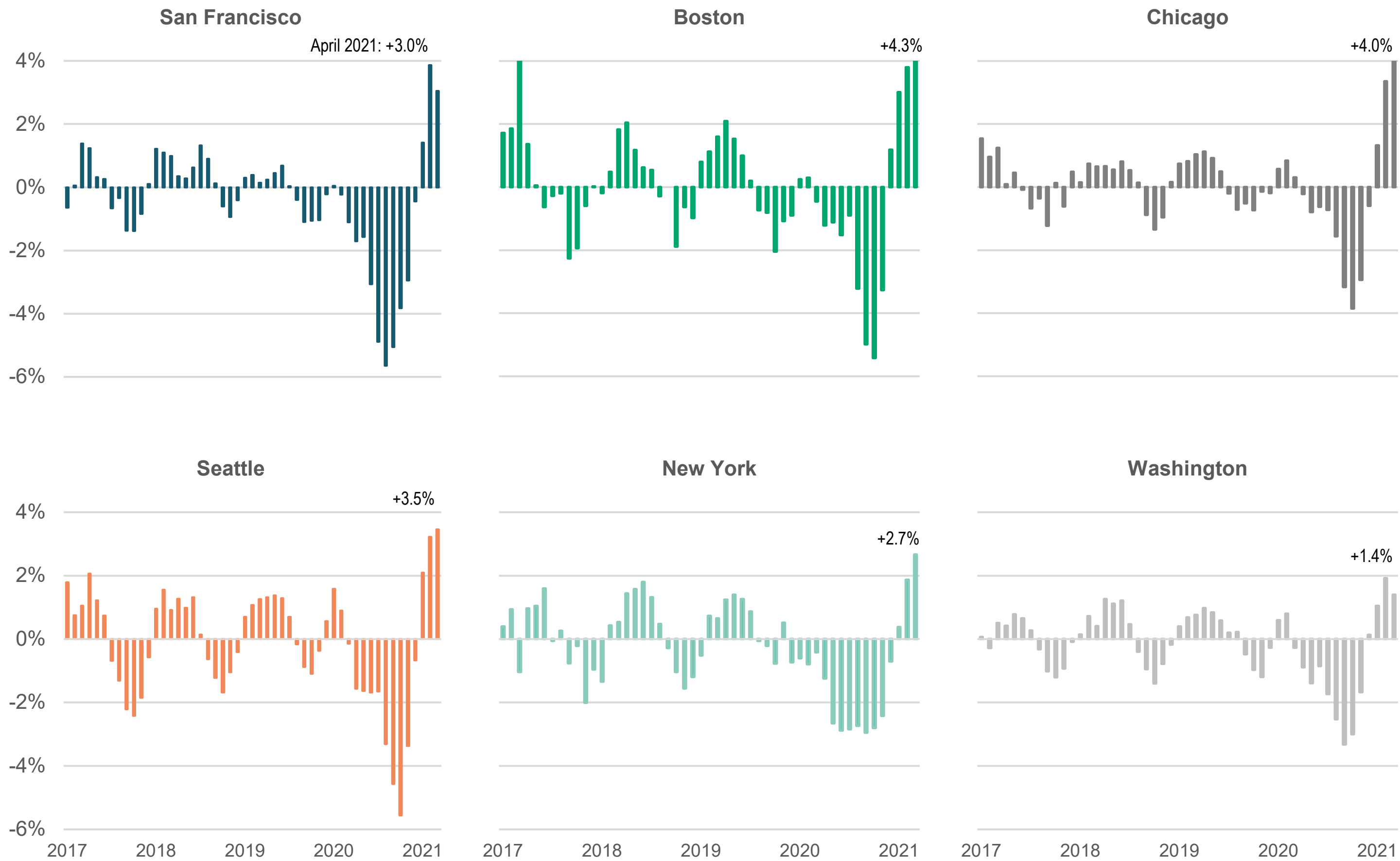
Source: BNP Paribas Asset Management, Bloomberg as of 12/05/2021

The key point is that, at an aggregate level, personal incomes have actually risen during the pandemic, due to government largesse. This is a key contrast with the 2008–10 recession, and one of the reasons why this time may be different.

One implication of the government's income support efforts is that shelter costs have already begun to turn around. Rents of primary residences, and owners' equivalent rents (OER) are the largest components of shelter costs (the remainder being lodging away from home) and make up 7.8% and 24.2% of the overall CPI index, respectively. In the months after the first lockdowns, rents came under pressure as many renters, often employed in sectors most impacted by the lockdowns, were unable to work and saw their incomes decline. Shelter inflation fell from 3.4% year-on-year (YoY) before the pandemic to 1.70% YoY in March 2021.

However, in recent weeks, anecdotal evidence and commercial real estate data suggest that primary rents have begun to firm, particularly in the largest metropolitan areas that had been worst affected by the pandemic. Some of the CPI increases reported by the Bureau of Labor Statistics reflect the removal of rent-forgiveness, of course. But there is evidence that newly negotiated rental contracts are being struck at higher rents, a story corroborated by our own Commercial Real Estate analysts. The chart on the next page, taken from the apartmentlist.com website, shows its calculation of actual negotiated rents on like-for-like apartments in six of the largest US metropolitan areas. The indication is that rents, and thus likely OER, have bottomed. Should the economy return quickly to full employment, as we think it will, shelter inflation will strengthen further.

Exhibit 5: Rent prices have rebounded in US cities hit by the pandemic



Source: https://www.apartmentlist.com as of April 2021

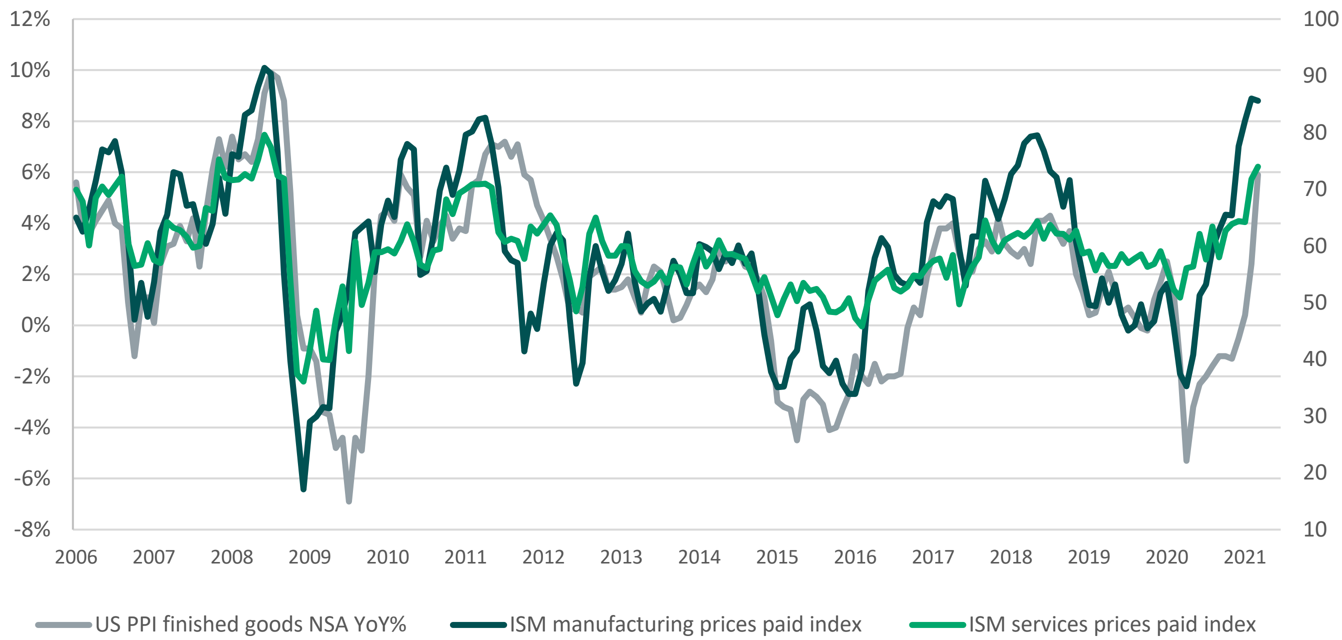
The strength of personal incomes, despite the furloughing of millions of workers during the pandemic, strongly suggests that the fiscal stimulus provided by the federal government may be larger than warranted by the output gap.

For context, the magnitude of the 2021 fiscal impulse (made up of the USD 900 billion December 2020 package and the USD 1.9 trillion March 2021 package) is comparable to the USD 2.3 trillion of support provided in early 2020, and dwarfs the fiscal assistance provided after the Great Financial Crisis. Putting aside the additional infrastructure plans that have been proposed, the 2021 stimulus package, at around 13% of GDP, is eye-popping in its scale.

Indeed, former Treasury Secretary Larry Summers and former IMF Chief Economist, Olivier Blanchard, have accused the Biden administration of irresponsibility. In February, Blanchard had estimated the US economy's demand gap at between USD 680 billion and USD 900 billion, and that was prior to the acceleration in the vaccine rollout and easing of social restrictions. Of course, the ultimate impact on aggregate demand of the fiscal packages depends on the (highly uncertain) multipliers involved, but Blanchard's assessment is that USD 2.8 trillion in fiscal measures is highly likely to be excessive and runs the risk of substantially overheating the economy and stoking inflation.

So, are we yet seeing any cyclical inflation pressures, beyond short-term bottleneck issues? It can be difficult to disentangle the two effects, but the answer, at least on input costs, is 'yes'. A common message from the most recent earnings calls from large corporations is the dramatic increases in input costs across categories: Fuel, agricultural commodities, metals, packaging, etc. The same message finds echoes in the ISM manufacturing and non-manufacturing surveys of 'prices paid'. Reported input prices are rising, driving up finished goods prices, as demonstrated in the chart on the next page. The surge in commodities and other input prices can be attributed to the simultaneous reopening of many large economies, restocking demand, as well as the impact of the pandemic on labor and logistics, and in some cases, weather.

Exhibit 6: ISM 'prices paid' indices for manufacturing and non-manufacturing, and PPI finished goods prices



Source: BNP Paribas Asset Management, Bloomberg as of 12/05/2021

Of course, this would not be the first time that commodities and input prices have strongly rebounded following an economic contraction, and we cannot necessarily extrapolate from input prices to output prices. For higher prices to pass through to consumers, rather than squeeze margins, companies must have some pricing power. Yet, some CEOs (notably at Nestlé, Unilever, Reckitt Benckiser, Procter & Gamble, and Kimberly Clark, among others) are confirming that they are beginning to pass these higher costs on to their customers. As Warren Buffet recently noted, "people have money in their pockets and they'll pay the higher prices"[3].

To be fair, core goods prices in the CPI (which only represent 20% of the consumption basket) have so far barely risen. Goods prices are also likely to level off, especially once short-term supply disruptions cease and households switch their expenditure back towards services.

The inflation sceptic will rightly point out that the case for a sustained firming of inflation must rest on more than just an overly generous fiscal stance, a recovery in shelter costs and a commodities boom. After all, in 2018, prior to the escalation of the US-China trade dispute, the US economy was also running at close to full employment with ample fiscal support from the Trump tax cuts, alongside rising commodities prices, with only limited impacts on CPI and PCE core inflation measures.

So, our next discussion point has to be the change in the Federal Reserve's framework, and the interaction between monetary and fiscal policy. In August 2020, the Federal Open Market Committee formally adopted a new 'flexible average inflation targeting' framework (FAIT). The Fed essentially recognized that, for years, it had mis-calibrated inflation dynamics and thus its policy stance, leading to a persistent undershoot of the 2.0% inflation target. That ongoing undershoot now threatens to undermine the stability of inflation expectations, putting the economy at risk of falling into a deflationary trap during future recessions. The new FAIT framework sets out that the central bank should look to 'make up' for periods of under-delivery, by allowing inflation to overshoot the target by a 'moderate' amount for 'some time', in order to average out at target.

[3] Warren Buffett sees 'significant' inflation amid 'red hot' US recovery | Financial Times (ft.com)

After a period of inflation undershoot, rather than adjusting policy proactively on the basis of (unreliable) inflation forecasts, the new framework calls for a reactive policy rule that waits for actual inflation to arrive before the policy stance is adjusted. Because the policy rule is reactive, it will likely be late in raising rates. At the same time, because it aims to deliver an overshoot that must eventually be dampened, the peak of the policy rate will likely be higher.

The key point, however, is that FAIT is a response to the fact that the central bank finds itself with limited policy options when the policy rate is close to the effective lower bound. By committing to push inflation and inflation expectations back up, the Fed resets the equilibrium *nominal* rate at a higher level, and thus gives itself more room to cut *real* rates in times of crisis.

Despite our initial trepidation, we now **view the Fed as committed to the new FAIT framework.** Fed Chair Powell's communications over the last few months have been consistent – the Fed will not taper asset purchases until the economy has made 'significant progress' towards the full employment and price stability objectives, and policy rates will not be raised until the economy is at full employment (defined in a broad, inclusive sense) and inflation is sustainably at target and forecast to overshoot 'moderately' for some time. Furthermore, Powell has clarified that the base effects and supply bottlenecks we will see in the coming months are 'transitory' and do not pass the inflation overshoot test.

At the same time, as we have a new monetary policy framework focused on a broader definition of full employment that includes the fortunes of minority groups, Treasury Secretary Yellen has indicated she will use the spending and taxation powers at her disposal to address inequality and opportunity. In effect, the Fed has committed itself to accommodating an extraordinarily large fiscal expansion, and only tighten its policy stance in a reactive fashion, once the economy is actually overheating and generating both wage and consumer price inflation.

This degree of coordination between fiscal and monetary authorities, as well as the ease of each component, is almost unprecedented in peacetime, and what is extraordinary is that the objective of the exercise appears to be to generate a (mild) economic boom, rather than a 'soft landing'.

Of course, many investors are not yet convinced of the Fed's commitment to FAIT, and there are reasons to be skeptical; after all, the Fed has under-delivered before. Would the Fed really tolerate an overheating of the economy that generated financial imbalances, for example? But our assessment is that the Fed has learnt some humility in terms of its ability to forecast inflation and regards the risk of falling into a deflationary trap as more serious than the risks posed by a frothy equity market. So, over the coming months, the Fed will doubtless repeat its messaging and burnish its credibility.

The Fed has a new framework, but can it actually generate inflation?

The inflation sceptic will argue that the flatness of the wage Phillips curve (i.e., the low sensitivity of wage growth to the level of capacity utilization) means that the response of wages, and then consumer prices, to even very low levels of unemployment will likely be limited. Recent experience certainly suggests that assertion could be correct. However, we would note that although, over recent decades, the Phillips curve has appeared to be relatively flat, its slope has yet to be tested at very low levels of unemployment. We will also note that prior to the pandemic, there was some evidence that wage growth was beginning to accelerate and broaden out to lower paid professions.

Furthermore, the suggestion that the Philips curve used to be steeper may itself be wrong – relatively recent research based on cross-sectional state-level data suggests that the Phillips curve has been very flat since 1978, and that the apparent flattening has been due to an anchoring of inflation expectations[4]. If correct, the implication of this work is that the Fed's efforts to shift inflation expectations by reframing its policy rule will be more important in driving inflation outcomes than its success at running the economy hot. Put another way, the conclusion is that output gaps don't matter that much – inflation is also about inflation expectations.

Our own view, of course, is that inflation expectations are hard to shift unless the economy is simultaneously running hot. Expectations tend to be as much adaptive as anticipatory, meaning they are shaped by recent experience and need to be 'shocked'. Just as Volcker the monetarist had to break the high inflation regime of the 1970s and early 80s by inflicting some economic hardship, so Fed Chair Powell will have to deliver a period of wage growth and inflation overshoot to prove that he is committed to average inflation targeting and shock expectations out of the 'lowflation' regime. How quickly inflation expectations can be adjusted remains to be seen, but the current context of extremely accommodative macroeconomic policy and post-pandemic supply shortages provides a good backdrop to generate the inflation required.

[4] "The Slope of the Phillips Curve: Evidence from US States", Hazell et al, NBER Working Paper 28005, May 2021

Could changes in international trade and the reorganization of supply chains be inflationary?

The Japanese experience with mild deflation of the last 20 years suggests that Powell's strategy of running the economy hot to drive inflation higher may be a Sisyphean task. However, recent developments in international trade, given developments in the US-China trade relationship could be helpful. The tightening of investment controls and rise in tariffs point to the limits that the West is beginning to impose on Chinese access to US and European markets and technologies.

Furthermore, the pandemic has revealed the vulnerabilities of modern, global supply chains that rely on logistics. Nations are recognizing that a number of sectors, such as medical goods, vaccines, microchips, as well as advanced technologies like artificial intelligence and battery development, have national security importance that require a degree of domestic self-sufficiency and protection. The implication is that the level of international competition in a number of industries and goods categories is likely to decline.

In theory, then, a less competitive world will permit higher goods inflation. Certainly, there is strong evidence that when the US imposed anti-dumping import tariffs on South Korean washing machine manufacturers, US manufacturers were able to raise their prices meaningfully.

However, at the same time, the pandemic has demonstrated the potential of technologies that support remote working. Increasing numbers of service jobs that were 'non-tradeable' are now easily performed across borders, allowing US technology companies to hire programmers in Ukraine, and European asset managers to outsource credit research to firms in India. At some point, the deployment of artificial intelligence technologies will likely mean certain occupations require far fewer human workers.

Overall, then, we think the deflationary impact of technology will likely outweigh the supportive impact of less globalization. However, we also note that, in the short term, some of the rapid reorganization of supply chains after the pandemic has the potential to disrupt deliveries for a while, adding to bottleneck price pressures.

What about structural issues such as demographics?

One explanation for the low inflation climate over the last 20 years is the impact of domestic and global demographic pressures. Demographics is not a topic that most economists spend much time talking about, but they really should, as there are profound changes taking place in advanced economies that will determine the size of our economies, the size of government, inequality, and probably inflation, too.

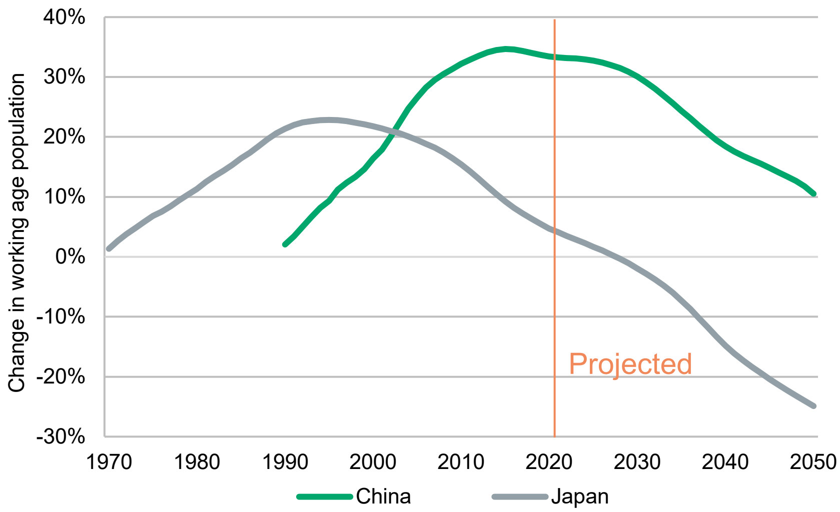
Looking first to the US, over the last 20 years, the United States has been relatively fortunate in enjoying steady 0.5% to 1.0% per annum growth in its working age population, supported by net immigration. However, with the so-called baby-boomers retiring, immigration restrictions tightening and fertility rates declining, that pace of labor force growth is set to slow. It also means that dependency ratios – the proportion of workers versus economically inactive retirees and children – is set to deteriorate, with implications for inflation and real wages.

The real changes, however, are taking place in China. A recent book, *The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival*, by Charles Goodhart and Manoj Pradhan, makes a compelling argument that China's rise as an economic superpower, which was driven by a mix international trade liberalization and a sweet spot in its own demographics, drove global output up and inflation down.

Since 1990, China has benefited from a roughly 30% increase in its working age population, as well as an unprecedented internal migration from the countryside to its cities, adding several hundred million workers to the tradeable goods sector.

Her economic ascent was driven by several forces, of course: Cultural and national cohesion, political will, internal migration, massive infrastructure investment, capital controls and absorption of Western technology and manufacturing practices. But China's contribution to global growth is now set to slow – its working age population has begun to contract, while the dependency ratio is deteriorating. China's demographics, in other words, will soon resemble those of Japan.

Exhibit 7: China and Japan – working age population growth, actual and projected, %



Source: '*The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival* by Charles Goodhart and Manoj 2021

The natural question, of course, is why demographic decline did not lead to inflation in Japan. And here Goodhart & Pradhan's answer is that Japan's demographic reversal commenced just as China's demographic and economic boom began. With Japan being a manufacturing champion, it naturally was among the first to feel the deflationary impact of the arrival of its new competitor. Japan's deflationary episode, they argue, is explained by China's accession to the World Trade Organization and its demographic boom and is a poor historical parallel.

Goodhart & Pradhan draw several conclusions:

- China's falling working age population and rising dependency ratio are likely to significantly drive real wages up over time. As more of the population switch from being net producers to net consumers, competition for productive workers will rise. Higher wages, in turn, should begin to reverse inequality.
- The pressures on healthcare and pension systems from a growing cohort of retirees, at the same time as growth in taxable productive capacity is slowing, will place enormous pressure on government budgets. If politicians cannot raise enough tax revenue to equilibrate the economy, inflation will rise. Attempts by central banks to tighten policy to defend inflation targets could then put them at loggerheads with politicians, especially those of a populist bent. The temptation to reduce the burden of growing debt levels via an 'inflation tax' and debt monetization will rise.
- The change in demographics will mean less saving. The phenomenon of a 'global savings glut' may well be drawing to an end. Without an offset from central bank policy, global real yields should rise, which would put further pressure on government debt sustainability.
- These arguments suggest, therefore, that China's demographic reversal and the West's new containment strategy via limits on trade, technology transfer and investment restrictions will, over time, throttle China's deflationary impact on global prices of goods and services. The demographic arguments apply equally to several countries in Europe, too, of course.

The pandemic has arguably accelerated these trends, having highlighted the financial vulnerability of large parts of the working age population, compared to the pension and healthcare protections afforded to the elderly. One can see that the public's tolerance for the austerity that accompanied the Great Financial Crisis has evaporated, and the explosion in public debt that has come with the pandemic has been largely absorbed by central bank purchases, who have essentially printed money in exchange. Will the coming demographic pressures be dealt with any differently?

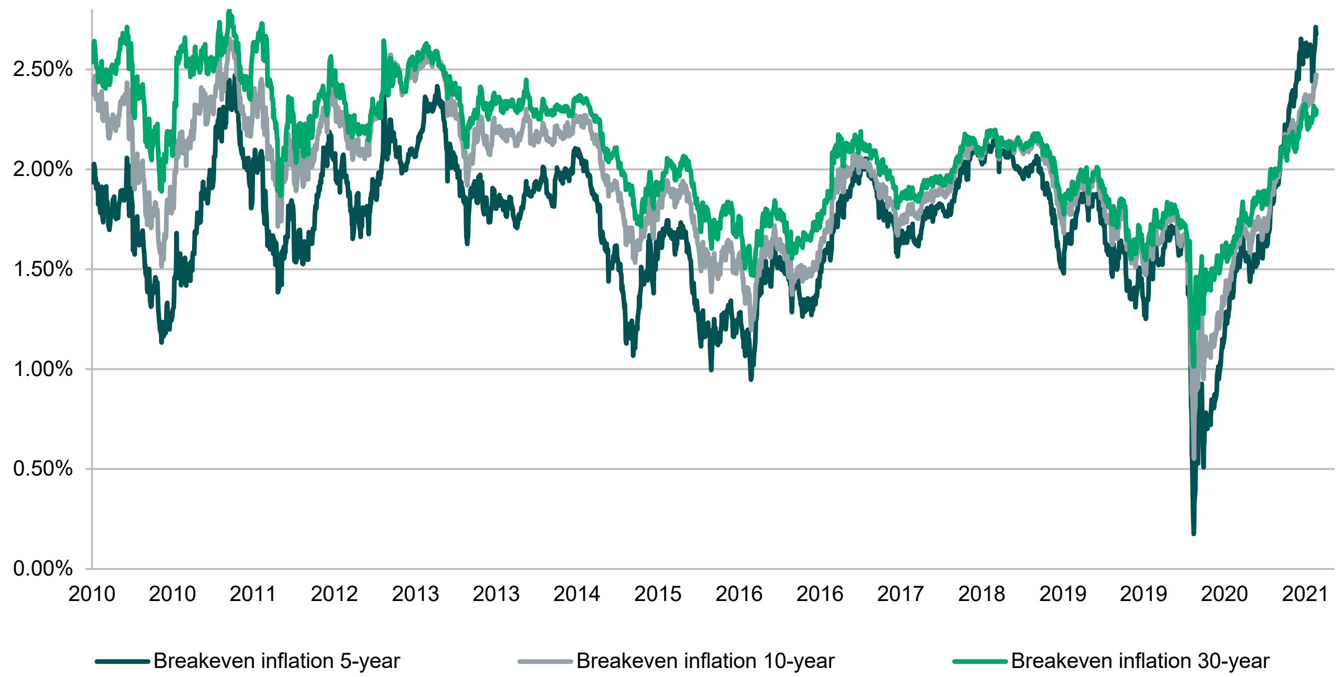
So, one really has to ask, will the inflation regime really stay the same? Are we really going back to a 'lowflation' environment? It is possible, but to assume that is the only plausible outcome is, in my view, complacent.

What are the implications for the Treasury market?

As outlined above, I am increasingly constructive on the US inflation outlook, and see far greater upside risks than I did 18 months ago. Drawing together the arguments above, I come to a number of conclusions:

- In the near term, Treasury investors are focusing on commodity prices, base effects and bottlenecks driving up the CPI. Most understand that these factors are transitory. However, there are concerns that the mix of fiscal and monetary stimulus could lead to the US economy overheating, and that underlying core inflation could then respond. The fact that the Fed is telling you that it wants to generate an overshoot in inflation makes it hard to dismiss the odds of that happening. Breakeven inflation rates will thus remain supported and should trade above pre-pandemic levels.

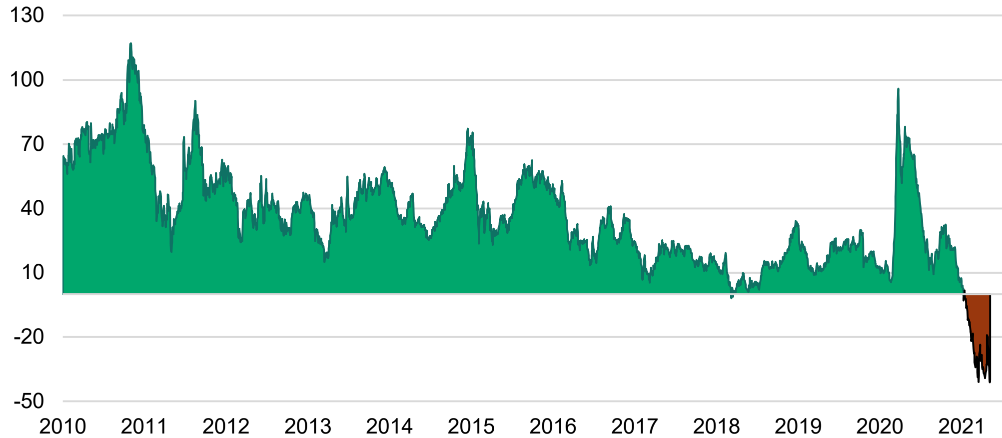
Exhibit 8: Five, 10 and 30-year TIPS-based breakeven inflation rates



Source: BNP Paribas Asset Management, Bloomberg, as of 12/05/2021

Of course, inflation markets have already repriced a lot. Ten-year TIPS breakevens have recovered from the pandemic crisis low of 0.55% to around 2.55%. The front end of the breakeven curve is already pricing several years of inflation overshoot, with 5-year breakevens at around 2.75%. The opportunity in breakevens is perhaps now on the slope of the breakeven curve, which should eventually re-steepen. After all, if the Fed does achieve a sustained inflation overshoot, investors will begin to wonder whether they should reprice inflation risk premia further out on the curve. And if the Fed fails to generate that overshoot, then the front end is vulnerable. The 5-year/30-year breakeven curve slope, at -40bp, is at its most inverted in history. That may be testament to the Fed's new FAIT framework, but the temporary inflation overshoot scenario is priced to perfection.

Exhibit 9: Five-year versus 30-year breakeven inflation rates



Source: BNP Paribas Asset Management, Bloomberg, as of 12/05/2021

- Second, the Fed is repressing financial conditions, which means real yields will remain contained for now – at least at the front end, given the Fed's policy rate guidance. However, at some point, the Fed will begin to remove accommodation. The first step will be a reduction in asset purchases, likely signaled in August or September, and implemented in early 2022. Hence, longer-dated real and nominal yields look vulnerable in the near term, though any sell-off should be limited by the rebalancing needs of pension funds.

  The Fed has and will continue to tolerate increases in longer-dated real yields that do not tighten financial conditions in a broader sense. Calibrating that tipping point is difficult, but we estimate that 5y5y real yields would impact other asset markets (i.e., equities) if they rose sustainably above 0.50%. At the time of writing, the 5y5y real yield is around +0.20%.

  If and when the Fed has succeeded in generating an inflation overshoot, it will at some point have to tighten policy – perhaps aggressively – to return inflation towards target. Average Inflation Targeting, therefore, should deliver a higher terminal policy rate (and thus higher nominal Treasury yields) than the regime it replaces. Real yields, however, might well, on average, be lower over the cycle.

- Third, investors should not expect a smooth ride. Volatility in asset prices is likely to rise. The Fed's FAIT framework is really a (vague) promise to be late in removing the punchbowl, and that means the party in asset prices could yet get out of hand. Already we are seeing excesses in certain assets, as acknowledged by the Fed's Financial Stability watchdogs. It is possible that the Fed will be forced to act and tighten policy before its FAIT framework suggests it should. The volatility and rotation between growth and value stocks shows how nervous equity investors are about higher real yields.

- Fourth, investors should think long and hard about whether we are still in a global secular stagnation environment characterized by excess savings, insufficient investment, muted inflation and low real yields. Demographics are reversing in a number of countries, savings rates are likely to decline over time, pension and healthcare systems will suck up resources, and some governments are launching significant infrastructure and climate change mitigation investments that will absorb spare capacity. Trend economic growth will slow further given population trends, but economies may well operate closer to full capacity. Heavy debt burdens will necessitate that real yields cannot rise too much, unless there is to be a debt crisis. Since inequality has rendered austerity politically unacceptable, and since real yields must be repressed for debt sustainability reasons, central banks will have to remain the marginal buyers of government debt. At some point, this currency seigniorage will devalue currencies and fan inflation. If so, the bull market in government bonds may finally be ending.

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