

Srinivas Thiruvadhanthai  
Director of Research

## Deflation Fears May Have Gotten Ahead of Themselves

\*Based on an article in the  
January 2015 *Levy Forecast*.

### Potential for Front End of Yield Curve to Steepen

Over the past several weeks, the front end of the yield curve has apparently been tugged in opposing directions by increasing fears of deflation and rising growth expectations. In 2015, deflation appears to be winning the tug of war as investors have fretted that plunging oil prices could push an already disinflationary U.S. price trend into deflation. Deflation risks are indeed elevated but current fears driven by oil prices are misplaced. We believe that the Federal Reserve is likely to look past some of the market concerns about deflation and give more hawkish signals in the next couple of months—and more so because the U.S. economic data will most likely be on the high side of market expectations and because news from the rest of the world may well suggest a modicum of stability. Consequently, rate hike expectations may advance, steepening the front end of the yield curve.

A marked steepening in the front end would provide attractive trading opportunities. Although the “global normalization scare” (discussed at greater length in the unedited version of this forecast) increases the probability that the Federal Reserve will begin to raise the federal funds rate this year, the more likely case is still that the Fed will not reach the point of pulling the trigger. Seeing the Fed either about to raise rates or actually executing the first rate hike would almost surely jolt financial markets around the world. If, indeed, the Federal Open Market Committee sits on its hands this year, it is likely that the erosion of the global economy will cause the next global recession before the Fed regains the inclination to raise rates. If so, the Fed’s focus will return to fighting economic weakness and deflation pressures, postponing interest rate hikes into the 2020s.

### Deflation Worries Depressing the Yield Curve

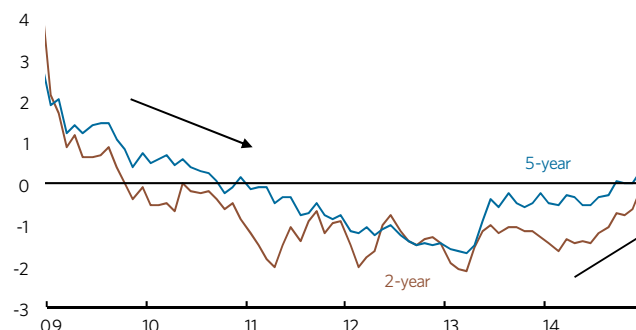
Expectations for U.S. economic growth have been firm, but their effect on the front end of the yield curve appears to have been counteracted by rising fears of deflation. Not coincidentally, public interest in deflation has spiked, and analysts have been reacting acutely to each new whiff of deflation.

There are several indications that markets are not worried about faltering growth prospects. First, consensus expectations of U.S. economic growth picked up in mid 2014 and remain elevated compared to most recent years. Second, real interest rates according to Treasury Inflation-Protected Securities (TIPS) have steadily increased from July 2014 (chart 1), suggesting that market participants are not concerned about weakening economic growth. Granted, the TIPS data are a flawed measure of expected real returns, but the contrast

#### Real Yields Rising Recently

CHART 1

Federal Reserve: Treasury Inflation-Protected Security Yields by Maturity  
% per annum, end-of-month level, last data point December 2014

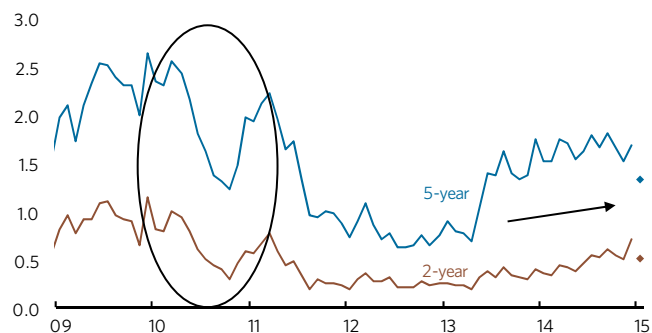


between rising real yields presently and declining yields in 2010—when deflation fears last spiked—is striking. Third, the behavior of the front end of the nominal yield curve also has been markedly different: in 2010, the 2-year and 5-year yields were plunging, whereas recently they have been range-bound until the past few days (chart 2).

A dissection of the yield curve by Fed researchers also supports the view that economic growth expectations have firmed. Specifically, researchers at the New York Fed have attempted to decompose Treasury yields across the curve into underlying expectations for interest rates and a term premium representing uncertainty about whether those expectations will be met. The data based on this decomposition suggest that underlying expectations for interest rates across the curve have actually increased (chart 3), indicating that growth expectations remain firm. However, term premiums have dwindled (chart 4), counteracting the effect of rising underlying rate expectations. (One should take model-based decompositions of the yield curve with a large grain of salt, but other models also show broadly similar trends.)

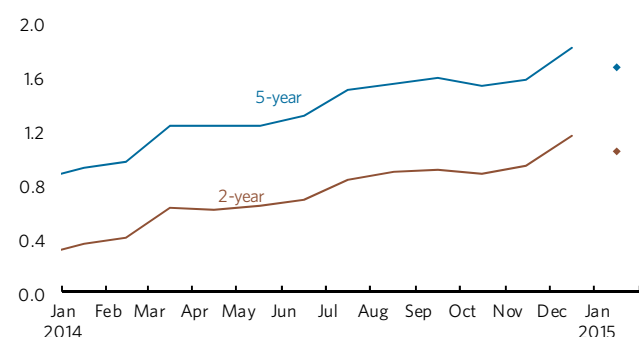
#### Yields Plunging in 2010, Now Rising Slowly CHART 2

Federal Reserve: Nominal Treasury Yields by Maturity  
% per annum, end-of-month level, last data point January 14, 2015



#### Interest Rate Expectations Rising in 2014 CHART 3

New York Fed: ACM Risk-Neutral Yield by Maturity  
% per annum, end-of-month level, last data point January 14, 2015



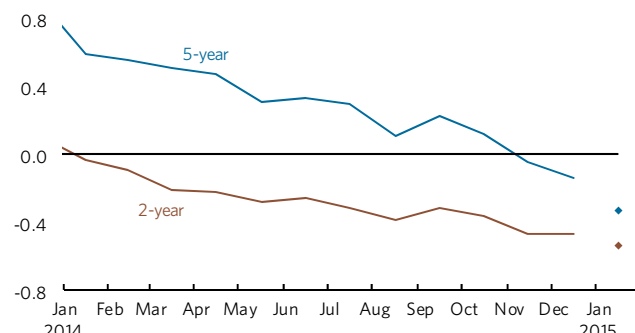
Meanwhile, assessments of deflation risk have clearly increased dramatically. A measure of the inflation risk premium, which gauges how much TIPS investors are implicitly paying to insure against upside surprises in inflation, has actually turned negative (chart 5), implying that TIPS investors now want to be compensated for downside risks to inflation. In fact, the decline in the inflation risk premium has driven the decline in the term premium component of nominal Treasury yields over the past few months (chart 6), and the inflation risk premium has almost surely moved even more negative in the past two weeks.

#### Misplaced Fear of Falling Oil Prices

Coming in the midst of disinflationary conditions worldwide and borderline deflationary circumstances in some countries, the plunge in oil prices appears to be playing a major role in fueling deflation worries (chart 7). Oil prices will continue to depress headline inflation reports released over the next few months. Moreover, because transportation costs affect many other costs, the impact of oil price declines may depress core consumer price inflation over the next several months.

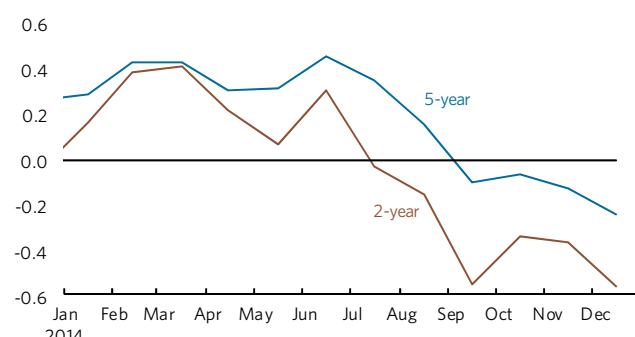
#### Term Premium Component of Yields Falling CHART 4

New York Fed: ACM Treasury Term Premium by Maturity  
% per annum, end-of-month level, last data point January 14, 2015



#### Inflation Risk Premiums Falling CHART 5

TIPS Breakeven Inflation Rate less Cleveland Fed Expected Inflation Rate  
% per annum, end-of-month level, last data point December 2014



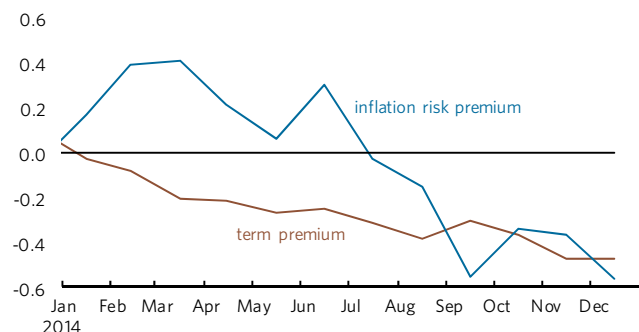
However, as we argued in our January 5, 2015 client bulletin, "Falling Oil Prices Do Not Worsen the Euro Area Deflation Threat," the steep drop in oil prices actually mitigates deflationary conditions in much of the net-oil-importing world. In principle, this is the same effect, but in the opposite direction, that we described when warning that the 2008 spike in oil prices would have deflationary consequences (see May 2008 *Levy Forecast*). Indeed, the minutes of the FOMC meeting in December 2014 show that the Fed saw cheaper energy costs as a net positive for the U.S. economy and the job market. Moreover, the minutes indicate that the Fed expects oil prices to depress inflation readings in the short-term but does not view the decline as a deflationary threat.

## Conclusion

The plunge in oil prices and the decline in interest rates may well provide a lift to the U.S. economy and much of the global economy over the next several months, and seasonal adjustment quirks will tend to exaggerate this enhanced performance. Couple these developments with the Fed's dismissive stance regarding the drop in oil prices, and the central bank may well sound more hawkish in the next couple of months than the markets are currently anticipating. The front end of the yield curve could steepen sharply as market expectations for Fed rate hikes are advanced.

### Falling Inflation Risks Weighing on Yields CHART 6

ACM Term Premium and Inflation-Risk Premium for 2-Year Treasury  
% per annum, last data point December 2014



### Oil Prices Driving Inflation Expectations Lower CHART 7

EIA: Spot Oil Price: West Texas Intermediate (WTI), \$/barrel  
Cleveland Fed: 2-Year Expected Inflation Rate, % per annum  
last data point December 2014



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