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ASSET MANAGEMENT

Mind the gap: Westminster Asset Management Investment Strategist Peter Lucas considers the difference between bond yields and inflation and what this implies for asset prices.



The gap between 10-year US bond yields and headline inflation is currently around -4%. This is only the fifth time in sixty years that bond yields have been below the rate of inflation and only the third time that the gap has been anything close to -4% (the long-term average is +2.18%). In previous episodes when real bond yields have gone negative, positive real yields have usually been restored through falls in inflation rather than rises in bond yields. For the past few months, egged on by Central Bankers, investors have clearly been thinking that the same thing will happen this time around. The VIX and bond yields have flatlined since March, the US dollar has been firm and growth shares have surged to new highs. Gold, the inflation ‘canary in the coalmine’, has gone down rather than up. But what if it’s different this time? What if inflation doesn’t fall and the gap with bond yields is filled via higher yields rather than lower inflation? If that’s where we are going, there are a whole lot of assets that are rather mispriced.

Let’s start with bonds. If inflation doesn’t fall, then bond yields must rise, possibly a lot. Low short-term interest rates will do little to arrest any upwards adjustment in bond yields given flat yield curves. Indeed, given the extremely low level of short-term interest rates, one could argue that the yield gap between Fed Funds and the 10-year bond should be close to the historic maximum of 3.7% rather than 1.3% as it is now. On that basis, the 10-year yield could rise 2.4% without any change in short-term interest rates. Inflation linked bonds should be largely insulated from this move, given that breakeven inflation rates are currently well below current inflation.

Next, the US dollar. My last article included a chart that demonstrated (a) the close historic correlation between the dollar with real interest rate differentials, and (b) the fact that the dollar is way stronger than it should be given the uncompetitive level of US real interest rates. If real interest rates do not rise through lower inflation (as investors hope), the dollar could be in trouble. And of course, a weak dollar would push up inflation further (in America at least) via higher import and commodity prices. Indeed, the weak dollar and pound were key drivers of the US/UK inflation story of the 1970’s. If we get a full-on inflation scare the go-to currency should be the yen. Not only is the yen very cheap by historical standards, but also it has the distinction of being a risk-off currency and is the currency of a country that been dogged by deflation for several decades. If there is one country that would welcome more inflation it is Japan.

A weaker dollar would be good news for commodities generally, but in the context of inflation scare, precious metals should be the real winners. Gold is the default option here, but platinum (relatively cheap) and silver (“high beta gold”) should outperform.

The story for equities is nuanced. Growth shares, with their high valuations and sensitivity to bond yields, are most at risk. Value shares should be more resilient and could even thrive. US equities should underperform, and market volatility should increase markedly.

The bottom line is that persistent inflation would lead to significant market shifts, to the detriment of bonds, the US dollar and growth shares and to the benefit of value shares, precious metals and currencies like the euro and yen. Will it happen? As regular readers of my articles will know, that is certainly my expectation. And to cap it all, markets are starting to behave in a way that is consistent with this story.

Peter Lucas

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