

## Another Piece of the Inflation Puzzle

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### Transcript:

Speculation about inflation is increasing as geopolitical tensions disrupt the production and supply of oil. As a result, gas prices have risen dramatically, shooting up \$1.02 to \$3.87 for regular unleaded from \$2.85 a year ago. Since prices at the pump are highly visible and have an immediate and direct impact on consumers, people are wondering whether inflation—if it *is* present—is transitory or is settling in for the long haul.

Are high gas prices a sign that persistent price inflation is just around the corner? Not necessarily—or at least not when measured by the gauges the government uses to analyze inflation.

The Federal Reserve's preferred measure of inflation is the U.S. Personal Consumption Expenditures Index, or PCE. The PCE, which is also known as core inflation because it excludes food and energy, came in at .9% annualized in April. This remains well within the Fed's preferred range of 1.6% to 2% annually.

Headline inflation, which includes food and energy, came in at an annualized 2.7% in March. While this number is relatively low, it is being driven by the 37.7% increase in fuel costs.

Keep in mind that the Fed prefers core data as its inflation gauge because it is a good indicator of *future* headline inflation. If the core number is low (as it was in April), it implies that future headline inflation will trend lower.

Fed Chairman Ben Bernanke recently asserted that the current rise in oil and other commodity prices is likely to be transitory. This argument is based on economic fundamentals. In the U.S., high unemployment and excess production capacity suggest that inflation will remain contained. Market and economic pressures emanating from abroad send a similar message.

Other indicators used to measure inflationary trends suggest that Chairman Bernanke may be right. One piece of the inflation puzzle we analyze involves the breakeven rate, which is the difference between the yield on a Treasury Inflation Protected Security and the yield on a non-inflation-protected bond, known as a nominal.

The five-year breakeven rate, represented by the red line on the chart, shows that investors currently expect inflation to come in at an average annual rate of roughly 2.25% over the next five years.

The blue line shows that investors expect inflation starting in five years to be 2.75% over the subsequent five years. In an economy that is poised for growth or expansion, we would expect to see exactly what the chart shows, with longer-term inflation expectations exceeding shorter-term expectations, creating a positive spread.

This spread, although still positive, recently started to converge, narrowing to 49 basis points from a high of just over 143 basis points in late October. This shows that investor sentiment may be starting to align with the Fed's belief that the recent increase in energy and food prices may be transitory in nature.

Our view is similar to the Fed's. While we believe the potential for long-term inflationary pressure exists, it seems unlikely due to the elevated unemployment rate, a slow-to-improve labor market and overall sluggishness in the economy. If the economy and employment were to turn up sharply while policymakers remained overly accommodative, we could see a substantial rise in the risk of future inflation. However, we are not at that point today.

If inflation becomes an issue, the Fed will raise interest rates. In terms of fixed-income asset allocation, SEI would reduce its exposure to long-maturity Treasuries and investment-grade bonds, and would move into money market funds, short-maturity fixed income and TIPS. On the equity side, we believe investment managers would look for stocks with pricing power. If inflation becomes acute, we would expect to see them seek defensive positions and favor value stocks over growth while avoiding capital-intensive industries.

At present, inflation is not a significant concern beyond its impact on food and energy. Whether it will pose a challenge in the future remains to be seen.

If you have any questions regarding this commentary, or questions surrounding the market, please contact your SEI representative.

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