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Economics Group

Interest Rate Weekly

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TIP: Pay Little Heed to Current TIPS Breakeven Inflation

Narrowing spreads between traditional Treasuries and TIPS over the past year imply a decline in long-term inflation expectations, but factors unique to the TIPS market raise doubt over the value of current signals.

Fall in Long-Term Inflation Expectations Overstated by TIPS

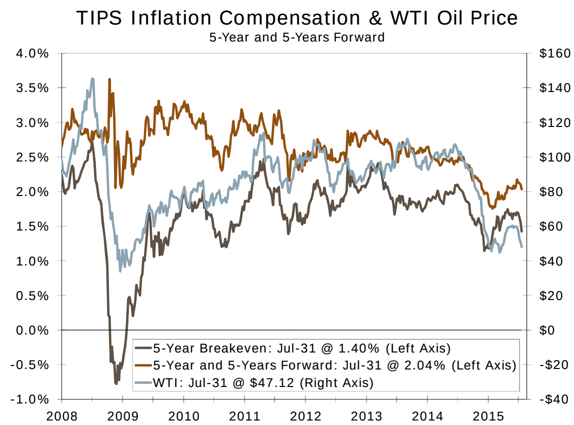
Spreads between traditional U.S. Treasury yields and yields for Treasury Inflation Protected Securities (TIPS) have become an increasingly ubiquitous gauge of inflation expectations. Yet, given liquidity premiums for TIPS and the reduced risk for extreme inflation outcomes, the signals stemming from TIPS breakeven inflation rates appear out of step with other gauges of inflation expectations.

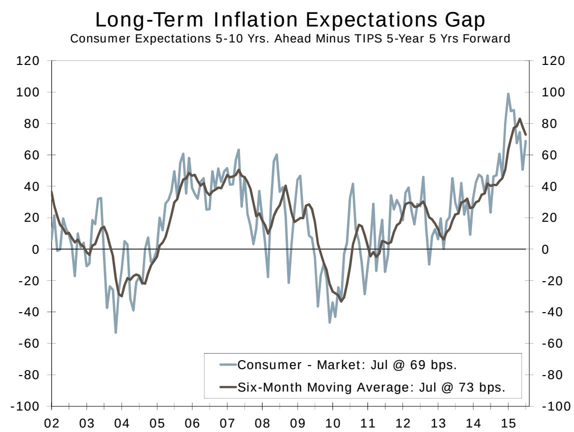
Recent TIPS spreads have indicated a decline in inflation expectations, which may make it more difficult for the Fed to achieve the price-stability side of its dual mandate. The breakeven rate of inflation over the next five years has fallen by more than 60 bps over the past year. Given the fall in commodity prices, some dialing back of inflation expectations over the near term seems reasonable. However, longer-term breakeven rates, measured by the five-year five years forward, have also declined, and look unduly influenced by changes in the price of oil (top chart).

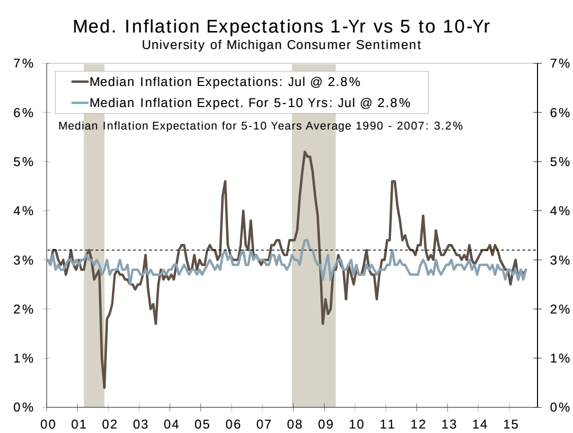
As the FOMC has been noting since last October, the decline in the market-based measures of inflation expectations has not been seen in survey-based measures of future inflation. The gap between inflation compensation indicated by TIPS and consumers' inflation expectations has declined a bit in recent months, but remains at elevated levels (middle chart). Consumer perceptions of inflation 5-10 years from now have been little changed, with the median long-term inflation rate averaging 2.7 percent over the past 12 months, only a touch lower than the 2.8 percent average the prior 12 months (bottom chart). Moreover, other gauges of inflation expectations from market participants have also indicated no material change in longer-term inflation expectations. The Federal Reserve Bank of New York's June Primary Dealer Survey showed the median submission for the most likely CPI inflation outcome for the next 5-10 years as 2.25 percent, only 3 bps lower than a year earlier and on par with the June 2013 survey.

Why the Dislocation?

The recent dislocation between market and survey-based measures of long-term inflation expectations may be due to the curiously tight relationship with commodity prices, as well as changes in risk and liquidity premiums. At less than one-tenth the size of the traditional Treasury market, TIPS yields contain a liquidity premium that leads breakeven rates to understate market participants' views of future inflation. Similar to other markets, TIPS have been thinly traded over the past year, which may have pushed up the liquidity premium and in turn led to a narrower spread with Treasuries. A reduction in the perceived risk of extreme inflation outcomes may also be driving investors away from TIPS, as the $3.5 trillion expansion of the Fed's balance sheet has not generated the runaway inflation many feared.







Source: Bloomberg LP, University of Michigan and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual						Forecast					
	2014				2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.50	2.00
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.28	0.70	0.95	1.20	1.45	1.70	2.20
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.50	5.00
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	3.98	4.15	4.23	4.28	4.37	4.63	4.75
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.01	0.13	0.55	0.86	1.15	1.33	1.72
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.11	0.27	0.63	0.91	1.22	1.42	1.75
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.28	0.69	0.99	1.24	1.57	1.79	2.17
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.64	0.86	1.08	1.27	1.72	1.94	2.38
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.63	1.78	1.89	2.01	2.20	2.32	2.61
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.35	2.41	2.49	2.55	2.66	2.80	2.91
30 Year Bond	3.56	3.34	3.21	2.75	2.54	3.11	3.18	3.22	3.27	3.34	3.55	3.72

Forecast as of: July 31, 2015

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	1.8	2.9	N/A
FOMC	1.8 to 2.0	2.4 to 2.7	2.1 to 2.5
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.2 to 5.3	4.9 to 5.1	4.9 to 5.1
PCE Inflation			
Wells Fargo	1.0	2.0	N/A
FOMC	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0

Forecast as of: July 31, 2015

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: June 17, 2015

Sources: IHS Global Insight, Bloomberg LP, Federal Reserve Board and Wells Fargo Securities, LLC

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