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What could push inflation and 10-year yields higher

Economist

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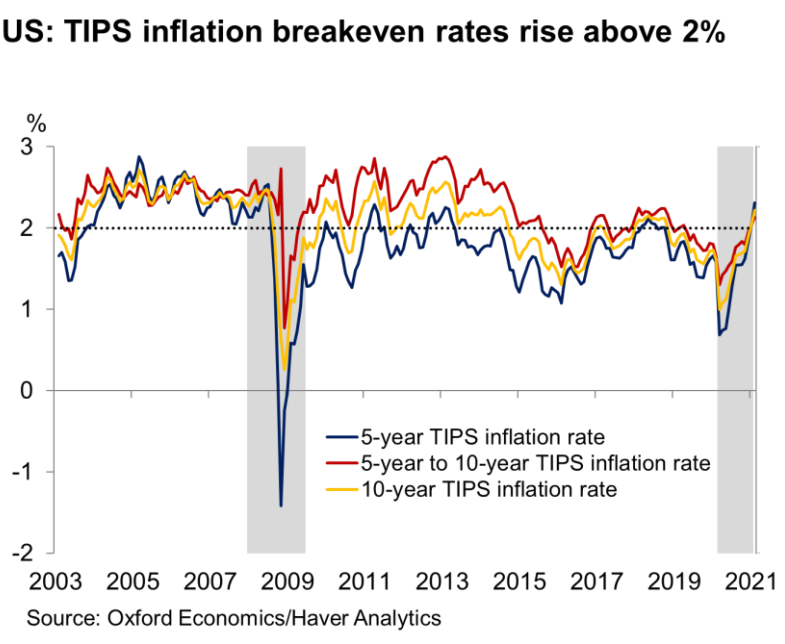
- **Our base case calls for US inflation remaining benign and long-term interest rates rising only gradually. Higher inflation in the spring should be transitory and driven largely by base effects. So the Federal Reserve should patiently look past this increase and delay rate liftoff until mid-2023 and QE tapering until 2022. Consequently, 10-year Treasury note yields should keep just gradually rising to 1.5%-1.6% by year-end on the back of improved economic growth.**
- **However, upside risks to inflation and yields are building. The risks stem from additional fiscal stimulus leading to stronger-than-forecast GDP growth, a spike in inflation, earlier and more aggressive Fed rate lift-off, and earlier tapering of QE asset purchases amid high Treasury borrowing needs.**
- **We model a scenario in which cyclical inflationary forces overtake secular disinflationary impulses. In this scenario, inflation expectations jump higher amid more fiscal aid boosting GDP growth while labor force participation remains depressed. This produces a prolonged period of above-target inflation. The Fed responds by removing monetary policy accommodation earlier and more aggressively than markets expect. This combination sends 10-year yields sharply higher, reaching 2% by yearend 2021 and 2.4% by end-2022.**

The benchmark 10-year Treasury note yield breached 1% at the start of the year for the first time since March and has reached a recent high of 1.2%. Investors have raised their expectations for growth, inflation, and Treasury borrowing given the prospect of further fiscal stimulus. Treasury inflation-protected securities (TIPS) break-even inflation rates have broken through the 2% threshold for the first time since October 2018 **(Figure 1).**

Figure 1: Market-based inflation expectations surpass 2%



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What could push inflation and 10-year yields higher

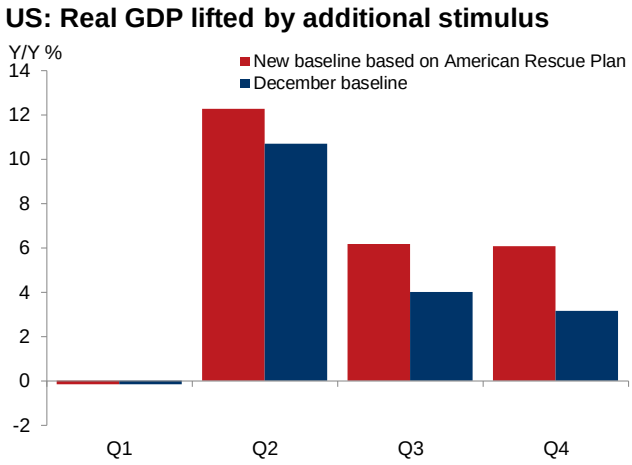
The likely prospect of another sizable fiscal stimulus package – we assume $1.3tn – being passed in coming weeks has led us to significantly revise up our GDP growth estimate nearly by 3ppts Q4/Q4 in 2021 to 6.1% from 3.2% in our December baseline **(Figure 2)**. Our new forecast has inflation rising as well, reflecting the stronger growth and easy year-on-year comparisons because prices plummeted during the initial stages of the Covid crisis last year. The base effect alone – assuming no change in prices through April – lifts the y/y% rate for the personal consumption expenditure (PCE) price index to 1.9% from 1.3% in December 2020. The robust spring pickup in activity should add further to this gain, lifting it to 2.7% y/y during Q2. Inflation should remain at 2% or above for about two years, which hasn't happened since the Global Financial Crisis.

However, this stimulus-led boost to growth and inflation should be rather transitory. With GDP growth returning to a more moderate pace of around 2.7% in 2022, inflation should slow to around 2%. Secular disinflationary forces should again dominate as stimulus fades. The Fed should patiently look past the transitory increase in inflation and not start lifting rates until mid-2023, with QE tapering beginning in 2022. We forecast that the 10-year Treasury note yield rises gradually to 1.5%-1.6% by year-end **(Figure 3).**

That said, as we discussed in a recent global Research Briefing, a combination of factors could propel inflation above expectations to an average 2.5% over the next several years. They include a stronger cyclical recovery this year, the dovish change to the Fed's mandate, explosive growth in monetary aggregates fuelled by large rounds of federal fiscal transfers, and quantitative easing (QE asset purchases) **(Figure 4)**.

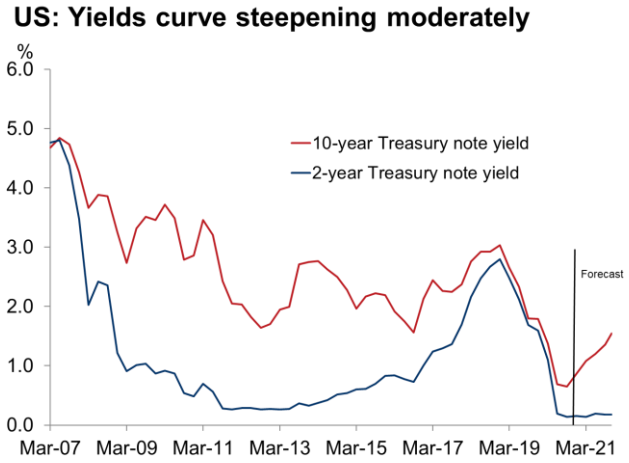
So far, the rise in money supply hasn't led to an increase in inflation because the multiplier has been quite low. Households have used the surfeit of money to pay down debt, increase savings, or invest in assets (notably equities). However, once the economy more fully reopens starting in the springtime, the extra money along with a rise in household wealth could fund an even larger pop in consumer spending than we forecast. This could finally give companies some pricing power to pass along higher input costs to consumers, which helps underpin a persistent overshoot of the Fed's 2% inflation target (**Chart 5)**.

Figure 2: We lifted 2021 GDP growth 3ppts Q4/Q4



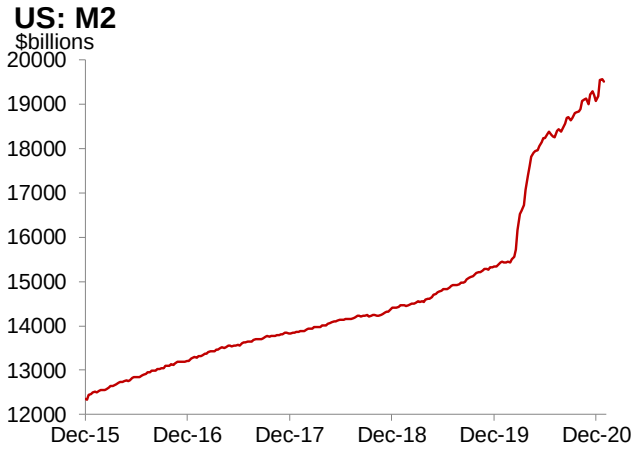
Source : Oxford Economics/Haver Analytics

Figure 3: Our baseline forecast calls for a gradual rise in 10-year yields



Source : Oxford Economics/Haver Analytics

Figure 4: Money supply has jumped sharply higher due to stimulus



Source : Oxford Economics/Haver Analytics

These factors, along with another year of $3tn-plus budget deficits, raise concerns that long-term interest rates will climb more rapidly and higher than we and the consensus anticipate.

Upside inflation and rate scenario

To examine this upside possibility, we developed an alternative scenario using our Oxford Economic Model. The scenario follows closely in line with the global inflation scenario presented in our recent Research Briefing, "How high inflation could ruin 2021 for investors."

We included the following assumptions for the US:

- **Labor market participation** fails to rise any further after collapsing during the pandemic from 64.4% to 61.4% currently **(Figure 6).** The pandemic might have accelerated the retirement of baby boomers, and younger workers who dropped out of the labor force, some due to child care issues, might not return. This fosters faster wage gains.

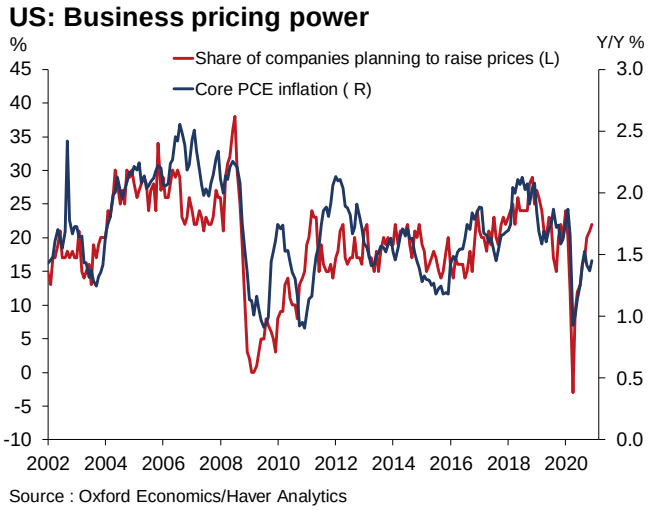
- **Inflation expectations** as measured by the University of Michigan for the next five years rise 30bps to 3% by mid-summer, the highest since September 2013. The elevated level is sustained for the next several years, reflecting consumers' view that the pickup in inflation will be sustainable.

- **Fed monetary policy tightening** unfolds a year ahead of our baseline forecast. With inflation sustainably above 2%, the Fed commences rate liftoff in mid-2022 and QE tapering in mid-2021. The pace of fed fund rate increases is also more rapid, reaching 1.38% by yearend 2023 **(Figure 7)**.

- **Global bond yields** rise on a global increase in inflation. Using the modelling work from our prior global inflation scenario, we assume the acceleration in inflation isn't confined just to the US. This helps lift bond yields around the world, which reduces the downward weight on US long-term interest rates.

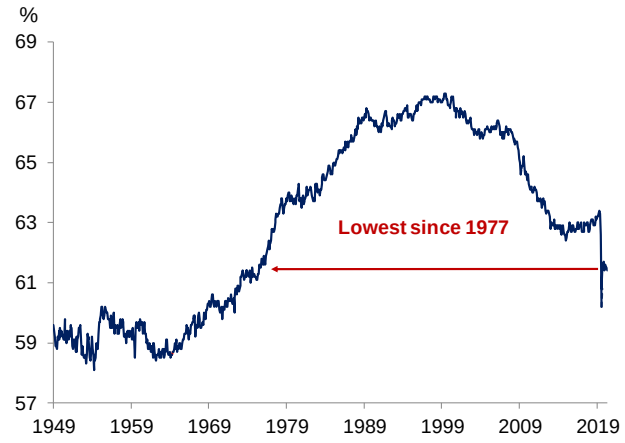
This alternative scenario illustrates the risk that the expected acceleration in inflation this spring isn't short-lived but persists over the next several years **(Figure 8)**. The unmooring of inflation expectations and businesses gaining pricing power would mark an important change from recent

Figure 5: A return to corporate pricing power would lift consumer inflation



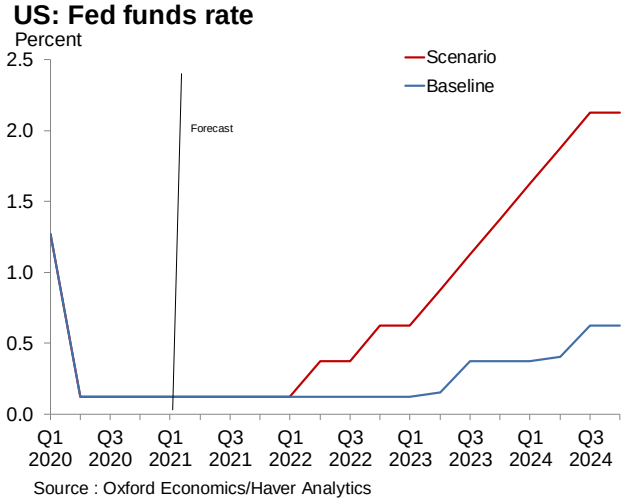
Source : Oxford Economics/Haver Analytics

Figure 6: If the labor force participation rate stagnates at a low level, wage growth rises



Source: Oxford Economics/Haver Analytics

Figure 7: The Fed lifts rates earlier and more rapidly under our inflation scenario



Source : Oxford Economics/Haver Analytics

cycles and would foster a pass-through of higher wages to consumer prices.

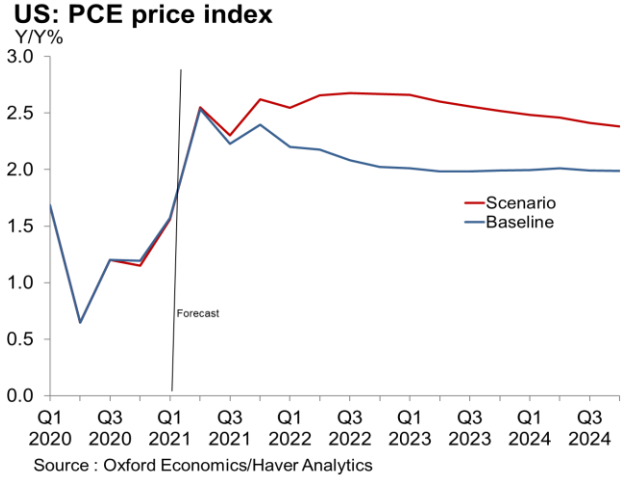
The Fed's preferred inflation measure, the PCE index, consistently remains above the 2% target for at least a year by mid-2022. It ranges between 2.5% and 2.7%, and overshoots our baseline forecast by a moderate 25bps to 50bps. At the same time, the unemployment rate falls to 3.5%, though not entirely for the right reason because the labor participation rate remains depressed. Nevertheless, the unemployment rate matches the pre-pandemic full-employment reading and that along with the faster inflation trend leads the Fed to initiate rate liftoff by mid-2022.

That means the Fed would be tapering its QE asset purchases staring in Q3 2021 and likely end the tapering within eight months. That would engender further upward pressure on long-term rates. In the past, just talk about tapering triggered a "taper tantrum" that sent long-term interest rates sharply higher. Based on our forecast for still-large Treasury borrowing needs of around $2.5tn in calendar year 2021, Fed tapering would reduce the central bank's share of net new Treasury issuance to 32% from 55% in 2020 **(Figure 9)**. In 2022, its share would decline to 10%, with US borrowing needs declining, but remaining high at around $1.3tn.

Our modelling work illustrates that a combination of stronger growth, a large acceleration in inflation, faster and more Fed rate hikes, more rapid QE tapering, and a concomitant rise in inflation and long-term rates outside of the US could lift the yield on the 10-year Treasury note yield to about 2.1% by year-end 2021 and to 2.43% by the end of 2022. These levels are roughly 50bps and 65bps above our base case forecast **(Figure 10).**

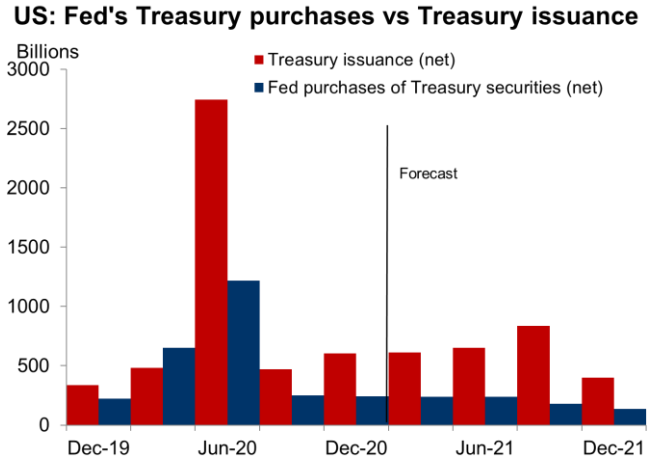
Thereafter our scenario shows the Fed raising the fed funds rate moderately above the 1.8% long-run neutral rate to 2.13% in late 2024, a bit below the peak of 2.38% reached in the prior tightening cycle in early 2019. The 10-year yield would rise to around 3.1%, the highest since mid-2011.

Figure 8: Inflation stays persistently above 2%, unlike the prior decade or our base case



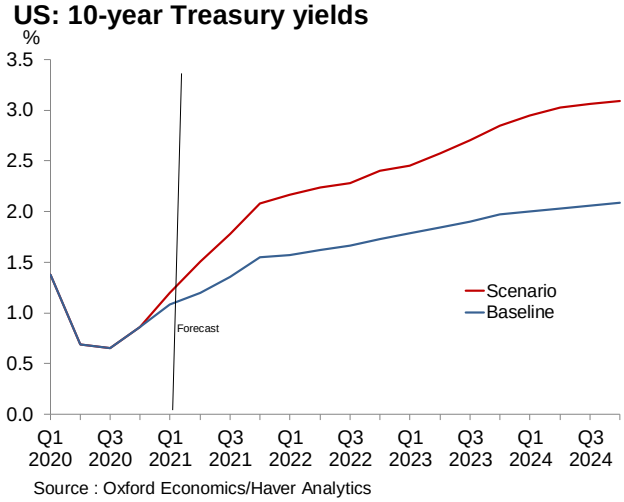
Source : Oxford Economics/Haver Analytics

Figure 9: The Fed would taper QE asset purchases more quickly



Source : Oxford Economics/Haver Analytics

Figure 10: 10-year Treasury yields would be lifted signficantly higher



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