MARKET COMMENTARY

Fig. 1: 5-year-5-year forward inflation expectation rate

Source: Bloomberg, Mill Creek.

One of the primary inflation indicators we monitor is called the "5-year-5-year (5y5y) forward inflation expectation rate." This rate is a market-based measure of average inflation starting five years from now and going five years into the future – in other words, the average inflation rate for the last five years of the next decade.

This rate is useful because it ignores temporary factors and focuses on a horizon that central banks should be able to control. Currently, the 5y5y rate indicates that inflation will average 2.5%, a rate well within the Fed's target range, between April 2027 and April 2032 (Fig. 1). That should give us some confidence that the Fed will successfully bring inflation back down over the course of a few years.

However, the 5y5y doesn't tell us anything about the potential range of outcomes around the 2.5% average. The long-term inflation base case might be 2.5%, but how likely is an inflation disaster? Is it higher today than last year or higher than pre-COVID? A new paper by Jens Hilscher (US Davis), Alon Raviv (Bar-Ilan University), and Ricardo Reis (LSE) tries to answer that question.

They find that market participants are currently pricing in a 15% probability of an inflation disaster, defined as inflation that averages over 4% for the five-year horizon starting five years. The probability was near zero at the end of 2019. Our quarterly outlook, "Simplify, Simplify, Simplify" discussed some of the current challenges (mostly of their own making) facing the Fed. Add re-convincing the market that it retains inflation credibility to that list of challenges.

QUICK LINKS

- Down on the Farm
- Steepen the Curve!
- Q2 2022 Outlook: Simplify, Simplify, Simplify!
- The worst (bond) bear market in 40 years

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