MONEY & MACRO PRO

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CPI RECESSION DECOMPOSITION

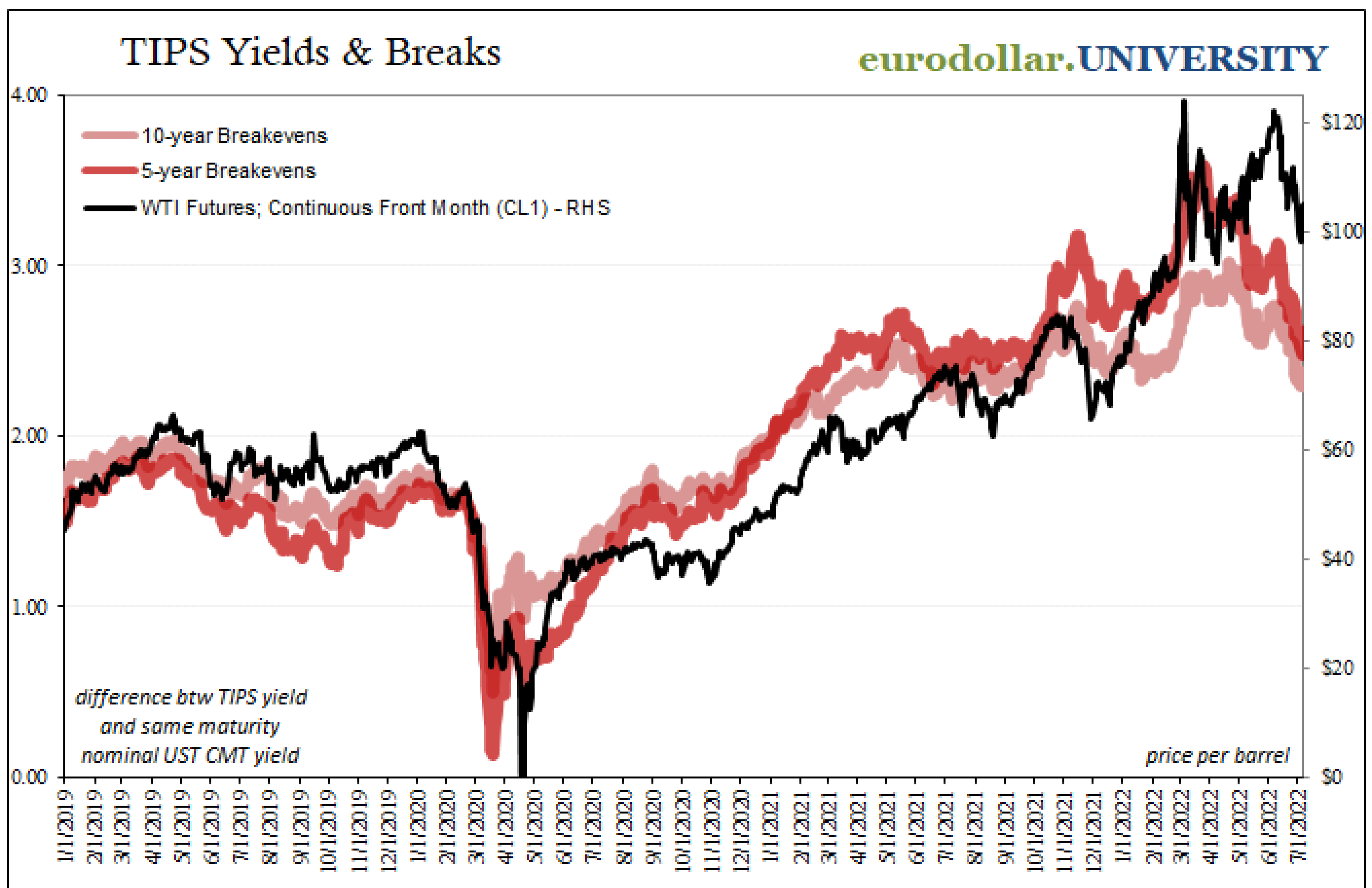
Market-based 'Inflation' Expectations Have Really Changed

Inflation protection in the TIPS market isn't exactly protection from inflation. Yes, I'm going to split hairs here, once more banging away on the categorical difference inflation from "inflation." The federal government calculates this "inflation" insurance based upon the CPI. TIPS prices therefore interest coupons get rebalanced on an annual basis from that index.

As we are very well aware these days, the CPI is largely driven by energy meaning oil therefore gasoline. It is a sizable chunk of the consumer bucket, and then motor fuel prices being among the most volatile components meaning the huge moves move around the headline more than other parts.

Since TIPS pays for CPI, it pays to know this close relationship. After all, the best way to judge how much "inflation" protection might be worth is to begin analyzing the situation in crude oil; WTI its US benchmark.

You should suspect a close relationship between TIPS breakeven rates – particularly at the 5-year maturity – and the track of WTI. It's one of those remarkable pieces of *this-shouldn't-work-like-this* because you don't take breakevens literally, so why do they follow oil so closely? For this reason, the correlation isn't one to one, yet it's close enough and has been over the long run.



Oil prices first surged then these market-based CPI expectations followed early March, both remained elevated through much of April. From late April forward, however, *right when* the 2-year nominal (not TIPS) Treasury yield began to trade sideways defying the Fed's aggressive rate hike scheme, WTI and breakevens have seriously diverged (see: below).

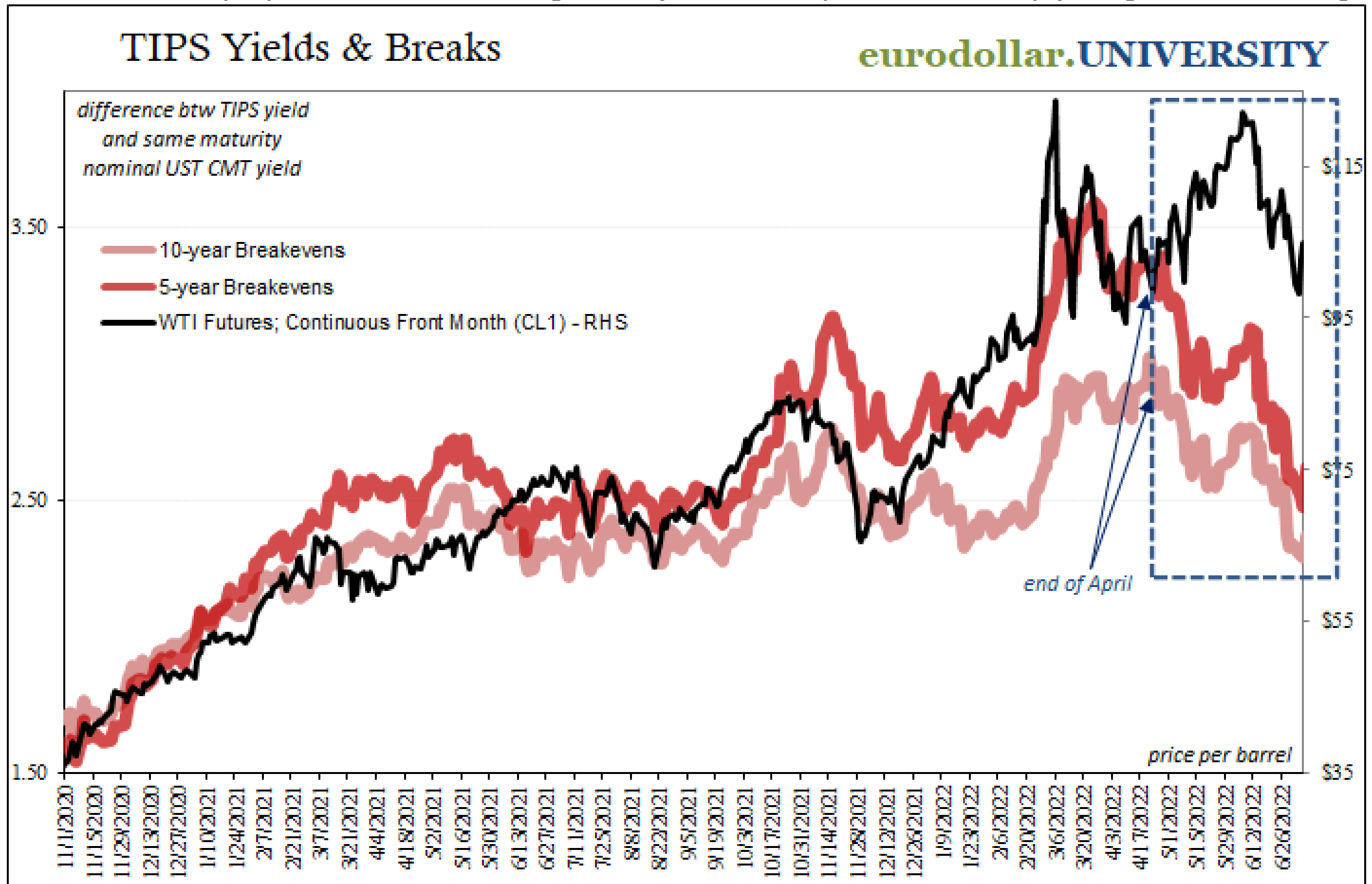
And not by a little. Each has since moved along separated tracks, breaking their previous longer-term correlation and leading to a huge, very noticeable gap for the first time in recent memory. While more volatile, sure, oil prices have remained sticky mostly above $100 and more. At the same time, TIPS investors are trading "inflation" protection as decidedly less valuable despite this, a trend now extending beyond two months (not some random market fluctuation).

The question, then, why have TIPS breakevens broken from WTI? Why April?

You know where this is going. The market which is most depending upon discounting future CPIs has for months traded as if CPIs ***aren't going to be so heavily influenced by high oil prices***. That's the only conclusion we can (honestly) draw, and honestly it's incredibly consistent with pretty much everything else apart from the FOMC's absurdly hawkish position.

Federal Reserve officials famously, unwisely pay no attention to market signals, even these which are inside that very space they now exclusively seek to navigate. Deviating TIPS from oil, though, like the tale of two labor data, one is convenient for justifying rate hikes while the other argues directly against them.

There is no riddle here, just hapless policymakers blindly following a preset political course and doing their best to keep up the charade as long as they can. That pretense is simply to ignore increasing,



proliferating, deepening recession signals coming in from far and wide (and, TIPS, a little too close to home). We know what changed in mid- to late-April.

Look at today's employment estimates, for example. The Establishment Survey downshifted in March, at the very least representing a likewise downshift in jobs. The Household Survey took this indicated slowdown several steps further; it didn't just suggest a small slowdown in employment, it outright pictures what sure looks like a beginning recession.

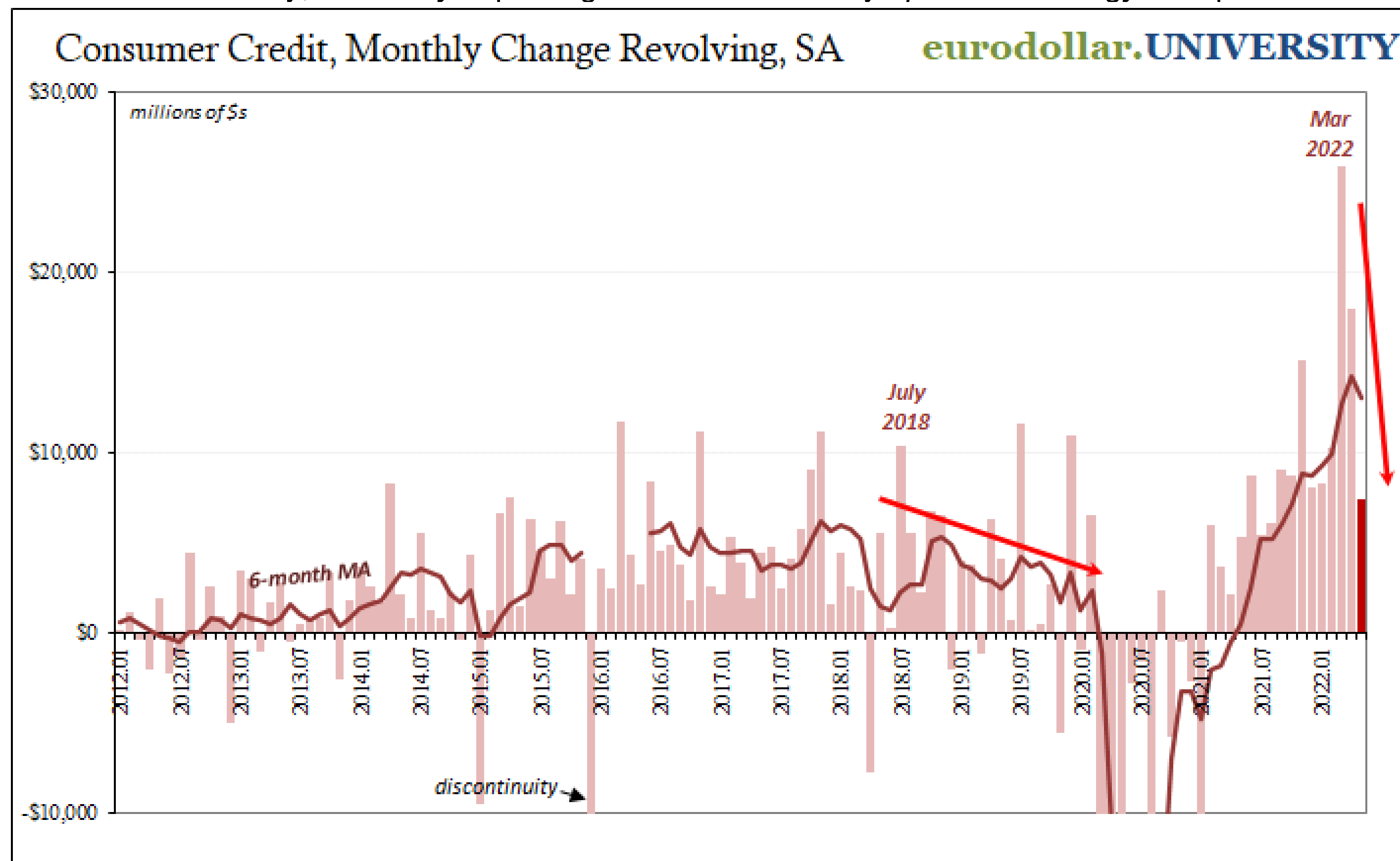
The economy seems to have been slammed with that last spike in oil. We have other data from today which piles still more toward the TIPS view (falling expectations for the CPI). The Federal Reserve reported that in the month of May 2022, consumer credit increased far less than expected, particularly revolving consumer credit which only added about $7 billion.

While that's still a relatively sizable gain in the aggregate seasonally-adjusted revolving balance, it is way, *way* down from March's epic, record-sized surge (nearly +$26 billion). Did consumers have to max out credit cards to help pay for gasoline and the rest of "inflation?"

Once they had, add to it a dicey employment picture (however you slice it, by whichever series) with stubbornly high gasoline and all of this simply pounds the overall economy closer to recession territory – *beginning around April*. Decelerating revolving credit is, as it has been, a key sign of retrenchment, risk aversion, meaning scaling back on spending plans (particularly discretionary).

Any number of statistics who serious deterioration across the goods economy (new orders, etc.), and no wonder the TIPS market is looking at CPI protection becoming less valuable even though the usual CPI-driver, oil and motor fuel, haven't really changed.

The market is clearly, *decidedly* expecting the whole economy *apart from energy* to experience a



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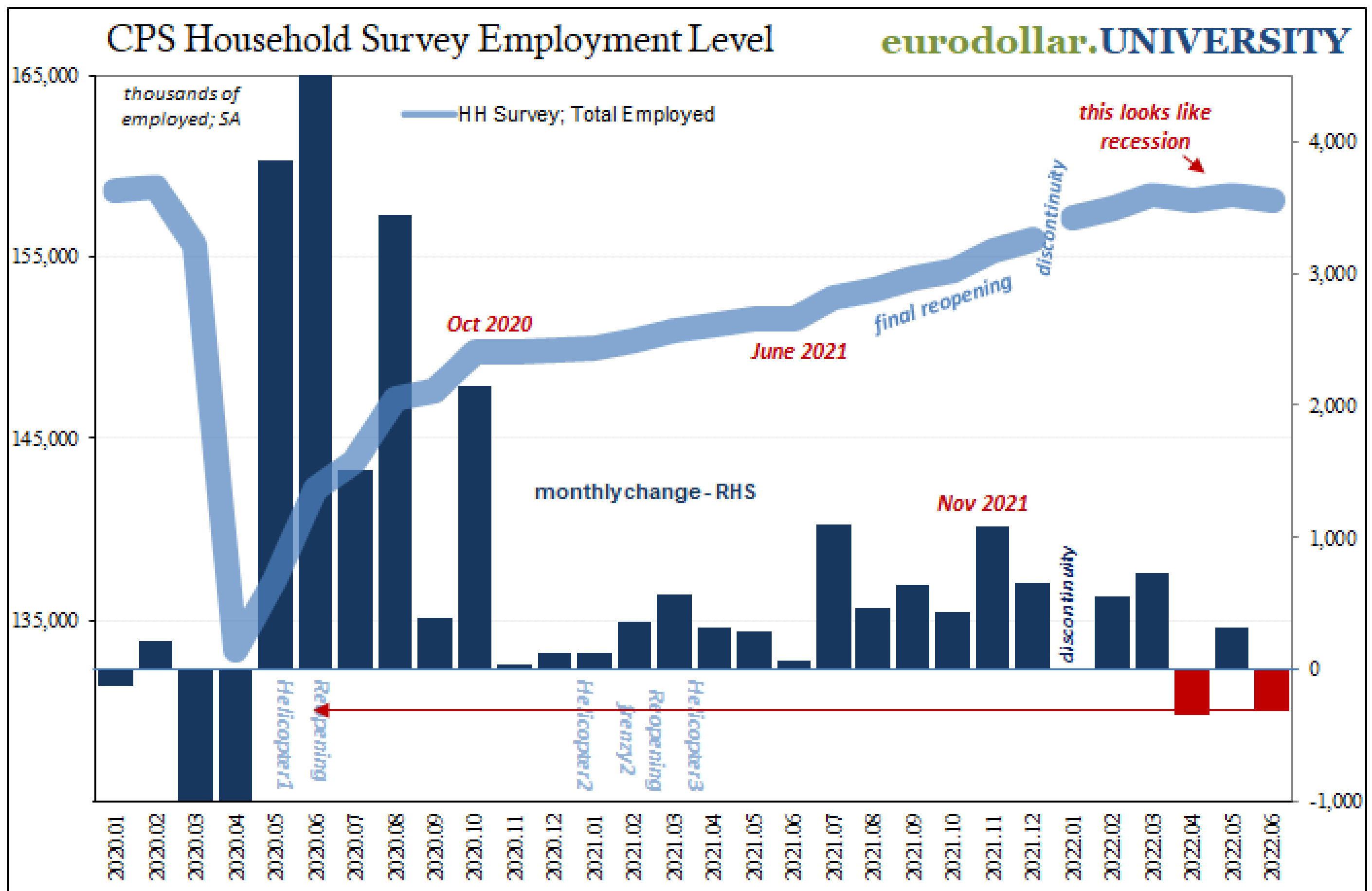
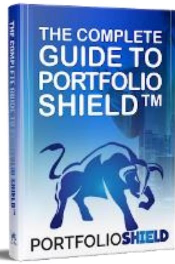
imminent downturn in "inflation." This, of course, is nothing different from yield and eurodollar curves, even crashing commodities crashing due to these same gross (and global) demand concerns.

Powell hasn't gotten the market's message "inflation's" days may well already be numbered, no matter how inflexibly painful crude will remain – *because of* how persistent gasoline prices can be. TIPS have surely diverged for the exact same reason the HH Survey has declined.

Recession isn't just some distant future probability to worry about maybe next year. More and more of everything is moving and behaving as if its imminent, assuming it hasn't already started.

And that includes what sure looks like the emerging downside of "inflation."





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