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Markit Commentary

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Inflation expectations dive with commodities

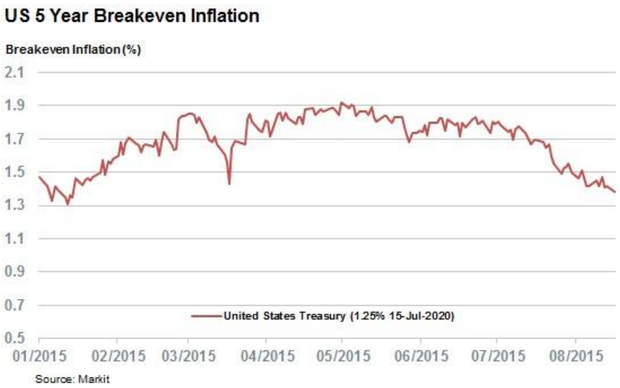
The commodities crash has seen breakeven inflation retreat in earnest in the last few weeks, prompting ETF investors to exit inflation hedged bond ETFs.

- US five year breakeven inflation stands at 1.39%; lowest level since January
- European and UK inflation linked bonds have also fallen by 40bps in recent weeks
- Inflation linked bond ETFs have seen four weeks of outflows for the first time since October

The current commodities slump, as gauged by the 13 year low seen in the Bloomberg Commodities index, continues to be felt in the bond market. While more obvious sectors such as mining and oil and gas have borne the brunt of the recent tumble, its impact is starting to filter through to other asset classes such as inflation linked bonds. These instruments, whose coupons are adjusted for inflation, have seen a fall in breakeven inflation in recent weeks as the market adjusts to the new reality.

TIPS inflation expectations sink

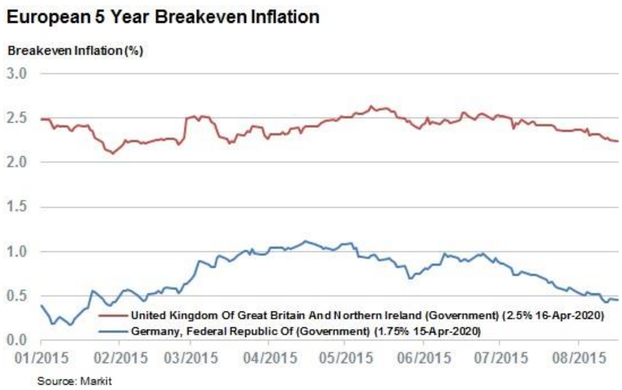
The breakeven inflation for five year Treasury Inflation-Protected Securities (TIPS), which gauges the market's expectations for US inflation in the coming five years, has fallen significantly in the wake of the recent commodities slump. The latest reading indicates that bond traders are pricing a 1.38% inflation rate in these securities for the coming five years, down from 1.8% at the end of June.



While the current breakeven inflation is still around 8bps off the lows seen in January, the direction of travel is still 8bps off January's yearly lows, the trend shows little signs of slowing down as the breakeven inflation tightened by 7bps in the last week alone. The lows will no doubt be tested in the coming days, especially given that commodities have continued their retreat today.

Trend also felt in Europe

US bonds traders are not the only ones factoring in lower inflation in the wake of the commodities slump as German and UK inflation indexed securities have also seen the same trend in the last few weeks.



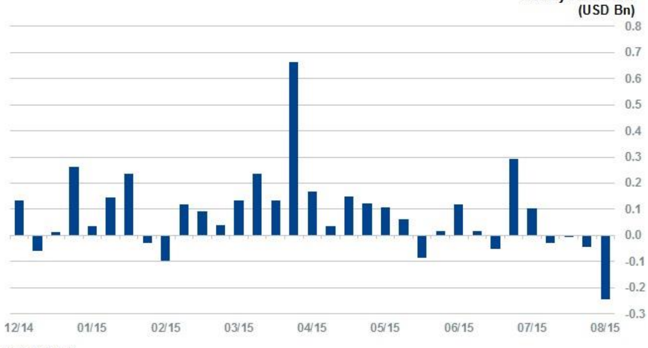
German five year breakeven inflation now stands at 45bps. This is less than half the levels seen in May, which was the last time investors were pricing more than 1% inflation into five year German inflation linked securities.

UK inflation linked bonds have seen a tightening of the same magnitude, but the five year breakeven inflation rate of inflation linked GILTS is still relatively high at 2.23%.

Implication for policy makers
This trend will no doubt pose a headache for US and UK policy makers as the deflationary pressures stemming from low commodities prices could help perpetuate the current low interest rate environment.

Commodities driven deflation could also poses a challenge for eurozone policy makers as it undermines the effectiveness of ECB's quantitative easing program. While inflation expectations priced into German inflation linked bonds are still 25bps off the yearly lows seen just before the announcement of the ECB's quantitative easing program, its sharp fall will no doubt cause some concern for policy makers.

Investors flee inflation ETFs
Inflation linked bonds outperform their conventional peers in times of rising inflation and underperform when the opposite occurs. Tt should therefore come as little surprise that investors have been actively withdrawing funds from ETFs which invest in inflation linked securities over the last few weeks.



Source: Markit

Overall, the 50 inflation linked bond ETFs have seen four weeks of straight outflows with investors withdrawing a total of $325m.

These outflows come in the wake of a string of underperformance which has seen the largest inflation linked bond ETF, the iShares TIPS Bond ETF underperform its conventional peer, the iShares US Treasury Bonds ETF by 1.1% in the last month in total returns.

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