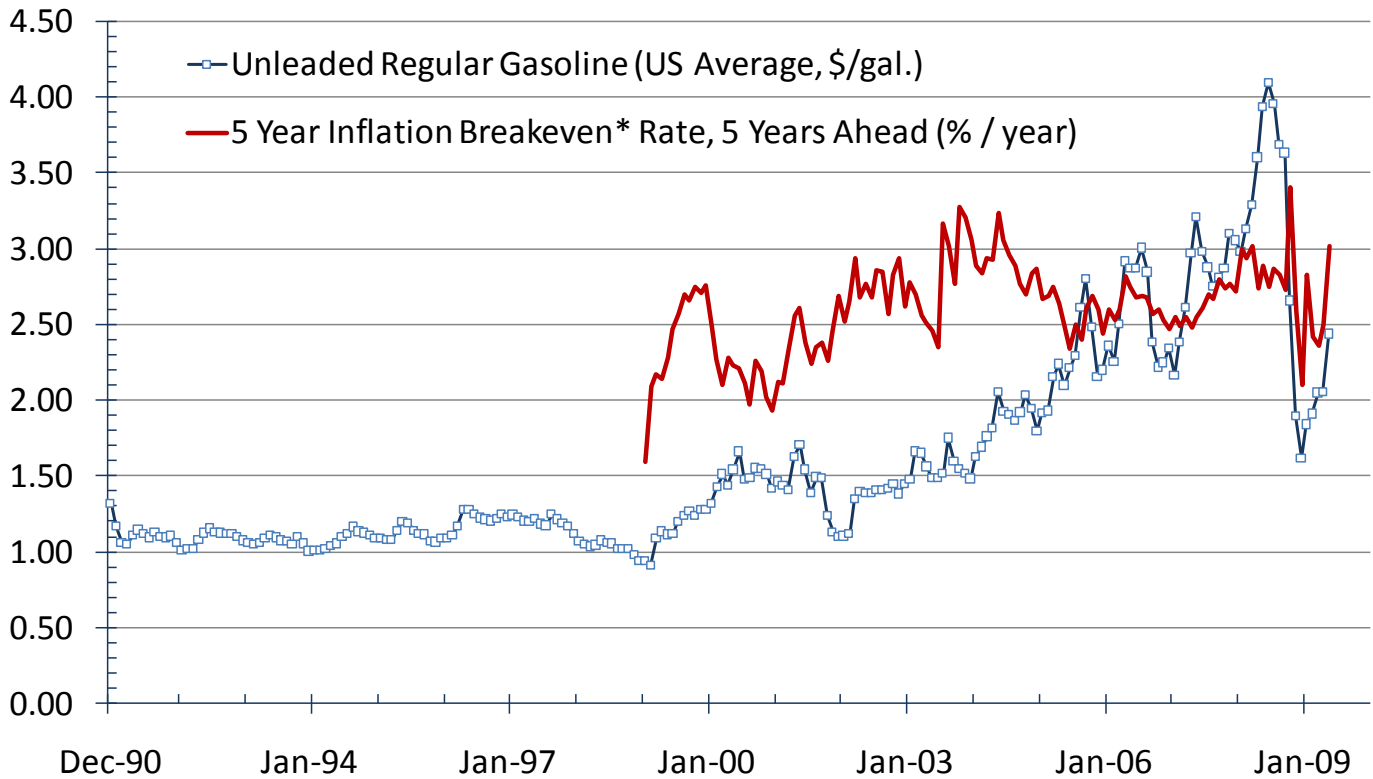


Concerns of an Eventual Increase in the Inflation Rate are Real

- Treasury bond yields have jumped sharply since the Federal Reserve announced plans in March to support the market with substantial purchases, and longer maturities suffered much larger increases in their yields than short and intermediate-term notes. The difference between the yield on the benchmark 10-year note (which offered an annualized 3.75 per cent to its maturity in February 2019 at one point last week) and the 2-year note (still near 1.0 per cent) expanded to its widest level on record.
- Meanwhile, commodities have been on a tear. Crude oil has more than doubled since its low, economically-sensitive copper is up +70 per cent, and a composite measure of shipping rates called the Baltic Dry Freight index has rebounded to 3,500 after plunging to less than 700 six months ago. The Journal of Commerce index of 18 industrial commodities rose +9.5 per cent during May, its strongest monthly gain on record since its inception in 1985.
- Investors appear convinced that the Fed will need to maintain its current super-low interest rate policy for some time, but concurrently they seem increasingly concerned about the inflationary implications of such an accommodative stance, especially now that equity markets have recovered a fair chunk of their earlier losses.
- Some observers may be overly complacent about future inflation risks, citing what appears — on the face, anyway — to be low inflation expectations imbedded in TIPS (Treasury Inflation Protected Securities).
- For the TIPS bond maturing in January 2019, we compute a yield-to-maturity of 1.65 per cent per annum, before any consideration of its inflation protection feature. The holder is entitled to an augmentation of principal — the coupon rises proportionally, too — that is determined by the eventual increase in the Consumer Price Index until maturity. By comparison, a traditional Treasury note with a similar maturity is priced to yield 3.65 per cent per annum. The difference (2.0 per cent per annum) is the “implied breakeven inflation rate,” the average inflation rate (from now until 2019) above which an investor would be better off holding TIPS than conventional bonds.
- Our assumption for CPI inflation over the next 10 years is 2.5%, so the TIPS bonds are attractive for defensive investors concerned more about a potential increase in the cost of living than in generating current income.
- Shorter-term TIPS reflect the markets’ current concern about excess capacity of labor and invested capital that has the potential to foster an environment of falling consumer prices — i.e. deflation. The implied inflation breakeven over the next 2 years is only 0.2 per cent per annum, and for the 5-year horizon, it is less than 1.5 per cent. The shorter the term, the more the TIPS are affected by volatile components of the CPI — like gasoline.
- The stock market — and the Federal Reserve — are very interested in intermediate-to-longer term inflation expectations, so they watch the “forward curve” of inflation expectations. One of the Fed’s favorite indicators of inflation expectations is the “5 year breakeven, 5 years from now.” If the average CPI gain over 10 years is 2.0% but the first 5 years is only 1.5%, then inflation is now expected to be over 3.0% from years 6 through 10. This indicator is now at a new post-crisis high, back to levels not seen since early 2008, when oil was still rising above \$100 per barrel.

We Monitor Gasoline Prices for Short-Term Inflation Signals and Five-Year Forward Breakeven Rates for the Intermediate to Longer-Term Inflation Expectations



Note: The inflation "breakeven rate" is the prospective annual rate of appreciation of the Consumer Price Index at which an investor would be similarly compensated by a conventional Treasury note and by a TIPS (Treasury Inflation Protected Security) of comparable maturity. Source: Department of Energy, Federal Reserve.

Our chart puts the recent surge in gasoline prices in context. After more than a decade of relatively cheap gas, prices at the pump rose dramatically for the next nine years, peaking a year ago at over \$4 /gallon. The worldwide economic contraction caused a supply imbalance and a steep drop that helped support consumer spending power during the darkest days of the financial crisis.

Now that gasoline prices have risen back toward their average level over the past several years, the salutary effect of their drop — both in terms of its impact on consumer spending power and also on the inflation indexes — is eroding.

This is one of the reasons that markets are becoming more concerned about the timing and strength of renewed inflationary pressures, and the Federal Reserve's eventual policy response.

Tom McManus

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