

May 2023

# Vanguard Inflation Market Commentary

## Recap:

Inflation markets continue to reflect the volatile nature of the markets this year, as we grapple with end-of-cycle dynamics and the shifting balance between soft and hard landing scenarios. During May, soft landing conditions returned as US economic data surprised to the upside, while fears around US debt ceiling risks and further fallout from the regional banking crisis did not materialize. As a result, broader rate complexes sold off, including real rates, as the market unwound most of the implied rate cuts through the end of 2023 that were priced at the end of April. Breakeven valuations however continue to remain at the cheaper end of the range. Forward concerns of a future recession have weighed on sentiment, and retail outflows remain a negative technical headwind. Real yields across the curve rose during the month, with the front end leading the move higher. 1-year yields crossed the 3% handle, and back-end real rates approached 2022 highs. The TIPS index posted a negative monthly return of -1.19% for the month, bringing YTD returns to 2.26%.

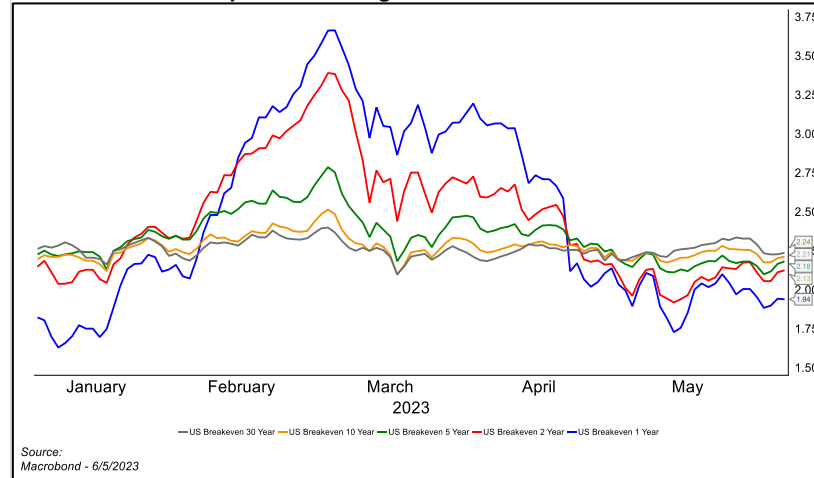
For the inflation data, the April CPI release helped with the soft-landing narrative, as headline and core inflation broadly came in line with market expectations of 0.40% MoM for both series. Powell's closely watched super-core category sharply fell from 0.40% MoM in March to 0.11% in April, bringing the 3-month average to 0.34%. The decline was not as optimistic under the surface, as it was led by outsized slowdowns in travel-related subcomponents, namely hotels and public transportation, which are known for being more volatile. The remaining subcomponents in the index either accelerated or remained flat, suggesting underlying stickiness to the inflation picture. Rent and OER also bounced back from the sharp deceleration in March (0.56% and 0.54% MoM respectively, up from 0.49% and 0.48%). Overall, the slowdown in inflationary pressures is a welcome relief, and favorable base effects will result in a further significant drop in headline YoY rates (expected Headline CPI falling from 4.9% to 4.1%). On the flip side, core inflation remains sticky, with market-based fixing and Cleveland Fed nowcast projecting a robust +0.45 bp for the May release.

For Fed policy, recent communication from core members of the committee suggests a June skip for rate policy to allow them time to assess incoming data and the impact of credit tightening on economic activity. Any pause should not be interpreted as the peak terminal, however, as the Fed continues to stress data dependency and the potential need to do more given the tightness of the labor market and slow progress on bringing down inflation. As such, the market is currently pricing in an 80% chance of a hike in July, compared to implied rate cuts just a month before.

## Strategy/Outlook:

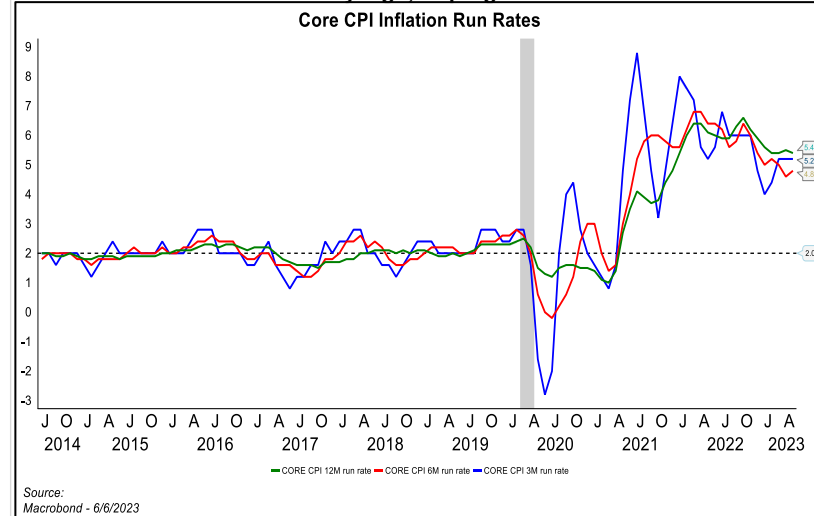
The TIPS markets continue to be challenged with various headwinds in the current environment. Downside risks emanating from the evolving bank stresses and tightening credit and monetary conditions have reduced investor appetite for the asset class. Flow technicals remain negative on the year and over the last 12 months, as both ETF and mutual fund flows have continued to see outflows in the industry. Valuations remain on the cheaper end of the range, in particular the front end of the breakeven curve, but muted risk appetite from the real money community and retail outflows suggest even cheaper valuations are needed to entice buyers to compensate for the inherent risk / illiquidity premium of the product at the moment. Overall, we view TIPS being mired in the current range for the time being, as the market continues to oscillate between regimes.

Breakeven inflation spreads trading water over the last few months



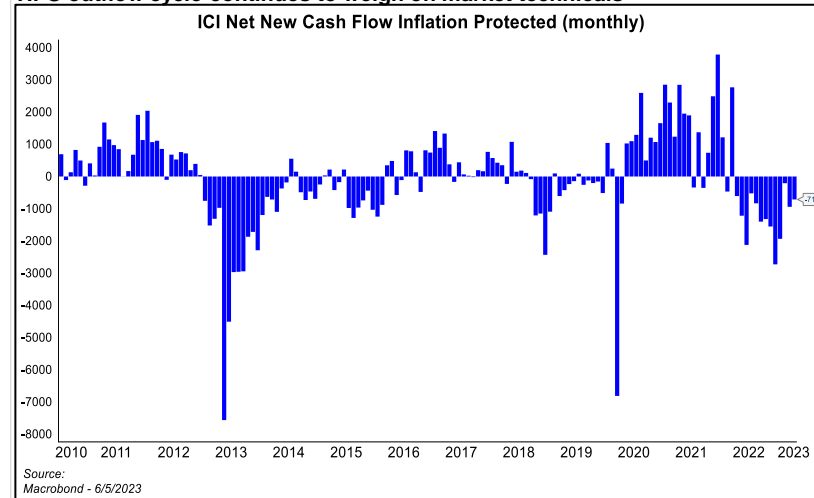
Source: Bloomberg

Core Inflation remains stubbornly high, as progress has been slow



Source Bloomberg

TIPS outflow cycle continues to weigh on market technicals



Source: Bloomberg

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