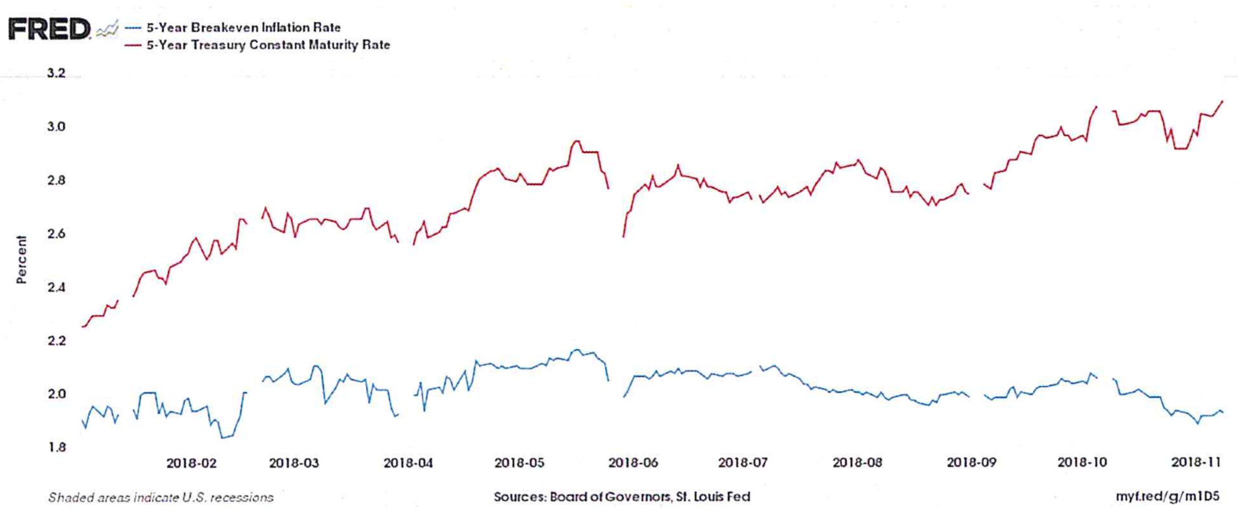
Gregory E. Cater CWS® CRC® AIF®
Certified Wealth Strategist®
Certified Retirement Counselor®
Accredited Investment Fiduciary®

32731 Egypt Lane, STE 801
Magnolia, Texas 77354
www.firstallied.com

936-321-1542
gcater@1stallied.com

Greg Cater Sr. and Greg Cater Jr.
Do Inflation Expectations Determine Bond Yields?
11/12/18

The yield on a bond has two components: Inflation risk, and default risk. US Treasury bonds have virtually no default risk, so barring anything screwy, a Treasury bond's yield should more or less follow inflation expectations. I will now present to you...something screwy.



The yield on a Five-Year Treasury bond has risen 79 basis points from 2.25% to 3.04% so far this year[1]. That is an increase of 33%! In that same time, the US Five-Year Breakeven, which is a market based measure of inflation expectations over the next five years, has actually dropped (1.91% to 1.90%)[1].

So what happened? Why have Treasury prices dropped while inflation expectations are flat? One reason might be related to something called the liquidity effect. The Federal Reserve is in a tightening cycle. Another phrase for that is Monetary Deceleration. During Monetary Deceleration, money (cash and equivalents) become scarce, and companies who need liquidity bid that money up, raising the short term interest rate. This rise in short term interest rates has an effect on longer term rates, causing them to increase. If the Fed keeps tightening, eventually the economy slows down (often into a recession), and the need for liquidity relaxes, causing rates to drop.

Another reason may be S&P 500 earning expectations. According to Goldman Sachs we may see a decline from 23% this year to 6% in 2019 and 4% in 2020[2].

Gregory E. Cater CWS® CRC® AIF®
Certified Wealth Strategist®
Certified Retirement Counselor®
Accredited Investment Fiduciary®

32731 Egypt Lane, STE 801
Magnolia, Texas 77354
www.firstallied.com
936-321-1542
gcater@1stallied.com

Works Cited:

1. Bloomberg Terminal
2. Bloomberg Article "Goldman Sachs See S&P 500 Profit Growth Slowing to 4% in 2020"