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The Day Ahead: There is Inflation, If You Look For It, And It's Not Helping Bonds

This commentary was delayed this morning due to several alerts posted on MBS Live. If you're not a member and haven't checked it out, you should.

Bonds are beginning the day with their **biggest sell-off** since January 2nd, but this one is a bit more disconcerting because it's taking 10yr yields over their 2.52% technical ceiling (hasn't been broken since March 2017). At face value, today's weakness means we can increasingly be convinced that the first major dose of momentum following the big, sideways consolidation of Q3 2017 is toward higher yields.

Looking a bit deeper, we can make good sense of this move by **breaking 10yr yields down** into their inflation-related and inflation-adjusted components. There are good, old-fashioned 10yr yields ("vanilla") which serve as the benchmark for all longer-term domestic interest rates. Then there are Treasury Inflation-Protected Securities (TIPS) which convey the 10yr rate of return in the absence of inflation.

TIPS trade in the open market and are auctioned just like vanilla Treasuries. By subtracting the TIPS yield from the vanilla yield, we get the **inflation premium** implied by traders, also known as the "breakeven" or simply "10yr inflation expectations." This is what the Fed refers to as "market-based inflation expectations" (as opposed to survey-based consumer inflation expectations).

Long-story short, **market-based** inflation expectations have driven the past month of bond market weakness, while all the non-inflation related momentum has remained sideways. In fact, it's not unfair to say that, after the initial post-election sell-off, inflation expectations have accounted for the **two distinct phases** in bond market momentum in 2017 and early 2018 (even though the non-inflation-related component accounts for slightly more of the overall move: .37 vs .3 in absolute terms).

MBS and Treasury

	Price / Yield	Change
MBS UMBS 6.0	99.43	-0.62
10 YR Treasury	4.9860	+0.0952
30 YR Treasury	5.3557	+0.0737

Pricing as of: 11/10 5:59PM EST



Average Mortgage Rates

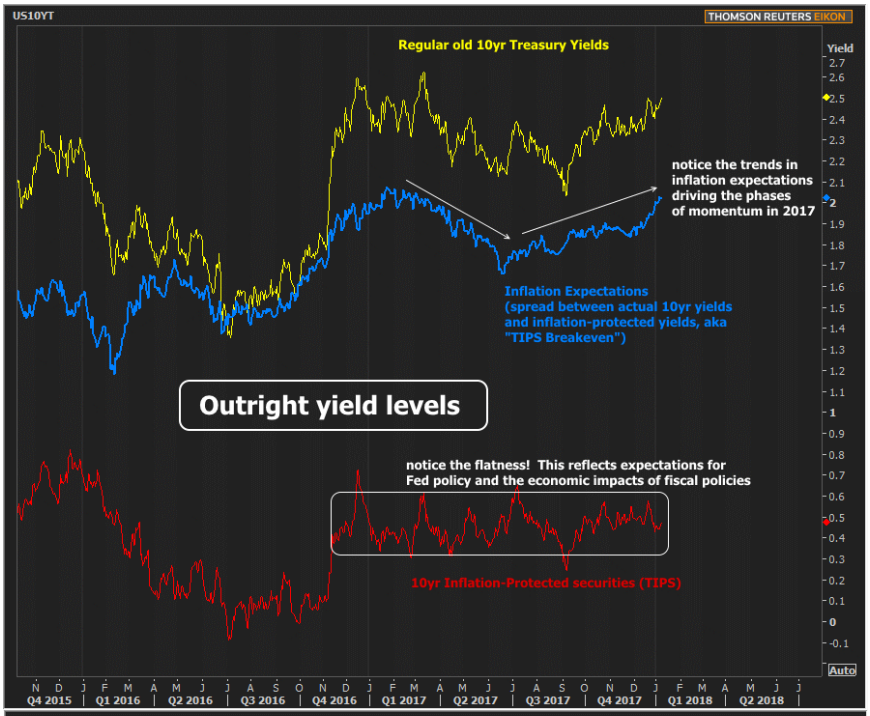
	Rate	Change	Points
Mortgage News Daily			
30YR Fixed	7.30%	+0.12	0.00
15YR Fixed	6.92%	+0.09	0.00
30YR FHA	6.89%	+0.07	0.00
30YR Jumbo	7.40%	+0.03	0.00
7/6 SOFR	6.80%	+0.31	0.00
30YR VA	6.90%	+0.07	0.00

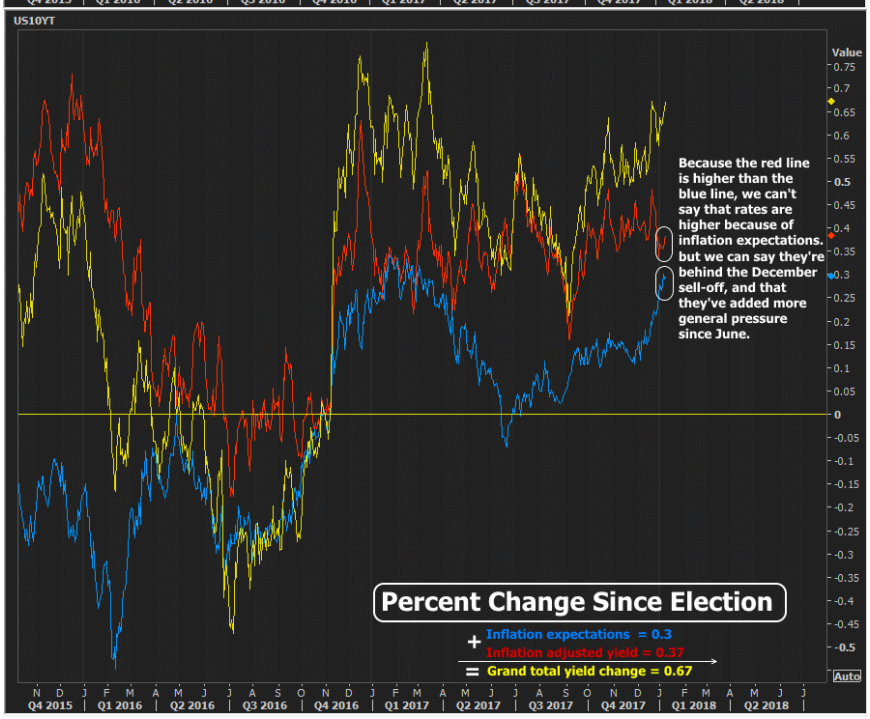
Rates as of: 11/10

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What's up with all this inflation fear?

There are **2x 800lb gorillas** in the room: oil prices and government spending.

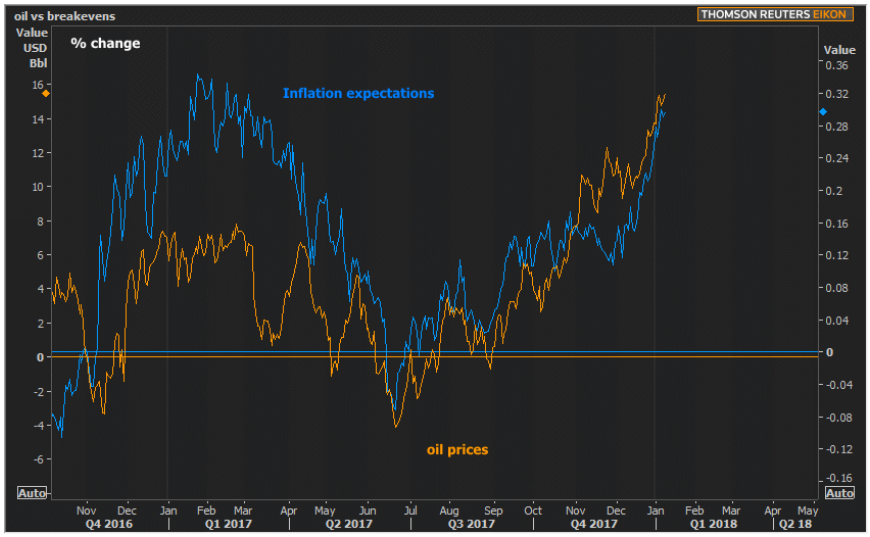
Notice the more prominent uptick in the blue line in the chart above in December. This coincides with the **tax bill** coming to fruition and Trump's mention of an **infrastructure spending bill** to be announced in January. The more the government spends, the more traders see inflation potentially increasing. This is by no means a 1:1, but it pushes bond yields higher, all things being equal.

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The **dark horse is oil.** As Ian Lyngen of BMO Capital Markets astutely pointed out in a client note this morning, there's strong correlation between oil prices and inflation expectations. The following chart shows the % change in both. Granted, it's not a perfectly linear correlation, but it does suggest the possibility that a cooling-off in oil prices could be the thing that helps bonds find their footing. Unfortunately, if oil manages to continue higher, it could contribute to supportive ceilings in bond yields being tested.



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