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Inflation Trade Gone Sour: Implication for Commodities

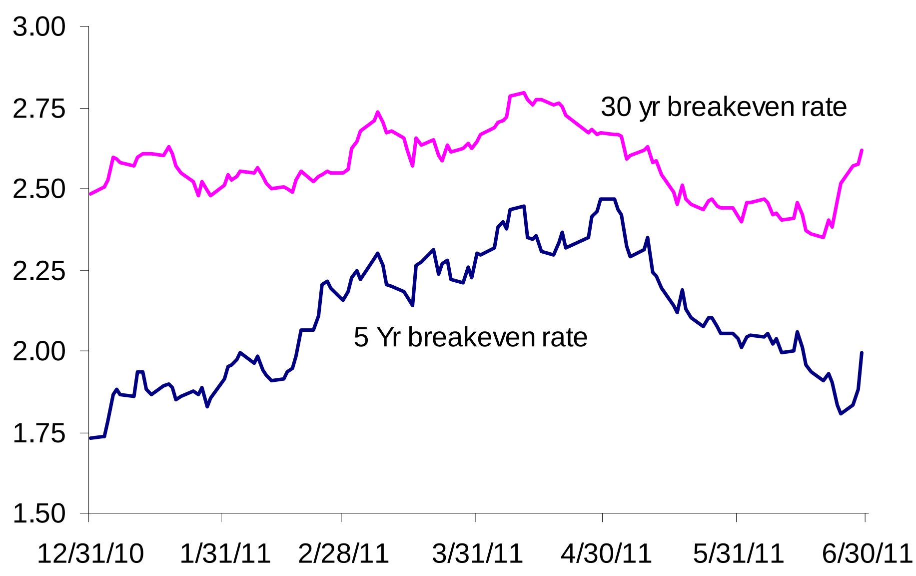
Bloomberg ran a top story today discussing a soured inflation trade it attributed to Morgan Stanley. We don't know whether Morgan Stanley lost any money or even made the trade described in the Bloomberg article, but it's useful to go through the details of the trade.

- The Bloomberg-described trade was that the 5-year TIPs spread (a measure of CPI inflation expectations) would climb faster than the 30-year TIPs spread. That had happened steadily from December 2010 through March 2011, so the trade may have been a bet that QE2 was inflationary in the near term and that the January-March trend (near-term inflation rising faster than long-term inflation) would continue.

- Supporting the trade were the combination of dollar weakness, rapidly rising oil and commodities (which translate into near-term CPI inflation), faster second-half 2010 growth and the incorrect view that the Fed was "printing money." This caused the bond market complex to price in higher inflation expectations through March 2011.

- However, beginning in April and especially May, inflation expectations went down for both maturities involved in the trade, with the 5-year expectation falling more than the 30-year expectation, in part due to lowered near-term GDP growth expectations.

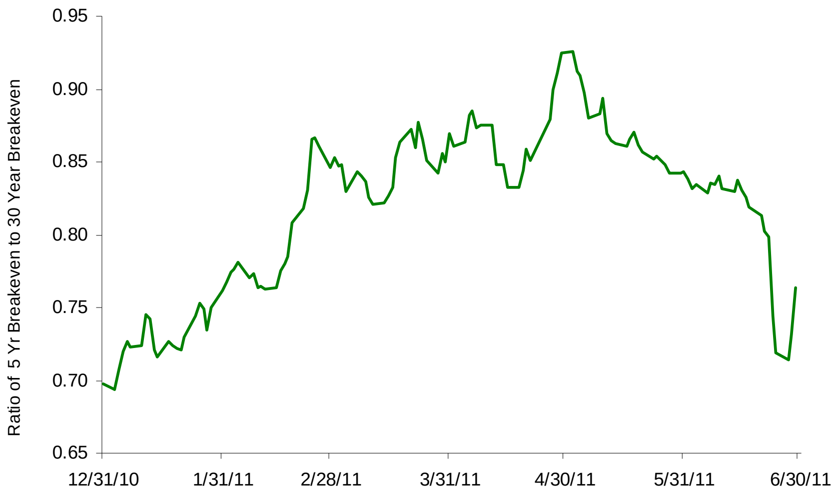
5 and 30 Year Breakeven Rates (last obs. June 29, 2011)



Source: Bloomberg; Encima Global

• The ratio of the 5-year and 30-year TIPs spreads climbed in January through April and then fell steadily through the June 27 bottom.

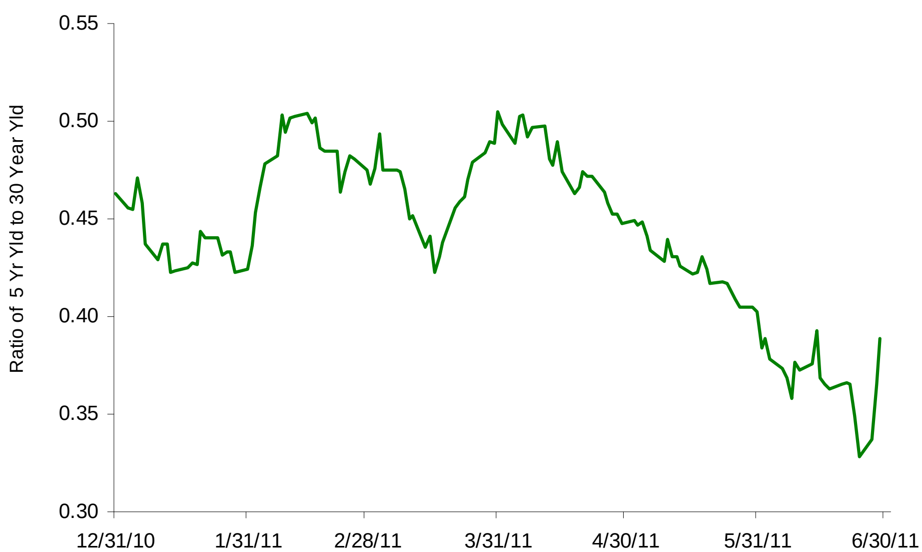
Ratio 5 / 30 Year Breakeven Rates (last obs. June 29, 2011)



Source: Bloomberg; Encima Global

• The TIPs spread is composed of the nominal Treasury yield, which in theory includes a real growth component and an inflation component; and the TIPs yield. The latter reflects the real growth outlook, but also includes a view of oil prices (since oil has a heavy impact on headline CPI which is part of the TIPs contract). One key component of the trade, the ratio of the 5 to 30 year Treasury yields, bottomed on June 24 at 0.33 after having been steady to rising in the first part of the year.

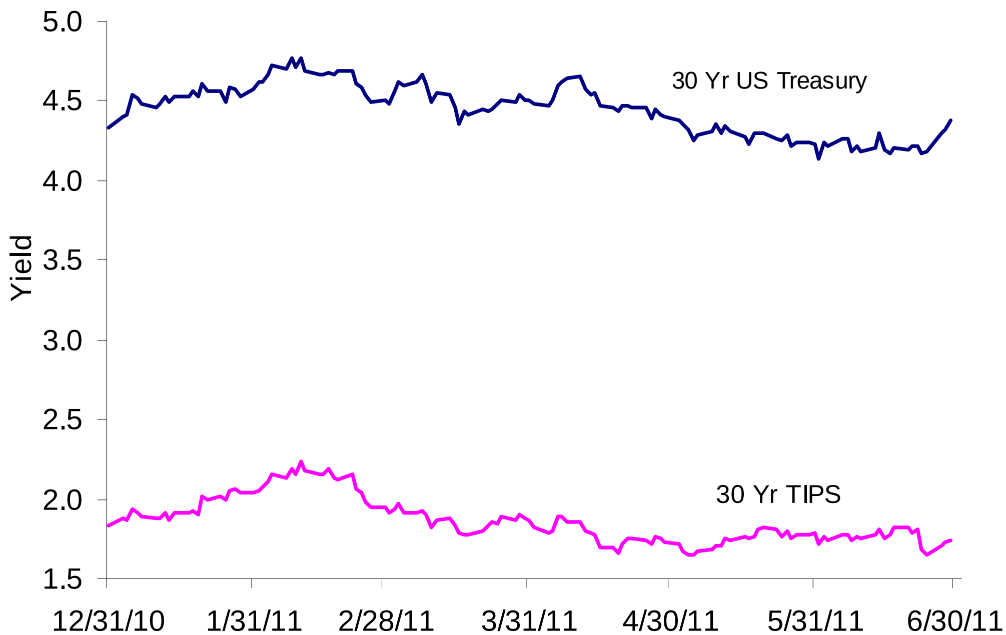
Ratio 5 / 30 Year US Treasury Yields (last obs. June 29, 2011)



Source: Bloomberg; Encima Global

- The decline in the ratios in April and May reflected the Fed's decision not to taper off its Treasury purchases (which creating what we think contributed to an artificial squeeze on Treasuries) and the downward pressure on the front end of the yield curve from FDIC capital requirements (see Whipsaw in Bond Yields on April 18.)

30 Year US Treasury and TIPS Yield (last obs. June 29, 2011)



Source: Bloomberg; Encima Global

The June spikes down to deep troughs in the ratios, which cost deeply anyone still in this trade, were a combination of:

- the most intense point in the bond squeeze as the Fed insisted on finishing its QE2 purchases at the highest possible prices simultaneous with deadlines on the Greece crisis and the U.S. debt limit negotiations;

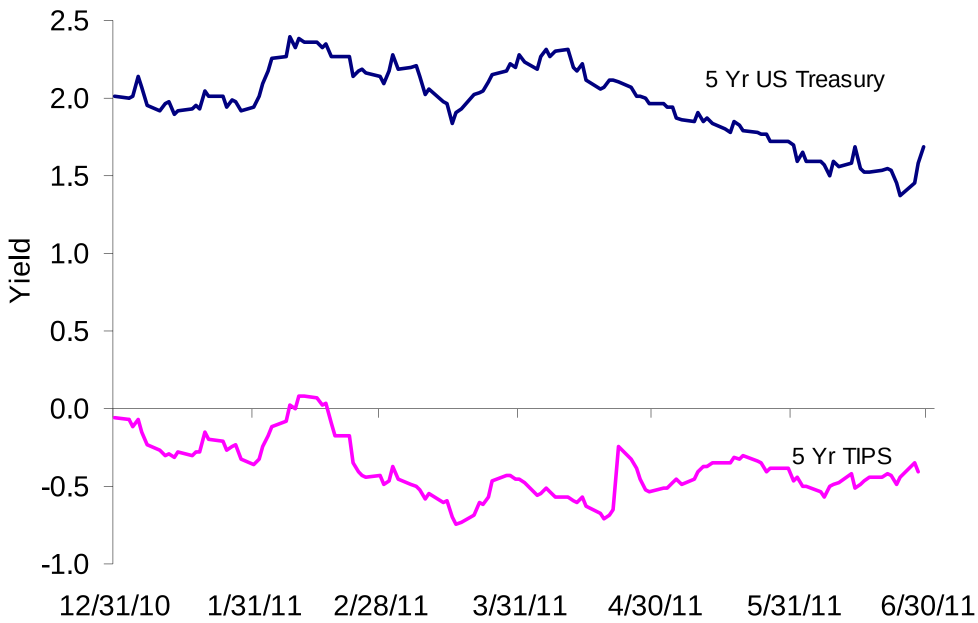
- the sharp decline in oil from June 9 through June 27, as word of the SPRO release spread (lower oil puts downward pressure on the TIPS spread);

- in its June 22 statement, the FOMC took out its references to inflation being "subdued", which may have triggered the sharpest decline in the 5-year yield on the view that the Fed was worried about inflation and might tighten (incorrect in our view).

- The late June troughs may also have reflected capitulation over a sizeable trade gone sour (which would have required buying the 5 year Treasury and selling the 30-year Treasury to close the position and/or selling the 5-year TIP and buying the 30-year TIP.)

- On the graph, note the sharp trough in the 5-year bond yield on June 24. Separately, note the decline in the yield on the 5-year TIP into negative territory in the first part of 2011, related to the combination of low growth expectations and rising oil prices, which the trade described in the Bloomberg article might have assumed was going to continue deeper into negative territory.

5 Year US Treasury and TIPS Yield (last obs. June 29, 2011)



Source: Bloomberg; Encima Global

Implication for Commodities

We think QE2 was incorrectly analyzed as inflationary "money printing." This pushed the dollar down in late 2010 and commodities up more suddenly than might have occurred otherwise. For example, gains in the CRB accelerated markedly after the Fed hinted at QE2 in late August 2010 (see graph below.)

Reuters / Jefferies CRB Commodities Futures Index (last obs. June 29, 2011)

Source: Reuters / Jefferies; Encima Global

- With the Fed pegging U.S. interest rates near zero while the rest of the world is going the other direction, we expect more dollar weakness and continued support for high commodity prices. This would change if President Obama or the Fed ended the weak-dollar policy, but for now that policy is firmly entrenched at the Fed and Treasury.

- However, in the near term, we think commodities may be in a plateau digesting the huge gains in late 2010 and the realization that QE2 didn't add to global liquidity and that regulators are rationing credit so that the excess cash at banks isn't rapidly multiplied through fast loan growth (too much money chasing too few goods.)

- A possible trigger for a resumption in commodity gains: recent bank loan growth remains fast and the Fed shows no hint of a rate hike.

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