ECRI

Case Study

U.S.: Inflation Cycle Turns Down (2018)

ECRI Helps Clients Manage Inflation Cycle Risk

Objective

Inflation cycle turning points can cost fixed income managers dearly. ECRI's objective is to protect clients from being blindsided by an inflation cycle turn, so that they can then profit from them, as illustrated by our experience in recent years.

ECRI has long recognized that inflation has its own distinct cycles, which the USFIG is specifically designed to anticipate.

Consensus Outlook, Summer & Fall 2018

August 2018: "Consensus expectations for inflation range from a gradual firming to a rapid ramp-up," with the bond market royalty pounding the table on a big bond bear market taking yields to well over 3%, to 4% or even 5%.

October 2018: "We may go past neutral, but we're a long way from neutral at this point, probably." — Fed Chairman Jay Powell

ECRI Outlook, Summer & Winter 2018

August 2018: "Contrary to consensus expectations, there is rising risk of a downturn in inflation, according to ECRI's U.S. Future Inflation Gauge. … Consensus and Fed measures of underlying inflation pressures indicate that inflation will keep rising, while our USFIG is hinting at a cooling in inflation pressures — a developing divergence that may once again catch the Fed unawares. … U.S. inflation cycles have become shorter and sharper this century. Therefore, they are more likely to catch the consensus off-guard."

December 2018: "The inflation cycle downswing is well underway and set to intensify, even as the Fed continues its rate hike cycle. That is the latest message from ECRI's U.S. future inflation gauges, which helped us make an accurate contrarian inflation downturn call back in the summer."

Action

Using our understanding of cycles that are monitored by ECRI's proprietary leading indexes for U.S. economic growth and inflation, we focused our clients on the appropriate insights and the knowledge that — regardless of what they said — the Fed was likely to cut rates in the face of slowing growth and falling inflation.

Based on that conviction, clients bet against the bearish consensus on bond prices, which paid handsomely as bond yields tumbled following the “Powell pivot” to a dovish stance in early January 2019.

Results

Even though inflation expectations held up above 2% for a couple of months after our summer inflation downturn call, by December 2018 they had plunged below 1.6%, having dropped some 50 basis points since summertime. Between early November 2018 and late August 2019, 10-year Treasury yields were cut in half, plunging from 3.23% to 1.51% — about where it stood on the eve of the Covid crisis.

Check out other ECRI case studies ↗*U.S.: Reflation Trade (2016)*