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PEAK CAPITAL MANAGEMENT

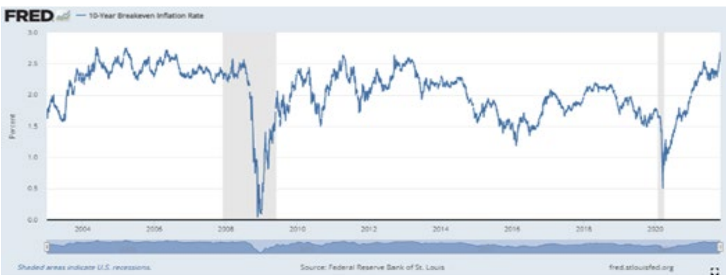
Professional Investment Management

BLOG POST
Inflation and Commodity Prices
11/22/2021

With supply chain issues causing disruptions across the global economy, we've seen inflation rise over the course of 2021. Consumer demand is quite strong, but bottlenecks at the ports and labor shortages have led to empty shelves and higher prices for most items that consumers buy every day. Inflation expectations, as measured by the breakeven rate of 10-year Treasuries, is at levels not seen since 2006. However, long-term Treasury yields remain relatively subdued.

Inflation Breakeven Rate

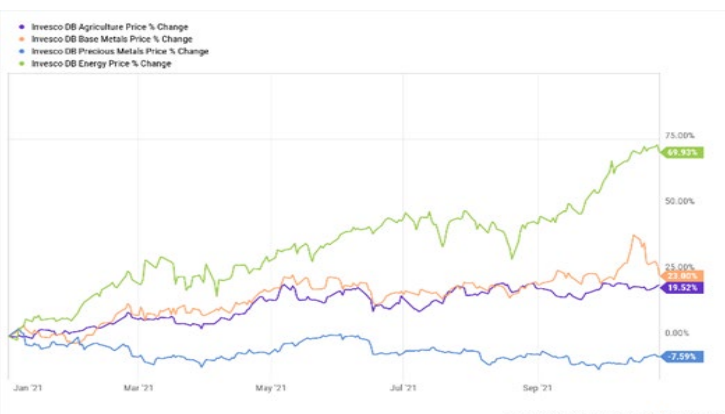
The chart below illustrates inflation expectations based on the 10-year nominal and TIPS yield. The current reading is 2.69%, which is above the Federal Reserve's long-term target of 2%.



According to the chart above, investors would be better off holding TIPs over the next ten years if inflation exceeds 2.69% (approximately), given that the coupons on TIPS would be adjusted upward based on the Consumer Price Index (CPI).

Commodity Prices

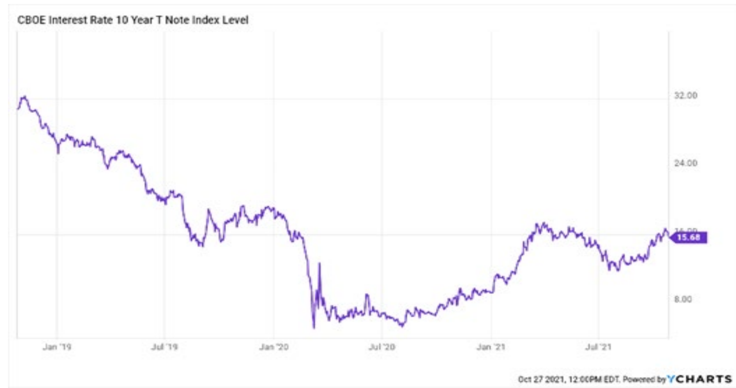
The chart below illustrates the year-to-date returns for four primary commodity groups – energy, precious and base metals, and agriculture.



Energy prices (i.e., crude oil, natural gas, gasoline, etc.) collectively are higher for the year by roughly 70%, but this comes after a decline of roughly -25% in 2020. Higher energy prices reflect a combination of higher demand and tighter supply. Likewise, agricultural prices (i.e., coffee, sugar, corn, etc.) are higher for the year by roughly 20%.

10-Year Treasury Yield

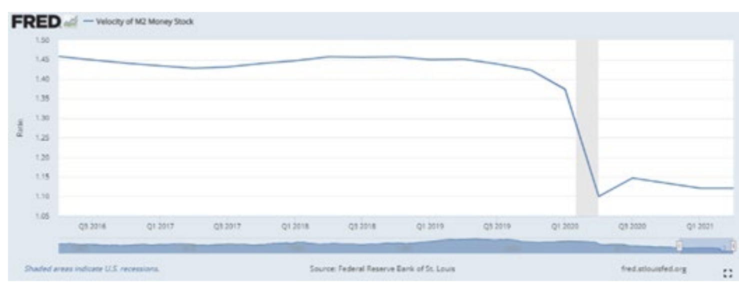
The chart below illustrates the 10-Year U.S. Treasury Yield Index (current yield x 100). The index currently sits at 15.7 (or 1.57%).



The 10-year index reveals an interesting pattern, particularly over the past year. After the plunge in yields in 2020 due to COVID, rates accelerated higher. After starting from such a low base of 0.5%, the 10-year yield peaked at roughly 1.75% around the end of March. But then the yield rolled back down below 1.2% despite inflation concerns. The current yield is still below levels just before the pandemic began last year.

Velocity of Money

The chart below illustrates the velocity of the domestic money supply. The velocity multiple currently stands at 1.12.



The chart above is telling and can provide some insight as to why the 10-year Treasury yield is not trading at a higher level. The velocity of money describes the number of times one dollar is spent to buy goods and services over a given period of time.

The velocity of money is important as it relates directly to inflation. While we have seen headline inflation creep higher due to supply chain issues and higher commodity prices, the velocity of the money supply is rather stagnate. This suggests that there are fewer transactions occurring between individuals in the economy than before, which does not suggest inflation.

Perhaps the bond market is playing a game of tug-of-war between the headline inflation number and what is occurring in the underlying economy.