

Inflationary Periods and Interest Rates

The Prospect of Persistent Inflation

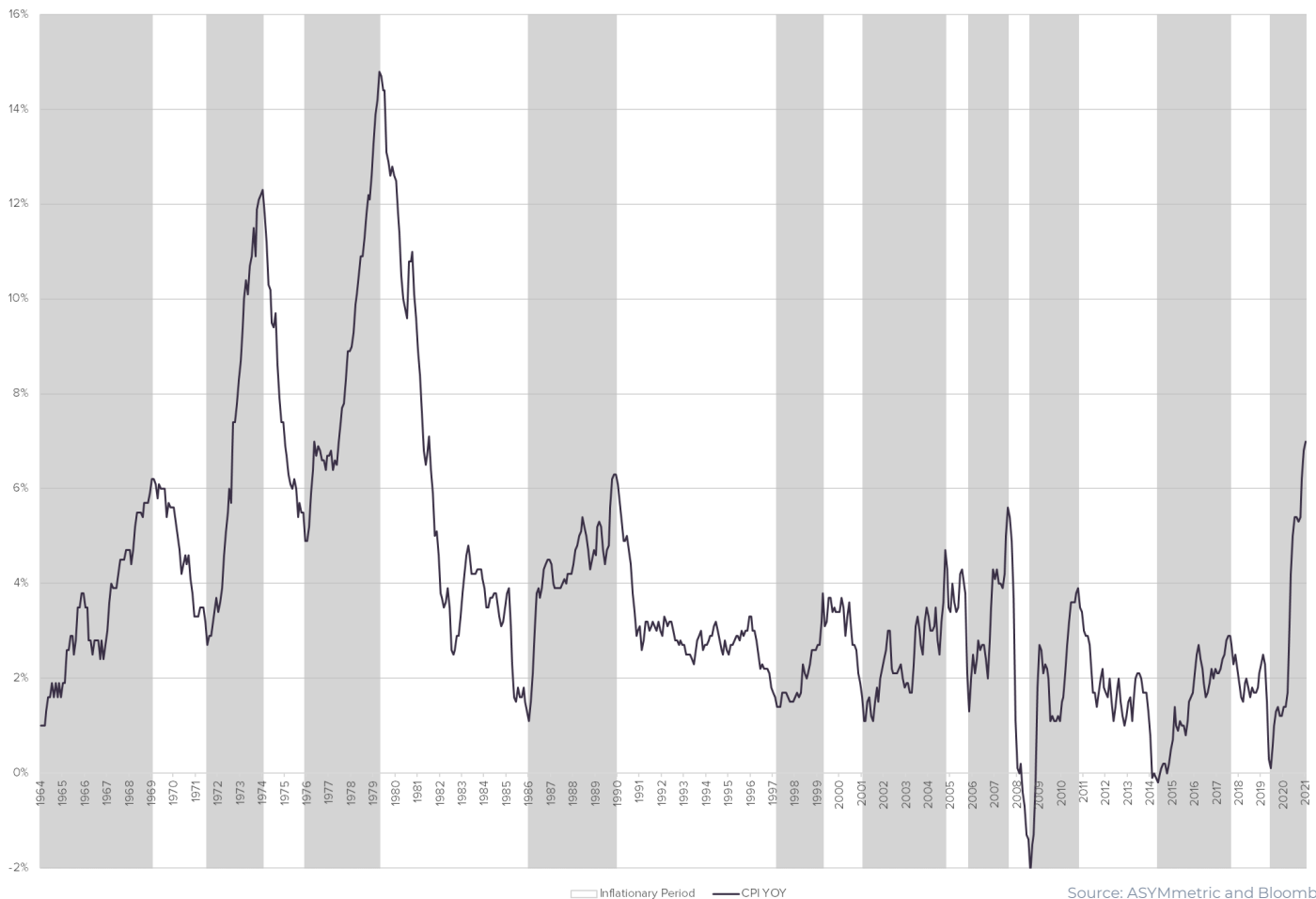
Current Inflation

Inflation in the United States, as measured by the Consumer Price Index (CPI), is at multi-decades highs. The last time the U.S. experienced inflation at current levels was in the early 1980s. This was coming off the energy crisis of the 1970s, when CPI climbed to over 14% and the interest rate on the 10-year U.S. Treasury was pushing 16%. This paper will examine U.S. inflationary periods from 1965 through the present, the relationship between inflation and interest rates and what to expect from the current inflationary environment.

Inflationary Periods

The U.S. has had ten inflationary periods since 1965. Inflationary periods are defined as trough-to-peak CPI, the gray shaded areas in the graph below. The inflationary trend since the early 1980s has generally been downward, characterized by lower lows and lower highs. Recent CPI levels have broken this multi-decade inflationary trend.

U.S. Inflationary Periods
CPI 1965-2021



Source: ASYMetric and Bloomberg

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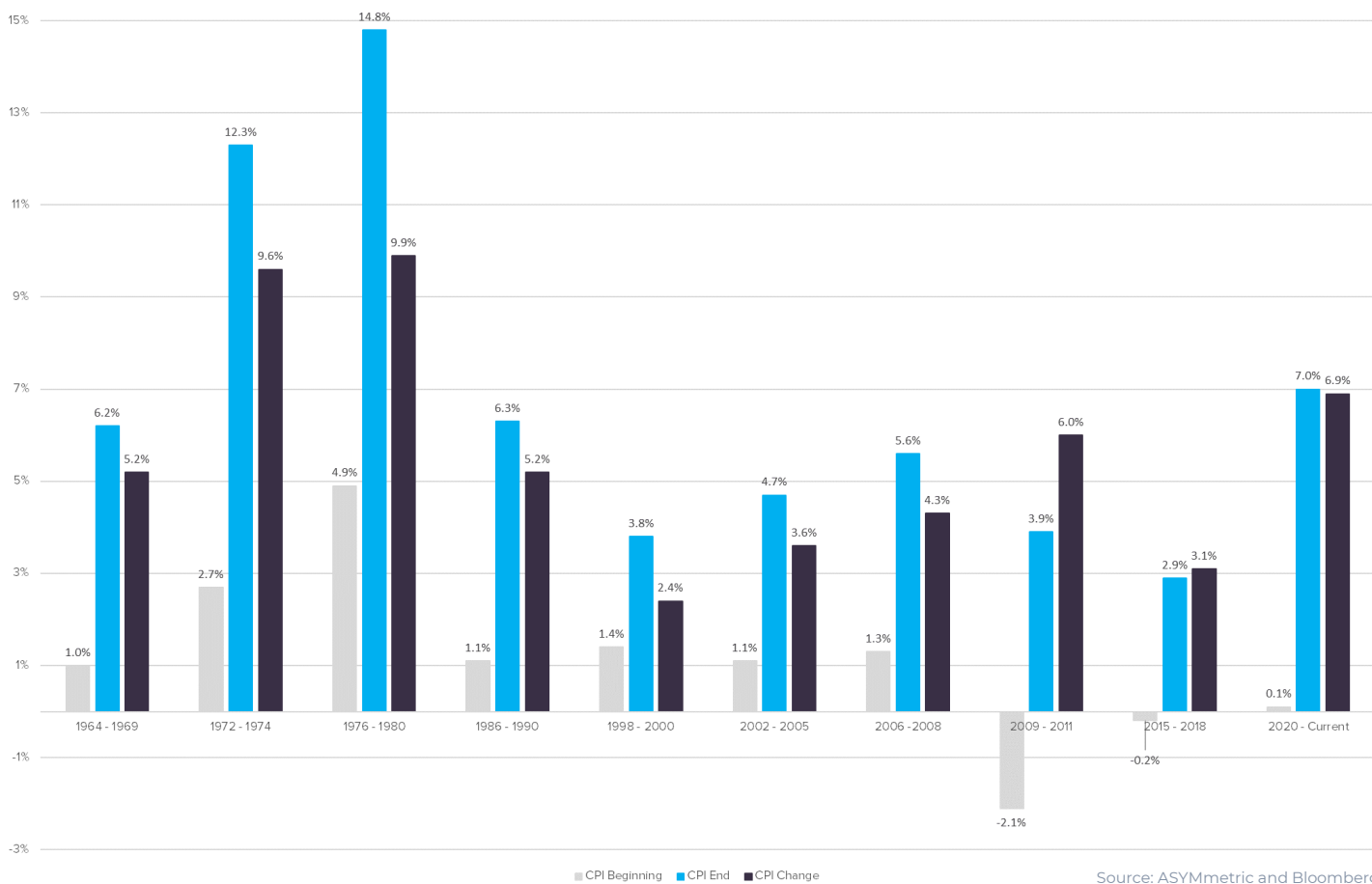
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Characteristics of Inflationary Periods

Inflationary periods were examined according to duration and magnitude. The average duration of an inflationary period in the United States is approximately three years — the shortest lasting 1.8 years and the longest lasting five years. The current inflationary period in the U.S. began in May of 2020 and has a current duration of 1.6 years. If averages were applied, this current inflationary cycle is at its mid-point and could keep climbing into mid-2023.

Inflation peaked in the early 1980s at 14.8%. The peak in Inflation in the '70s was caused by two oil embargoes and accommodative monetary policy to combat them. Inflation troughed in 2009 at -2.1%. The trough in inflation corresponds with the Great Recession. In the past ten inflationary periods, CPI troughed at 1.1% and peaked at 6.8%. The average change in inflation from low to high was 5.6%. CPI began the current inflationary cycle at 0.1%. Applying the average change in inflation to the current inflationary cycle, inflation should have peaked at 5.7% (0.1% + 5.6%), or applying average peak in CPI, inflation should have peaked at 6.8%. The magnitude of the current inflationary environment exceeds these levels.

Inflationary Periods
Change in CPI



Source: ASYMMetric and Bloomberg

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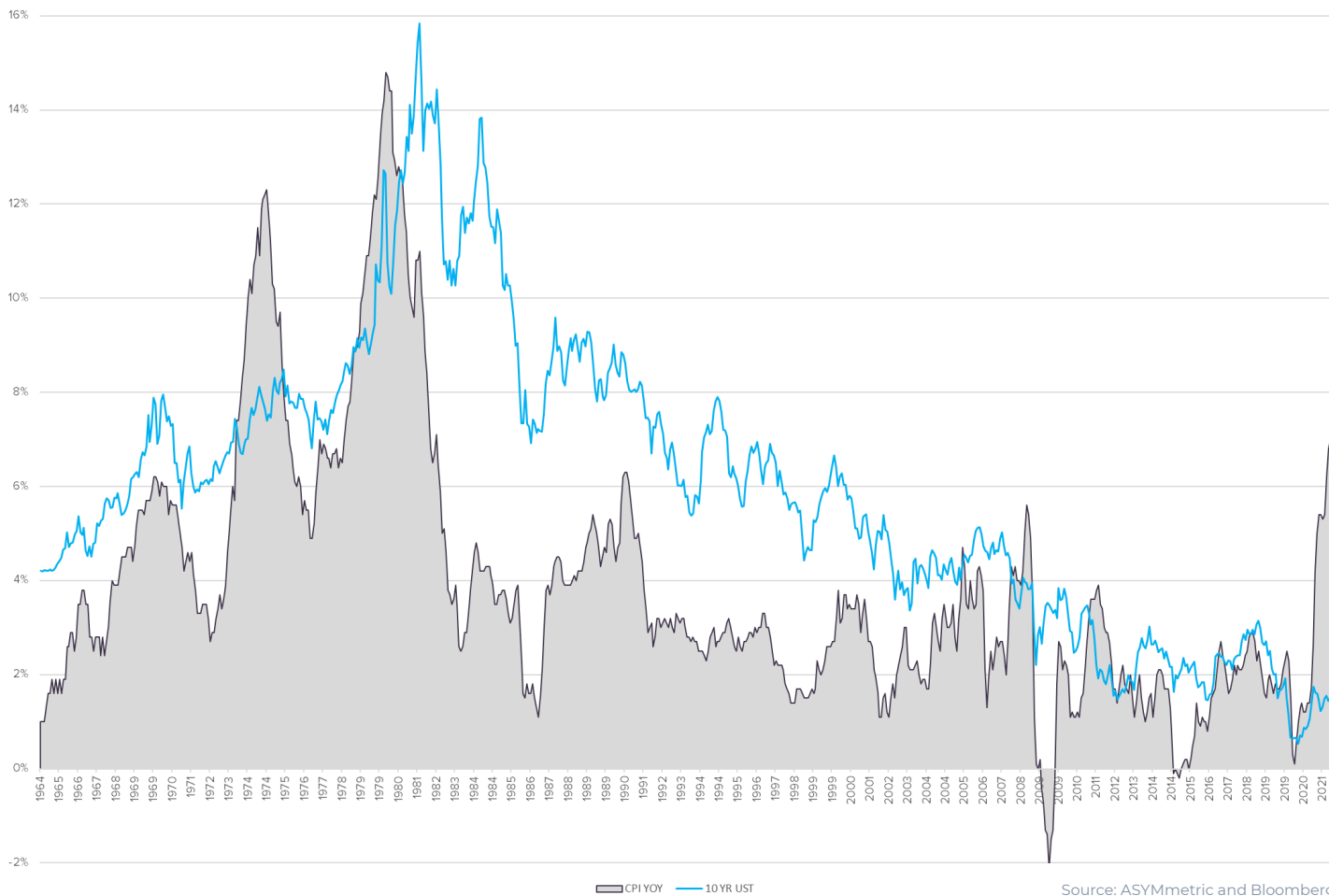
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Inflation and interest rates generally move together, as the graph below demonstrates. There has been a steady decline in inflation since the early 1980s. This is mirrored by a steady decline in interest rates over the same period. The yield on the benchmark 10-year U.S. Treasury was used to measure interest rates.

The preceding four decades have been described as the “Great Bull Market for Fixed Income.” Generally, declining inflation has supported declining interest rates. This relationship has been magnified by quantitative easing. Since quantitative easing was introduced in the U.S. in 2008, inflation and bond yields have hit their lowest levels in fifty years. Inflation hit -2.1% in 2009 and interest rates troughed at 0.5% in 2020.

If history is any guide to the future, inflation may be less transitory and more persistent than widely anticipated. Investors need to adapt to this paradigm shift and be prepared for a new reality that includes the prospect of higher inflation and rising interest rates.

Relationship between Inflation and Interest Rates
CPI v Yield 10-Year Treasury



Source: ASYMetric and Bloomberg

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