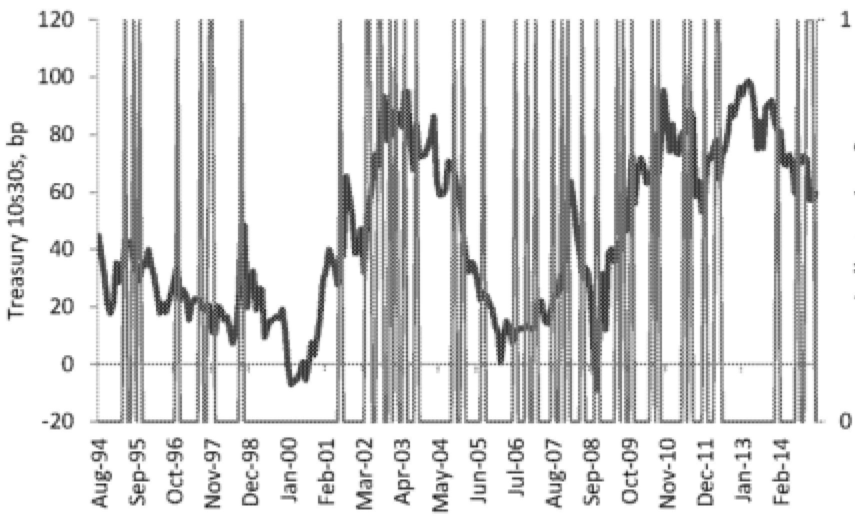
A note on the cash curve and inflation

Last autumn we noted historical evidence that 10s30s is forward looking with respect to inflation, and developed a simple indicator which illustrated that consistent bullish flattening (10s and 30s fall, 10s30s flattens) tends to presage a higher probability of declining inflation. The indicator is simple enough, we look at a rolling 20 trading day period and calculate the frequency of bullish flattening as a percentage of that 20 day period. Using Treasury data for 10s and 30s, and (month end) data from September 1994 until present, the unconditional probability of inflation declining over a 6m period was 53%. Conditioned upon a month-end bull flattening percentage of at least 60% (36 "events" during the historical period), the probability of CPI y/y falling over the subsequent 6m has historically been 75% (27 instances of falling inflation of the 36 events).

Treasury 10s30s and bull-flattening "events"



Source: Deutsche Bank

To be fair there is a potential reason to view this result with more caution that usual, and that potential reason is the possibility that the long end slope could be flatter than might otherwise be the case due to capital inflows, particularly from Europe. Indeed, our colleagues in economics currently project that headline CPI y/y will rise to 0.6% in Q3. Additionally conditions in the Middle East are obviously fluid and a deterioration in the security environment could push oil and inflation higher. On the other hand, a more aggressive Fed could lead to further dollar strength and renewed downward pressure on traded goods generally and oil in particular.

Portfolio managers flat in Q1, reduce credit overweight

It's so far been a rollercoaster year for real money investors. After lagging the benchmark for all of January, US bond fund managers reversed their underperformance and built a sizable lead over the benchmark in February through early March, only to see their excess return steadily chipped away in the recent weeks. As it stands, the median bond fund manager will likely finish the first quarter being close to flat to the benchmark. The following charts show the cumulative excess returns from top 20 US bond funds in 2015 and the market performance of 10y yields and credit spreads.