THE UNIVERSITY OF CHICAGO
HARRIS SCHOOL
OF PUBLIC POLICY

Inflation and Real Risks in Treasury Markets
– Oct 2023 –

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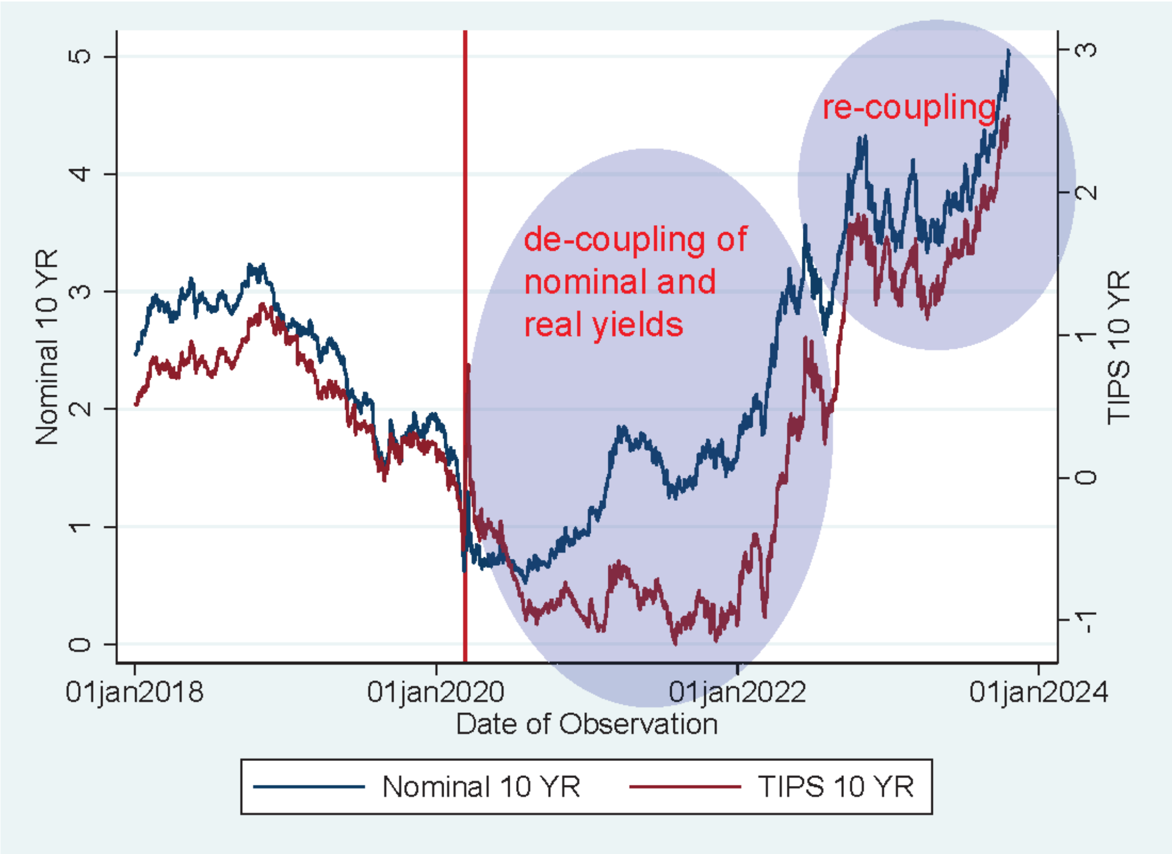
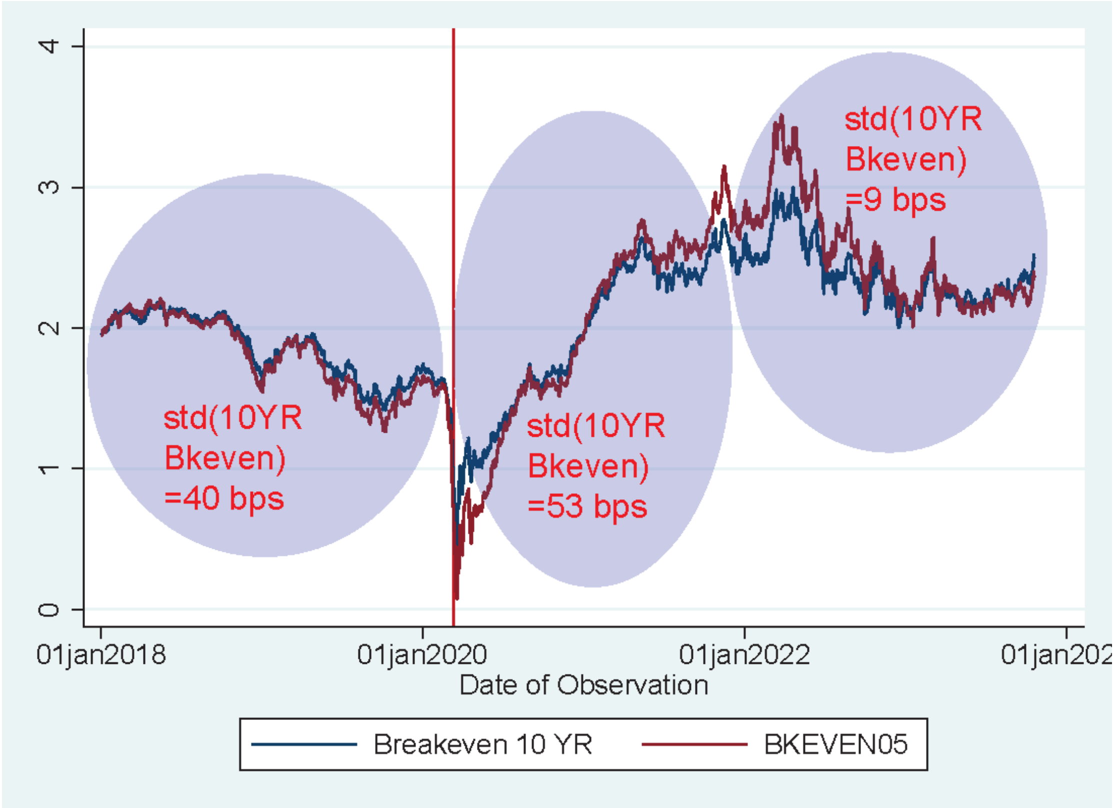
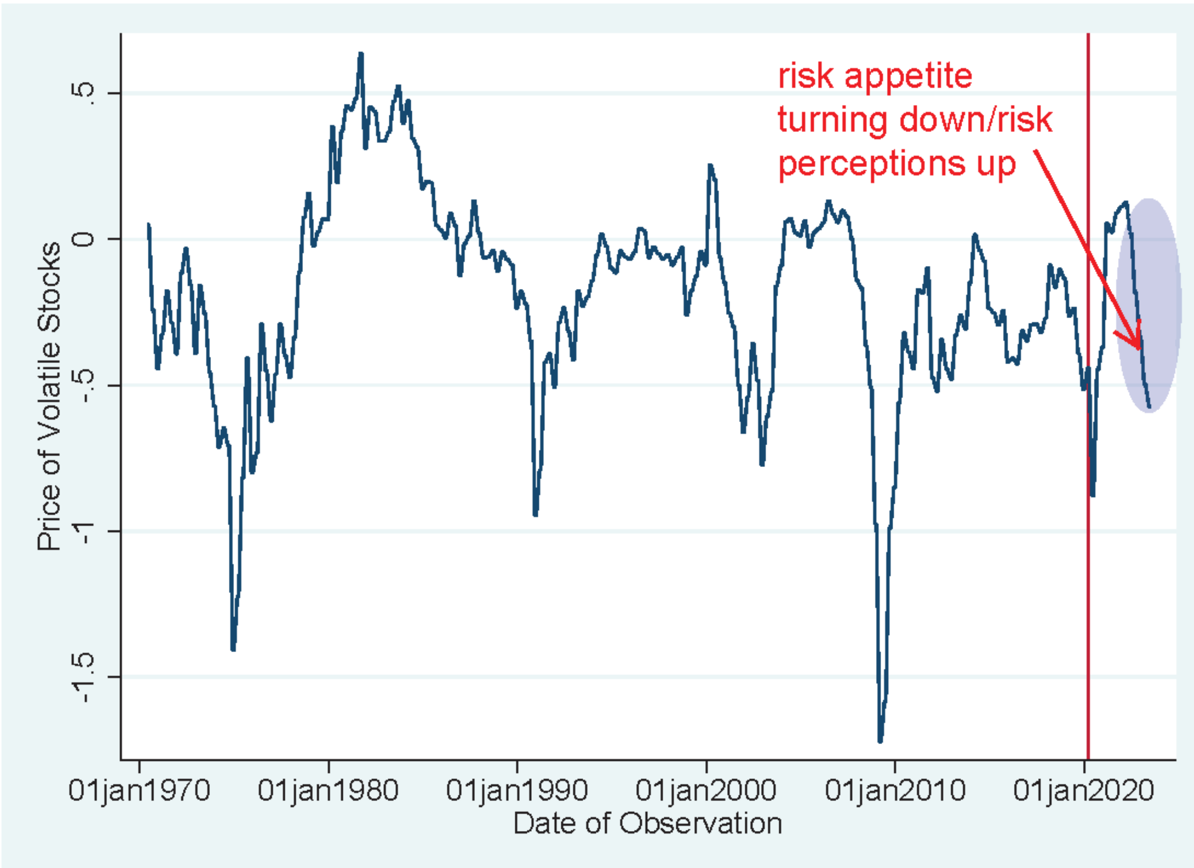
Nominal and Inflation-Indexed Treasury Yields



Market Inflation Compensation (10YR, 5YR)



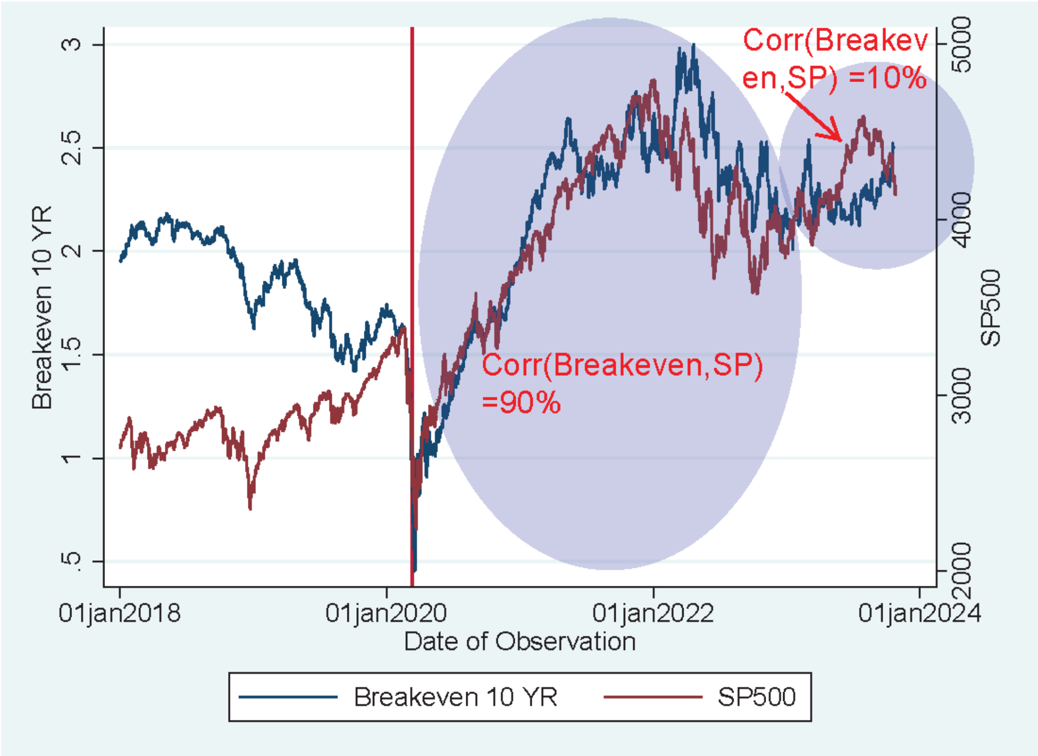
Risk Appetite/Risk Perceptions



- Price of Volatile Stocks (PVS)=B/M of low vol-B/M of high vol stocks
- Low PVS predicts low real investment and recessions
- Risk perceptions priced in both bond and cross-section of stocks

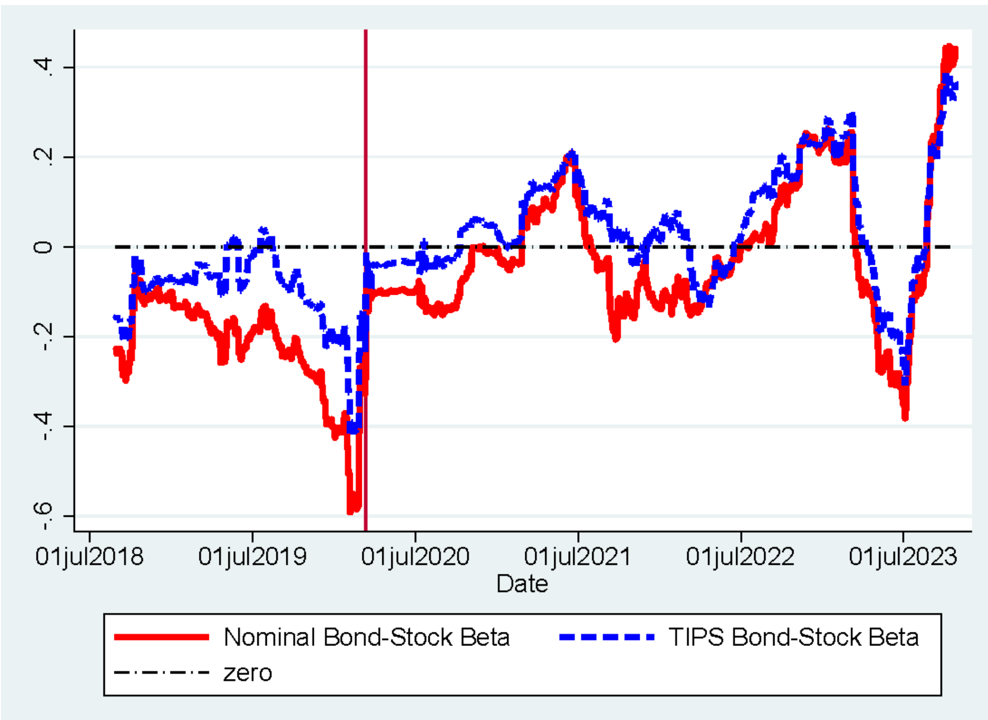
Pflueger, Siriwardane, Sunderam (2020, QJE), updated June 2023

Market Inflation Compensation vs. Stocks



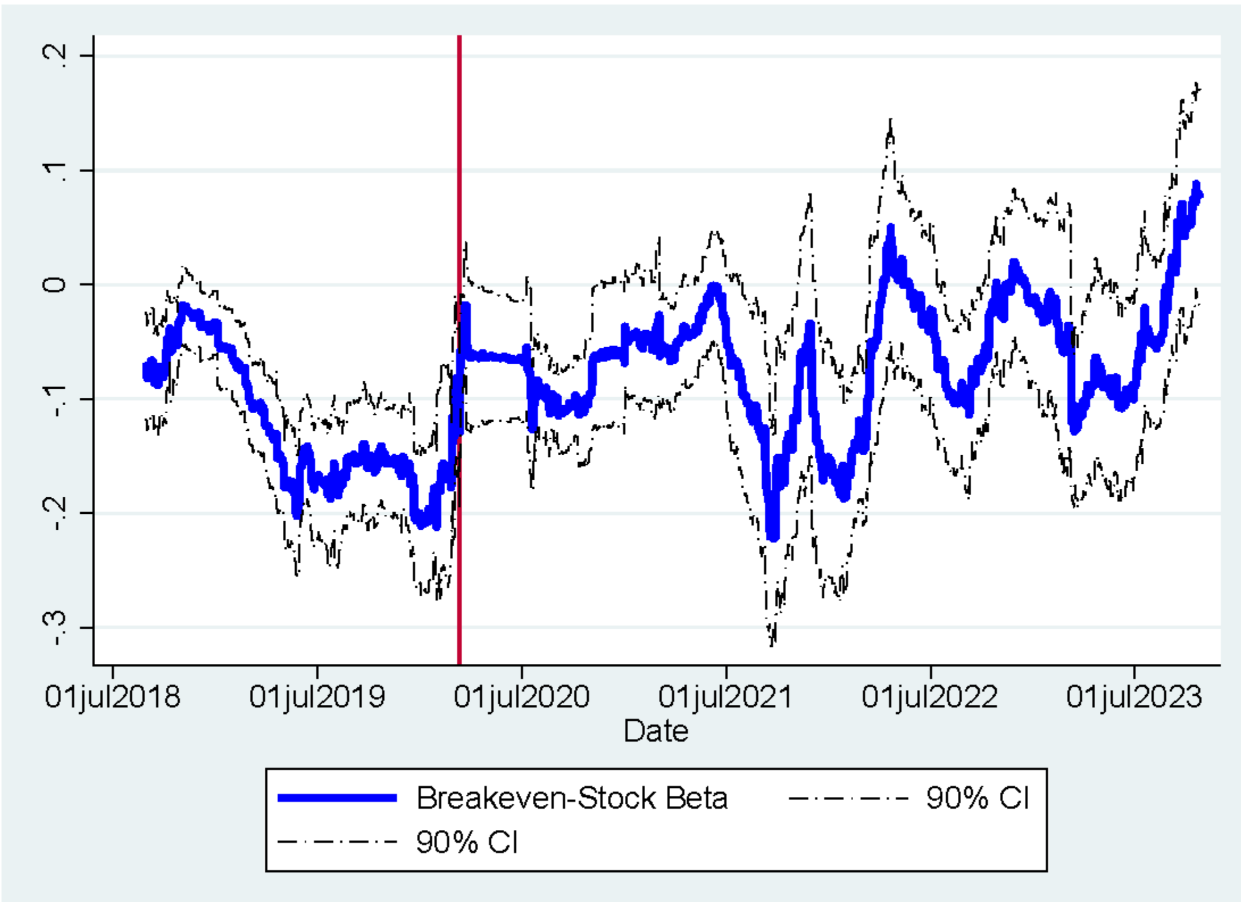
- Stable positive correlation between breakeven and stocks pre- vs. post-pandemic
- Correlation appears lower in 2023, but hard to tell whether this will persist

Nominal and Inflation-Indexed Bond-Stock Betas



- Nominal bond-stock betas remained < inflation-indexed bond beta pre- and post-pandemic
- Because yields inversely related to prices, same as corr(breakeven,stocks)>0
- Real bond-stock beta has moved up

Breakeven (Nominal-Indexed Bond) Return Beta



- In 2022, negative breakeven-stock return beta priced soft landing (Pflueger, 2023)
- Positive breakeven-stock return beta would price perceptions of stronger Fed response to supply shocks
- Latest increase in breakeven beta still pretty noisy

Breakeven return beta inversely related to correlation between stocks and market inflation compensation

Conclusion

- Bonds and stocks priced soft landing in 2022
- Markets appear to price more active monetary policy response to supply shocks in late-2023
- However, after volatile period post-pandemic, breakeven appears stable in 2023, suggesting that volatility of priced supply shocks has declined
- Risk appetite has started to fall/risk perceptions up