Inflation: Will It Stay or Will It Go? And What That Means for Your Bonds.
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2021 Growth Is White Hot

The shutdowns in 2020 hit the U.S. economy hard. As businesses re-open, 2021 economic growth comparisons year over year could ricochet up 7-8%. Pent-up demand could be strong as people emerge from 15 month hibernations. Many businesses went away for good, though, and the demand-supply imbalance is pushing up prices, the definition of inflation. The decisive question now is whether inflation will be transitory or more permanent.

What the Market Is Telling Us About Inflation

We can look at the guesses out there, but predictions are unreliable and often wrong.

When you really want to know what people are thinking about the future, watch what they *do*, not what they *say.* More specifically, look at the actions of investors in different parts of the bond market.

The 10-year Treasury rate has risen sharply since last August, now pricing in in an acceleration of inflation, and a fairly significant one that is expected to last several years. If inflation is here and here to stay for a while, what does this mean for your bond holdings?

What Inflation Means for Bonds

Higher prices (inflation) translate directly into higher interest rates and higher interest rates mean lower bond prices, right? Sometimes. But that is not the whole story. Like ice cream, bonds come in many flavors from plain vanilla (government bonds) to Ben & Jerry's Everything But the Kitchen Sink (junk bonds).

Rising rates and inflation inflict the most hurt on plain vanilla government bonds because government bonds prices are entirely impacted by interest rates. As an example, the recent 110 basis point increase in rates shaved 7% in value from the most boring bond flavor money can buy, a 10-year Treasury bond.

In contrast, high yield corporate bonds are the "Everything But the Kitchen Sink" flavor of bonds because many more factors influence their prices, not just interest rates. In fact, research has indicated a positive relationship between the prices of high yield bonds and inflation. Translation: rising interest rates equal rising high yield bond prices.

Conclusion

Rather than make predictions, we look to what market indicators are telling us. Right now, metrics are pricing in a sustained period of inflation. Making this the highest probability scenario, the best bets for bonds are to own high yield corporate bonds, but not to own government bonds.