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IDEA

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US Rates Strategy | North America

Oil and Inflation Markets III

Higher energy and commodity prices raise the risk of prolonged above-target inflation as the conflict crosses the 6-month mark. 1-year core CPI fixings and 1y1y CPI swap forwards remain above 2.5% and are a better gauge for inflation expectations. We construct CPI swap curve to calculate rolldown.

Key Takeaways

- Brent above $100/bbl and commodities at 10-year highs raise the risk of prolonged above-target inflation as the conflict passes the six-month mark.
- The shock is front-end: 1y core CPI fixings and 1y1y CPI swap forwards hold above 2.5%, while price hikes keep 10y breakevens range-bound.
- Seasonality cancels at annual tenors and shows up only in the points between. We build the CPI swap curve monthly out to 30 years in NSA index space.
- CPI swap rolldown spikes with gasoline shocks, separating mechanics from genuine expectations. We prefer near-term pricing off 1y1y, 2y1y and 1y core fixings.
- We enter long 1y1y vs short 5y5y CPI swap forward based on our PCA-based rich-cheap framework and upside risks to inflation. Stay neutral TIPS breakevens.

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Inflation Linked Bonds

United States | Commodities led higher inflation expectations

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Brent oil prices breached $100/bbl as the Middle East conflict stretches past six months. Energy prices continue to be the primary driver of the inflation complex. The price pressure extends beyond energy, with food and metals prices going higher too, taking the Bloomberg Commodity Index to its highest level in 10 years (Exhibit 1).

Looking at the recent trend, the August CPI print came in at 29bp, with the upside surprise driven by wireless category, which contributed 10bp. The underlying trend still looks benign: core goods is normalizing at a 0.9% 3m annualized rate, rents at 2.3%, and core CPI sits at 2.4% in level terms. That said, core CPI fixings point the other way over the next 12 months (Exhibit 2).

Central banks typically look through a short-term supply shock in oil, but if this one persists the impulse can become entrenched in market pricing of inflation. This is the 3rd publication to the series published before (here and here).

Exhibit 1: Commodity prices moving higher

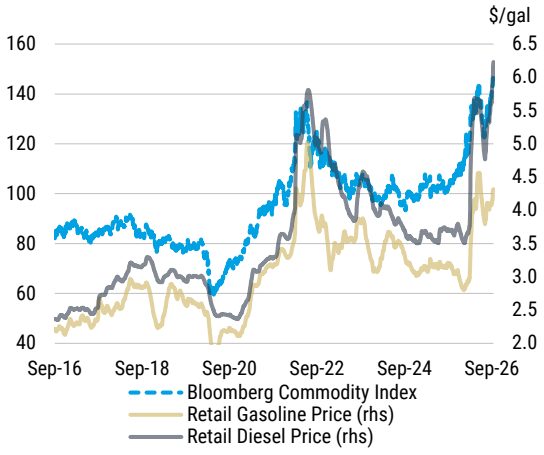
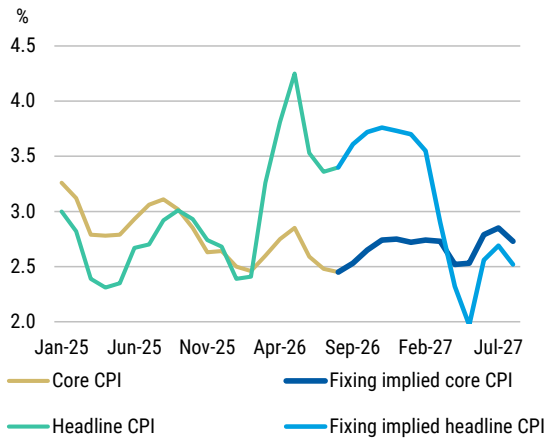


Exhibit 2: Core CPI fixings after removing the contribution of food and energy



For inflation markets, we usually focus on gasoline prices as this flows directly into the CPI basket, but rising diesel prices also pose an additional risk. Gasoline has an immediate and visible impact on inflation because households purchase it directly and it carries a relatively large weight in the CPI basket. Diesel, by contrast, has only a small direct presence in consumer inflation data because most of it is used commercially.

However, diesel can have a broad indirect inflation effect by raising transport, farming, construction and distribution costs. If sustained, these increases may be passed on through higher food, goods and transport-service prices. Elevated metal prices can similarly feed into core inflation by increasing manufacturing and construction input costs.

Core CPI fixing estimates 12 months out are a function of current inflation trends in the market and the market's expectation of future trends. Stripping the contribution of gasoline and food futures out of the headline fixings, the implied core path stays above 2.5% over the next 12 months (Exhibit 2).

Focusing on the gasoline component alone, the construction of which we described in Oil and Inflation Markets II, the gasoline contribution moves with two inputs: realized gas station prices for past months, and gasoline futures for forward months. We observe that headline CPI fixings ex-gasoline do not show a declining trend over the next 12 months.

Near-term inflation expectations have become correlated with retail gas station prices, which we can gauge through 1y1y and 2y1y CPI swap forwards (Exhibit 4). If the conflict continues for longer, that pricing can remain elevated.

Exhibit 3: Monthly realized CPI and fixings estimates | Gasoline contribution

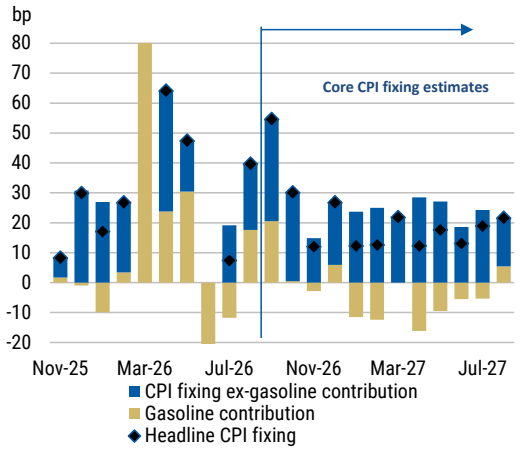
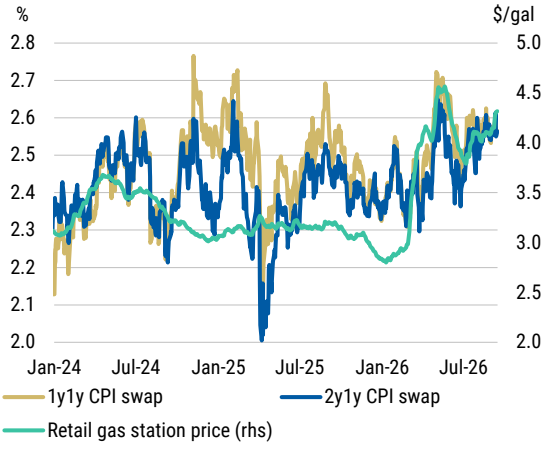


Exhibit 4: 1y1y and 2y1y CPI swap forwards tracking move in gas prices



Earlier we talked about 1-year CPI swap appearing low because of base effects from gasoline prices. In the below section, we show it via CPI swap curve.



Shocks & seasonality | CPI swap curve

In Oil and Inflation Markets, we showed how a gasoline shock in 1-year inflation swap mechanically traverses to tenors further out the curve by looking at annual tenors of the curve. To better visualize why the 1y CPI swap has swung so much, moving from 3.5% in May to 1.8% in August and 2.6% now, we start with the CPI swap curve at monthly tenors.

Constructing CPI swap curve

Before we get into construction of CPI swap curve, it is interesting to note that gasoline prices are the biggest contributor to seasonality in the CPI basket. This is because refiners move to a more expensive summer blend ahead of the June driving season and back to winter grade in September, so pump prices rise into early summer and fall into the autumn.

Ideally, there is no display of seasonality at the annual tenors as it gets cancelled out and it only moves in the points in between. We build the curve at monthly intervals from one month to 30 years. To construct the whole curve, we use CPI fixings for next 12 months and traded annual tenor CPI swaps further out (Exhibit 5).

CPI fixings give us the near-term monthly path for the index. Longer-dated swap rates anchor the curve further out, allowing us to fill in the monthly maturities between the usual annual points. Beyond the last quoted fixing, we draw a smooth path from one anchor to the next, then lay twelve seasonal multipliers over it, one per calendar month.

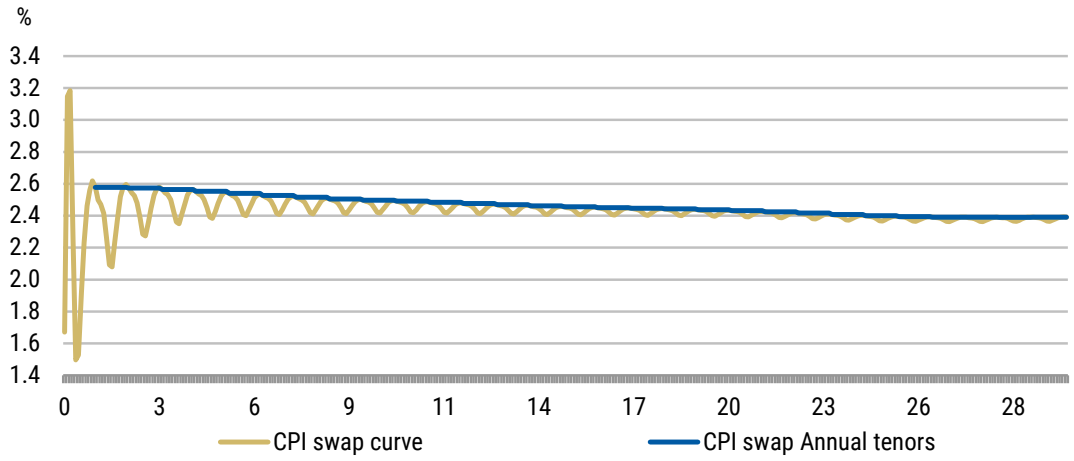
We do all this calculation in the monthly NSA index space. From this NSA index, we can easily calculate forwards or any rate from it.

CPI swap forward (month a to month b) = [(Index at month b) / (Index at month a)] ^ [12 /(b-a)] -1

p month rolldown for any tenor t = rate(p month fwd for tenor t) - rate(t)

Any point on this curve represents the annualized rate priced in for a CPI swap at that maturity. So, loosely speaking, a 10y CPI swap at 2.5% denotes the inflation expectation for that tenor, with no seasonal adjustment required. A 2% rate at the 18-month tenor, by contrast, contains seasonal drag from June to December (keeping the indexation lag in mind) and therefore appears low.

Exhibit 5: CPI swap curve



Coming back to the swings in the 1y CPI swap: because it is the ratio between the inflation index in two months, the shape of the gasoline curve can push it higher or lower. Depending on where the gasoline shock sits on the curve, the 1y CPI swap can move mechanically up or down. Exhibit 3 shows how a backwardated energy curve can cause payback of the rise in gasoline in future months.

At any point in time we can calculate the estimated move in the CPI swap that comes from the gasoline shock, and this is where the CPI swap curve comes into play. We freeze the curve, calculate the 3m forward for the 1y CPI swap, and subtract the spot 1y CPI swap from it. This metric is the 3-month rolldown for the 1y CPI swap.

In Exhibit 6 , the 3m1y CPI swap and the 1y CPI swap diverge by 120bp at the end of March. The 1y CPI swap would therefore go from 3.2% in March 2026 to 2% by the end of June if nothing else changes. This exact rolldown number will not realize as gasoline prices move, but it still helps us isolate the move in the 1y CPI swap that comes from a rise in actual inflation expectations from the part that is the rolldown effect.

In Exhibit 7 we plot the 3m rolldown of the 1y CPI swap against the move in gasoline prices. The spike in the 3-month rolldown coinciding with the shock in gasoline prices shows the role gasoline shocks play in the movement of the 1y CPI swap over the following months. 1y1y and 2y1y forwards are a better measure for gauging near-term inflation expectations as the gasoline shock has already rolled through. 1-year core CPI fixings are also a good measure as it removes the effect of food and energy.

Exhibit 6: 1y CPI swap and its 1m and 3m forwards

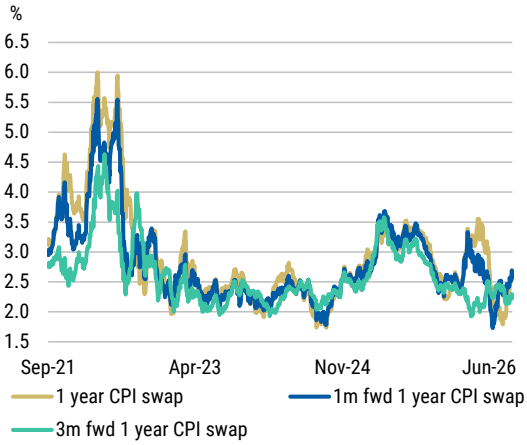
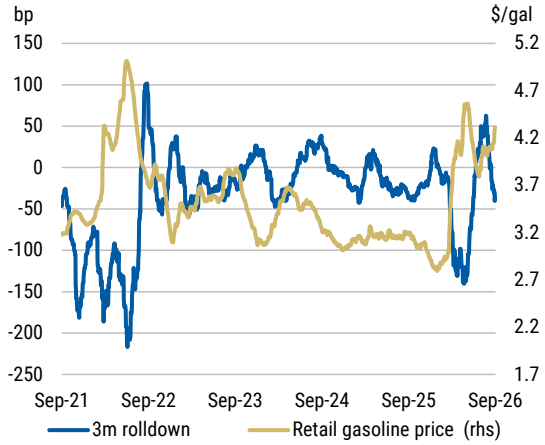


Exhibit 7: 3m rolldown along with retail gas station price shock



TIPS Breakevens

Inflation is on a decelerating trend, but the rise in commodity prices has left fed funds futures pricing in more than three hikes over the next three years for the US. The longer the conflict lasts, the risk of second-round effects of inflation increases.

As this commodity shock is global in nature, it has pushed market pricing of policy rate higher across other regions too (Exhibit 8). The move higher in the Fed funds peak rate has pushed 10-year real yields to multi-year highs. Ten-year breakeven has moved higher from its lows but overall it remains range-bound as the market pricing of hikes keeps long-term inflation expectations contained (Exhibit 9)

As our economists note in September FOMC Preview: Sticky Inflation Forces Rate Hikes, the Fed is expected to hike by 25bp in the upcoming meeting. The move in breakevens and real yields will depend on how high the Fed is willing to hike versus market expectations.

Exhibit 8: Global markets pricing in hikes because of the commodity shock

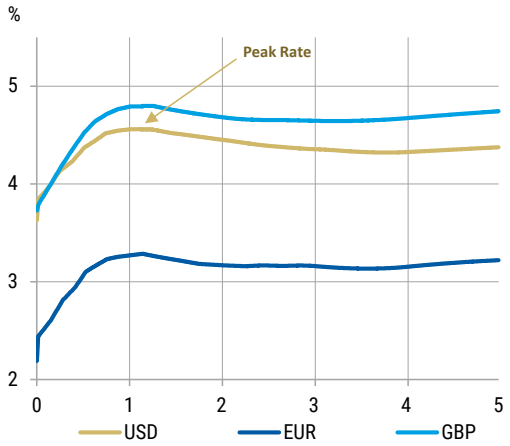
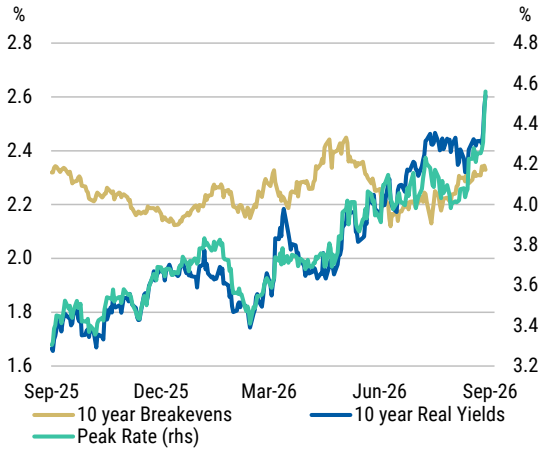


Exhibit 9: 10-year real yields move with peak rate



The playbook for inflation markets in the current environment is primarily a function of commodity prices. The reaction function of the Fed is also a factor. Keeping that in mind, we remain neutral outright TIPS breakevens and suggest investors stay positioned via relative value trades.

Rich cheap screener

Exhibit 10: PCA-based rich cheap on liquid CPI swap forwards

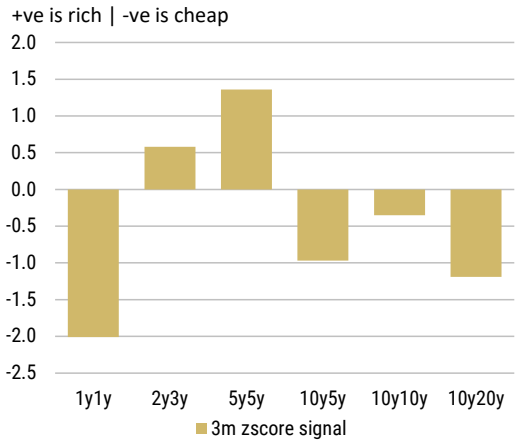


Exhibit 11: Spline-based Rich Cheap TIPS

Signal	TIPS	3m z-score
CHEAP	2.125% Apr-29	3.8
CHEAP	3.875% Apr-29	3.7
CHEAP	0.875% Jan-29	3.4
CHEAP	2.5% Jan-29	3.4
CHEAP	2.375% Oct-28	2.7
RICH	1.375% Jul-33	-3.2
RICH	1.75% Jan-34	-3.1
RICH	0.375% Jul-27	-3.0
RICH	0.625% Jul-32	-3.0
RICH	1.875% Jul-34	-3.0

We enter long 1y1y CPI swap versus short 5y5y CPI swap based on our PCA based z-score model. The trade performs if risks to near-term inflation increase and 1y1y CPI swap moves higher. The channel can be pass-through of higher commodity prices into inflation expectations. A mild hawkish Fed scenario is also beneficial for the trade as 5y5y CPI swap moves lower. The risks to this trade is a more-than-expected hawkish Fed policy or a rapid decline in commodity prices.

- **Trade idea: Enter long 1y1y vs short 5y5y CPI swap forward at 11bp with a target of 25bp and stop of 0bp**

Valuation Methodology and Risk

Inflation-Linked Bonds				
TRADE	**ENTRY LEVEL**	**ENTRY DATE**	**RATIONALE**	**RISKS**
Long 1y1y vs short 5y5y CPI swap forward	11bp	9/15/2026	This pair appears attractive based on our fair value model. A pass-through of higher commodity prices into inflation expectations and a mildly hawkish Fed benefits the trade	The risks to this trade is a more-than-expected hawkish Fed policy or a rapid decline in commodity prices

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