

ECONOMIC PERSPECTIVES

Government Bond Yields and Inflation Expectations

Victor A. Canto, PhD | September 14, 2026

KEY TAKEAWAYS

- **Market yields reveal inflation expectations.** Comparing nominal Treasury yields with inflation-protected yields provides a market-based estimate of expected inflation across different horizons.
- **Short horizons react more to temporary inflation shocks.** A one-year change in expected inflation carries a much larger weight in a 5-year average than in a 20-year average.
- **The term structure adds information.** Comparing 5-year and 20-year inflation expectations helps indicate whether markets expect inflation to rise, fall or remain stable beyond the first five years.
- **Forward measures point back toward 2%.** Our forward inflation calculations suggest a gradual return toward the Fed's 2% target, with the 10-year forward measure eventually moving below it.

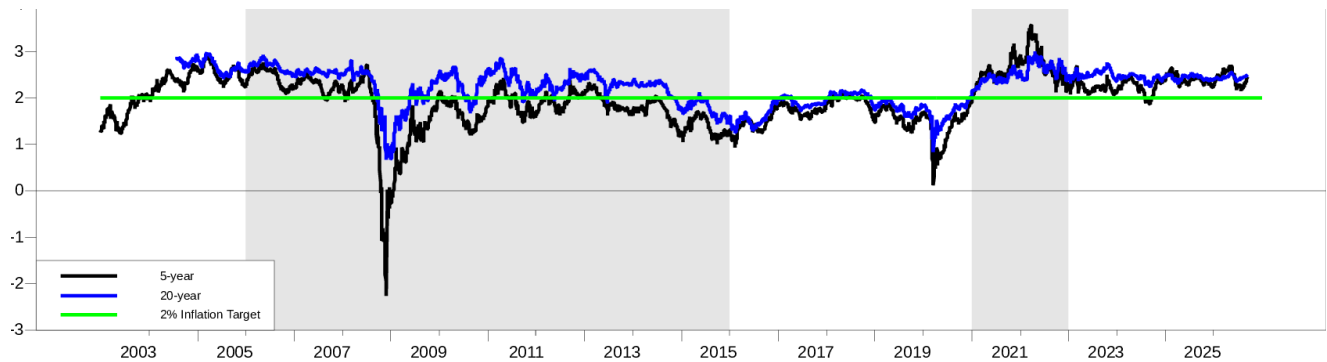
In a forward-looking efficient bond market, the equilibrium, or market-clearing, yield of different maturities reflects participants' yield expectations across different horizons. For example, the 4.75% yield of the constant-maturity 5-year government bond means that investors expect an average return of 4.75% over the next 5 years. Similarly, the 4.95% yield of the constant-maturity 10-year bond means that investors expect an average return of 4.95% over the next 10 years. Because the 10-year horizon includes the 5-year horizon, knowledge of these two yields also gives us an estimate of the expected yield on 5-year constant-maturity bonds 5 years from now.

The market also provides readily available yield information for a variety of constant-maturity inflation-protected government bonds. The Fisher equation provides an important insight that allows us to estimate the market's expected average inflation over different horizons. We simply subtract the expected real yield on inflation-protected government bonds from the nominal yield on traditional government bonds.

Inflation Expectations for a Variety of Horizons

The Federal Reserve Bank of St. Louis economic database, FRED, provides historical yields for government securities of different varieties. FRED also provides several inflation-protected bond series of different maturities. The latter reflect expected real yields over their terms to maturity. Including constant-maturity inflation-protected bonds in the analysis allows us to estimate market-expected inflation over the different horizons represented by these securities. To do so, all we need is yield information on nominal and inflation-protected, or real, securities of identical maturities. Daily data on the nominal and real yields of 5-year, 10-year and 20-year securities are readily available on FRED. Estimates of the market's average expected inflation looking ahead 5 and 20 years can be seen in Figure 1.

Figure 1 — Expected Inflation Rate: 5-Year and 20-Year Horizons



Source: La Jolla Economics

Some Housekeeping

Before we interpret the data, it is important to highlight the impact of a one-year change in expected inflation on the 5-year and 20-year expected inflation averages. Expected inflation in any one year has a 20% weight in the 5-year average expected inflation rate, i.e., $1/5$. In turn, that same year has a 5% impact on the average expected inflation rate over the next 20 years, i.e., $1/20$. For example, if inflation increases to 10% from 2% in year 1 and returns to 2% for the remainder, the average inflation rate for the first 5 years increases to 3.6%, while the 20-year average increases to only 2.4%. This numerical example provides a simple explanation for why abrupt temporary changes in year-over-year expected inflation have a much smaller impact on expected inflation over 20 years than on the average expected inflation over a 5-year horizon.

Notice that, as expected, the longer horizon declines by less than the shorter horizon during the Financial Crisis and pandemic declines. One explanation is that, during the two episodes, a flight to quality was caused by excess demand for money and a temporary decline in the expected inflation rate. The data also show that during the surge in inflation in 2022, the average expected inflation rate for the longer horizon increased by less than the shorter horizon. This is consistent with our earlier example showing that a one-year change in expected inflation leads to a larger change in the average inflation rate for the shorter horizon, i.e., the 5-year average, than for the longer horizon, i.e., the 20-year average.

More Housekeeping

The 20-year expected average inflation rate can be thought of as a combination of the 5-year expected average inflation rate plus the expected 15-year average inflation rate beginning 5 years from now. Technically, the 20-year average can be expressed as a weighted average of the first 5-year average expected inflation rate and the average inflation rate for the subsequent 15 years. The first 5 years receive a one-fourth, or 25%, weight, i.e., $5/20$, and the remaining 15-year average receives a 75% weight, or $15/20$. The math shows that whenever the 20-year expectation falls below the 5-year expectation, it is because the average inflation rate during the final 15 years is lower than the average during the first 5 years. Hence, by comparing the two averages, we can infer whether market participants expect the average inflation rate to rise, fall or remain the same over the longer term, i.e., beyond the first 5 years.

Looking at the data in Figure 1, it is apparent that from approximately 2006 to 2014, the 20-year expected inflation rate exceeded the rate for the first 5 years of the period. Ironically, this period coincides with Mr. Bernanke's chairmanship. Coincidence? One possible interpretation is that Mr. Bernanke took the Fed away from the Volcker price rule that served the U.S. so well during the previous four decades. The fact that the 20-year average expected inflation rate exceeded the 5-year average suggests that the market did not expect the then-current operating procedures to last for a long time.

Presumably, during the period reported in Figure 1, the Fed had a 2% inflation target. This provides us with a measure of the success or effectiveness of monetary policy under different Fed chairs. The ideal monetary policy would minimize,

and hopefully eliminate, any deviation from the 2% target. Notice that during the Bernanke years the expected inflation rate trended down and fell below the 2% inflation target. While the inflation rate was low, if the evaluation criterion is that deviations from the target are undesirable, the Bernanke policy missed its target.

From 2016 to the pandemic, expected inflation over the 5-year and 20-year horizons converged. One simple interpretation is that the Yellen Fed implemented its QT policy and moved the Fed toward the Volcker price rule. Notice also that during the Yellen years inflation expectations rose and approached the 2% target range, where they remained until Jay Powell took over the helm. The flight to quality during the pandemic led to a decline in expected inflation. In response to the crisis, Mr. Powell dusted off the Bernanke playbook. The Fed expanded its balance sheet and accommodated the spending blowout by buying government securities and thus expanding the monetary base.

Unable or unwilling to control the monetary base, the quantity of money circulating in the economy expanded, and the excess money supply fueled a rise in the U.S. inflation rate. We will never know whether the Powell Fed was derailed by the pandemic or whether Powell modified the operating procedures and effectively abandoned the 2% inflation target. Recently, however, the Fed has rediscovered its 2% inflation objective. The convergence of the expected 5-year and 20-year inflation rates seems to validate this interpretation of a steady inflation rate converging toward the Fed's target.

One Final Housekeeping Item

The existence of fixed-income instruments of different maturities, with and without inflation protection, allows us to construct what we call the forward expected inflation rate. The math for average inflation over two different holding periods, or investor horizons, is very simple. A 10-year average inflation rate can be expressed as a weighted average of two 5-year periods: one starting today and the other starting 5 years from today. We can calculate, as of today, what the market expects the average 5-year inflation rate to be 5 years from now. For example, the current 10-year yield stands at 4.95% versus a 4.75% 5-year yield, numbers that point to an increase in expected rates 5 years from now.

But we can say more than that. To estimate the 5-year forward nominal yield 5 years from now, all we need to do is multiply the current 10-year yield by 2 and subtract the current 5-year yield. This calculation puts the 5-year forward average expected nominal yield at 5.15%, 5 years from now. We can also calculate the corresponding inflation-protected forward yield as well as the forward expected average inflation rate.

Figure 2 shows the average expected inflation rate embodied in the difference between the 5-year government bond yield and the 5-year inflation-protected government bond yield. We also calculate the 5-year forward average expected inflation rate 5 years ahead; see the shaded area. Notice that the two series overlap, suggesting that there is no statistical difference between them. The data show a slight, gentle and slow decline toward the 2% target in the forward average inflation rate.

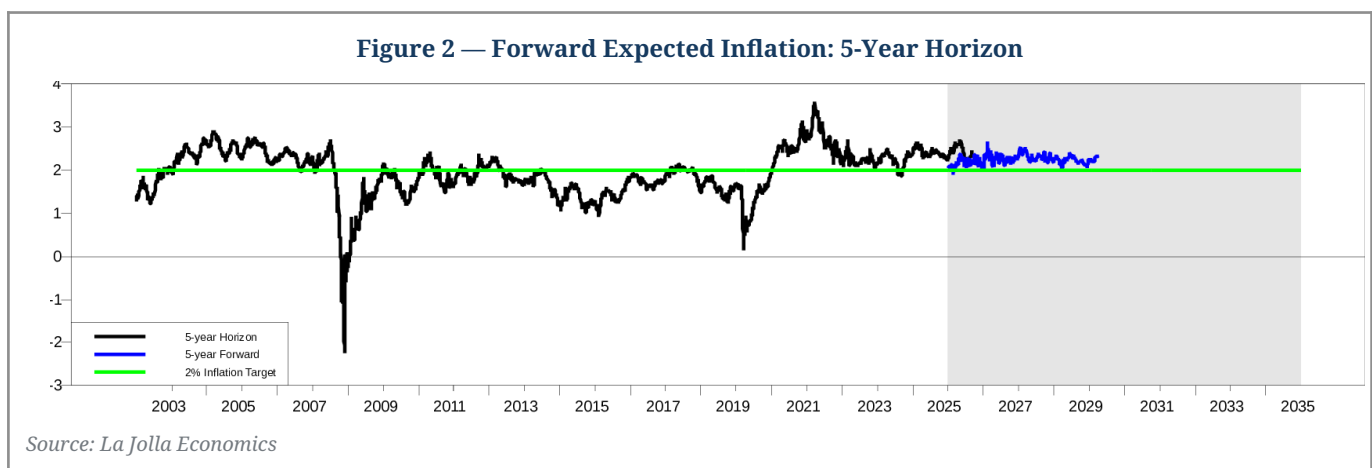
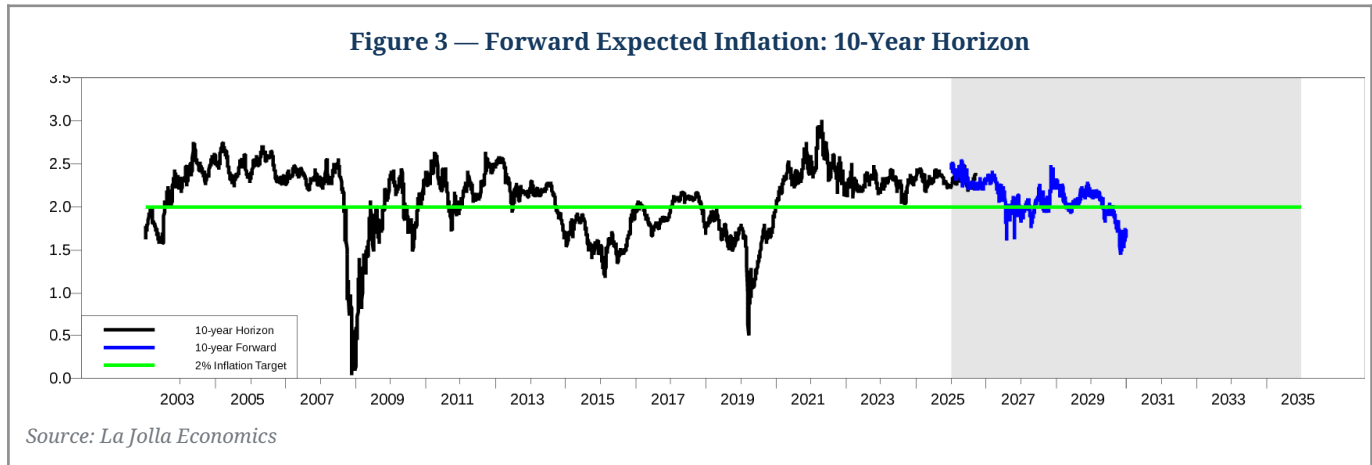


Figure 3 plots 10-year expected inflation, calculated by subtracting the inflation-protected 10-year bond yield from the regular 10-year bond yield. We also calculate the 10-year forward rate, i.e., the expected 10-year average inflation rate 10

years from now. The two series fit quite well and show that the forward rate expects inflation to decline and fall below the 2% target. Jointly, the data presented here point to a possible return to the 2% inflation target and an abandonment of the policies implemented by the Bernanke and Powell Feds.



Conclusion

Treasury markets provide more than a snapshot of current nominal interest rates. By comparing nominal and inflation-protected securities across maturities, we can infer the market's expected average inflation over different horizons and construct forward measures of inflation expectations.

The distinction between short and long horizons is important. Temporary inflation shocks have a much larger effect on the 5-year average than on the 20-year average, while the relationship between the two series can indicate whether investors expect inflation to rise or fall beyond the first five years.

The forward measures presented here suggest that inflation expectations are gradually moving back toward the Federal Reserve's 2% objective. In our interpretation, the convergence of 5-year and 20-year expectations and the decline in longer forward measures are consistent with a return to a steadier inflation regime centered on the Fed's stated target.

ABOUT THE AUTHOR



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Victor A. Canto is the founder of La Jolla Economics and a former CIO and Lazard adviser. A long-time professor and policy adviser, Victor holds a Ph.D. from the University of Chicago and brings deep macroeconomic expertise to Timber Point Capital Management's investment process.

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