

**Title:** DEFLATION RISK  
**Speaker:** Francis Longstaff, UCLA

**Importance:** Why this matters:

The worst economic episodes in US history have been accompanied by deflation. As a result, knowing the risk of future deflations is crucial to asset allocation decisions. In addition, asset prices must incorporate the expected probability of future bouts of deflation. As a result, understanding the probability of future deflationary episodes is important to setting asset prices.

**Investigation:** "Speaker analyzed XXX data to address the questions yyy, zzz, etc."

Longstaff used inflation swaps to infer the probability distribution of future levels of inflation. With those data, he was able to focus on the deflation tail of the distribution. He used inflation swaptions to infer risk-neutral probabilities. Using the difference between the two sets of probabilities, he was able to provide an estimate of the risk premium for bearing market (deflation) risk.

**Innovation:** Are there new techniques of interest in the data or approach to the problem?

The approach of deriving the probability distribution from the inflation swaps markets seems to provide better estimates of expected inflation than survey data or breakeven spreads (yield of nominal Treasuries minus the real yield of TIPS). In addition, the swaps market provides insights into the entire term distribution, while survey data and the breakeven spread only provide an estimate of the mean.

**Insights:** 1-2-3, what are the three most important things the speaker offered?

1. Currently, the risk premium for bearing inflation risk is close to zero, however the deflation tail risk is priced similarly to other types of tail risk.
2. The current forecast of deflation risk is material.

**Audience rating:** 4.48