

MACROCOSM

Grand Illusion

Monday, September 12, 2005

David Gitlitz

Bonds are captured by "money illusion" -- but the Fed is unlikely to play along.

Consistent with mounting evidence that the **economy** will overcome the **Gulf Coast** dislocations without suffering lingering damage, the irrational exuberance of the post-Katrina environment has come out of **fixed income markets** the past several sessions. **Credit market** participants who couldn't bid up prices fast enough amid alarmist proclamations that the disaster might put **the Fed** out of the **rate-hiking** business for good have been forced to pare their bets. But at current **yields**, long-dated issues -- with the **10-year Treasury** still hovering below 4.2% - - remain badly out of whack with what we see as the likely extent of the Fed's **rate normalization** cycle. We see nothing at this point that would incline the central bank toward any divergence from its "**measured**" course, moving the **funds rate** up by 25 basis points per meeting. On that schedule, the overnight rate target reaches 4.25% by year-end, and most likely 4.5% early next year.

That, however, outlines only the first level of vulnerability for **bonds** at these yields, which include virtually no premium for the **inflationary risks** engendered by policy staying so **easy** for so long. The rising intensity of those risks has been underscored by the price of **gold** continuing to rally in the post-Katrina expectations environment. At just below \$450, **dollar gold** is back at levels last seen late last year, prior to key Fed officials finally signaling their awareness of inflation reality. That's also some 35% above its 10-year moving average, a gap that statistical tests indicate has historically presaged a sharp inflation uptick (see "[Inflation: Disagreement Among Friends](#)" April 26, 2005). Rising gold also signals that even as the funds rate anticipated in **interest rate futures markets** has rebounded off its lows, the expected rate at which this policy cycle is now expected to conclude -- with funds no higher than 4% -- would still sit below **equilibrium** and continue to feed a dollar-cheapening **liquidity surplus**.

Attempts to explain the staying power of these exceptionally low yields in the face of such apparently daunting risks has challenged the imagination of analysts of all stripes. Given the extreme sensitivity of bonds to any sign of inflation over the past generation, the argument that these yields are themselves a manifestation of a quiescent inflation environment is at first blush difficult to dismiss out of hand. It was not so very long ago, after all, that the "**bond market vigilantes**" ruled the fixed-income roost, pushing yields up on the slightest provocation that data could be construed as hinting at **price pressure**, keeping inflation **risk premia** at elevated levels.

It's worth noting, though, that historically bonds have by no means an unblemished record of providing early warning of inflation trouble ahead. During the double-digit inflation episodes of the 1970s, for example, long-term bonds lagged well behind the price level breakout. And for those convinced that the **flattening yield curve** is *prima facie* evidence of non-existent inflation risk, consider that the **10-2 curve** went from a relatively **steep** 150 basis points to an **inversion**

of more than 200 basis points from late 1976 to early 1980. **CPI** surged from less than 5% to nearly 15% over that period.

In the disastrous blowback -- 10-year Treasury yields topped out at nearly 16% in 1981 -- the bond market took **The Who's** 1970s mantra "we won't get fooled again" as its motto, and kept yields an average of more than 400 basis points above inflation during most of the next 20 years. But while it took the market many years to overcome its inflation fear, the belief that higher inflation is now all but impossible has conquered the market over the past few years. For example, the **10-year TIPS spread** -- measuring the difference between the **nominal Treasury yields** and its **CPI-indexed** counterpart -- is now about 250 basis points. That's less than the current year-on-year CPI rate of 3.2%, and the six-month annualized rate of 4%. The bond market is betting that inflation will decline significantly from current levels.

It's instructive, as well, to observe that the 10-year TIPS "**real**" **yield**, now trading just above 1.6%, first went below 3% in mid-2002. That's when the market's earlier fears of Fed **tightening** were replaced by expectations of further rate cuts (the funds rate target was then at 1.75%), expectations that were soon reinforced by the Fed's first musings about the risk of **deflation**. Our analysis then was that the Fed had already overcome its deflation error, as seen in the dollar's easing against sensitive **commodities** and **foreign exchange**. We began warning at about that time that Fed efforts to root out nonexistent deflationary pressures entailed significant inflation risk (see "[A Deflation Dichotomy](#)" November 18, 2002). Indeed, the maintenance of such a low real TIPS yield can be seen as one measure of the extent to which monetary policy remains easy. It is not at all out of line with the **real funds rate**, which is currently running at around 1.5%, using the **PCE core deflator**. The long-term average real funds rate by that measure is about 2.5%.

If the persistence of such low real yields is part and parcel of the Fed's continued **accommodative** policy stance, the intriguing remaining question is why the inflation premium in nominal yields remains so low. We find compelling as an explanation a concept that has a distinguished lineage in economic history -- "**money illusion**." The term has long been associated with **Keynes' General Theory**, published in the 1930s, but it was actually first coined by the great **Yale** economist **Irving Fisher** in the late 1920s. In his 1930 masterwork **The Theory of Interest**, Fisher described the confusion between nominal and real values that can arise as a result of policy manipulation. He recounted several occasions when yields failed to account for changing conditions during inflationary environments, and suggested that "men are unable or unwilling to adjust at all accurately and promptly the money interest rate." Fisher observed that this "erratic behavior" of interest "is evidently a trick played on the money market by the 'money illusion' when contracts are made in unstable money." Eventually, yields rise to account for the higher price level, but Fisher found no support for the reverse proposition: that interest rates can be counted on to anticipate price change.

Bottom Line: Translating Fisher's insights into present-day experience, bonds appear mispriced for the inflation risk environment as a consequence of embracing policy-induced below-equilibrium real rates. Credit markets are now adjusting yields higher again after another episode of making overreaching bets undergirded by improbable assumptions. At current yields, bond holders remain badly exposed to the likely consequences of the policy setting they have so enthusiastically capitalized on. **TM**