

FED SHADOW

Well Anchored?

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The Fed's statements about inflation expectations are not anchored to reality.

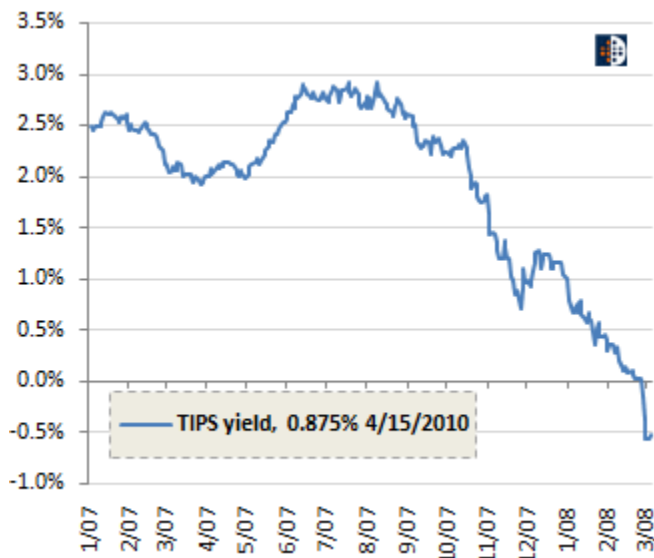
If the Fed is correct that inflation expectations remain "well anchored" even as it continues full bore in easy money mode, how does it explain recent action in the TIPS market, where the "real" yields on shorter maturities have sunk into negative territory? It's simple. Now that the market for inflation-indexed bonds is telling the Fed a story that it would prefer not to hear, the Fed can just tell itself that TIPS might not really reflect inflation expectations, despite the fact that Ben Bernanke and other Fed officials have routinely cited the "inflation compensation" inferred in TIPS yields as an inflation expectations indicator.

Update to strategic view

US MACRO: TIPS are problematic as inflation indicators, but negative yields and rising breakeven spreads generally concur with gold, oil, commodities and forex that inflation pressures are building. Rationales by Fed officials designed to deny this evidence from markets are doubly dangerous -- they mean the Fed is turning a blind eye to inflation risk, and the rationales' flimsiness diminishes the Fed's credibility. Given the Fed's stance, we believe inflation pressures will increase.

[\[see Investment Strategy Dashboard\]](#)

Yields on TIPS maturing in five years or less went negative late last week, after Bernanke's



congressional testimony made clear he has no plans to bring the current easing campaign to an early end. Futures promptly adjusted for the scope of expected additional funds rate cuts, pricing for a 100% probability of a 75 basis point move to 2.25% on March 18, and to 2% at the following meeting in late April. Movements in shorter-term TIPS closely correspond to the expected path of the real funds rate. The two-year issue is now yielding negative 0.51%, which indicates the market expects the Fed to sustain a negative funds rate at least until two years out (at current levels of headline CPI, the benchmark assumed in TIPS inflation compensation, the nominal 3% funds rate is negative 1.4% real.)

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The presence of negative yields on these inflation-indexed bonds necessarily implies that the market is willing to give up some nominal yield in the expectation that it will be more than made up by the inflation adjustment. At about 2.3% on the constant maturity five-year TIPS issue, the level of the inflation breakeven spread remains within recent ranges. However, the spread has widened out by about 40 bp since the Fed's "emergency" rate cut on January 22 brought increased focus to the inflationary implications of the Fed's current course.

But not to worry. At least not according to Fed Governor Frederic Mishkin, who has emerged as a leading institutional voice in this policy cycle (see ["Gold \\$1000, Here We Come"](#) February 28, 2008). "Inflation compensation measured by using TIPS yields is not the same thing as inflation expectations," he said in a speech this week. "Rather, movements in inflation compensation reflect not only changes in inflation expectations, but also changes in an inflation risk premium and in the relative liquidity of TIPS and similar maturity nominal Treasuries." In suggesting that rising TIPS spreads do not necessarily correspond to higher inflation expectations, Mishkin then went on to note that the spreads also rose substantially in 2003 and 2004, during what he said was a period of "heightened concerns about *deflation*." This, he said, "underscores the fact that we must be careful in using the forward rates of inflation compensation as a gauge of long-run inflation expectations."

In fact, those years were a period of deflation *obsession* for the Fed, in response to which they went into hyper-accommodative mode, cutting the funds rate to 1% by mid-2003. Over the following year, the 10-year breakeven spread bulged by more than 100 bp, as the market saw the Fed as flirting with inflationary overkill. Effectively, Mishkin is dismissing the effectiveness of TIPS as inflation expectations indicators for no better reason than because, in those years, expectations in the TIPS markets differed from the Fed's own expectations. As it turned out, the TIPS markets were right and the Fed was wrong -- CPI inflation has steadily risen since those years when the Fed was worried only about deflation, a fact that Mishkin surely knows. For Mishkin to seek to rationalize away this episode so disingenuously could be a telling -- and potentially troubling -- insight into the current thinking among senior policymakers.

Mishkin's motivation in downplaying the recent rise in inflation expectations is not difficult to figure out in the context of earlier remarks he made laying out the case for the Fed taking preemptive action in response to the financial market turmoil. Such preemptive action "would be counterproductive if these actions caused an increase in inflation expectations and the underlying rate of inflation," he said in January, prior to the Fed's sanctioning of 125 bp in cuts within eight days, which materially shifted expectations to a higher level. "The flexibility to act preemptively," he said, "presumes that inflation expectations are well anchored and unlikely to rise during a period of temporary monetary easing." It now appears that policymakers are going to considerable lengths to justify maintaining that presumption even in the face of growing evidence that expectations are becoming considerably less "well anchored." This is a serious matter, because as Mishkin himself said recently -- and quite correctly -- "the central bank needs to clearly indicate the rationale for its policy actions."

BOTTOM LINE: For our purposes, the TIPS market has considerably less utility as an inflation expectations indicator than asset prices such as gold, broader commodity indexes and foreign exchange, which are all in agreement that the Fed currently is in the midst of a substantial inflationary overshoot. Not unlike their nominal counterparts, for the most part TIPS have been loath to price in a potentially significant inflationary error in Fed policy. Even at more elevated levels, TIPS spreads remain well below current inflation rates. But when even such slow to respond market prices begin to show signs that trouble is potentially brewing, the wiser course of action is to pay due heed rather than attempt to explain it away. ▶