Fear Inflation Now

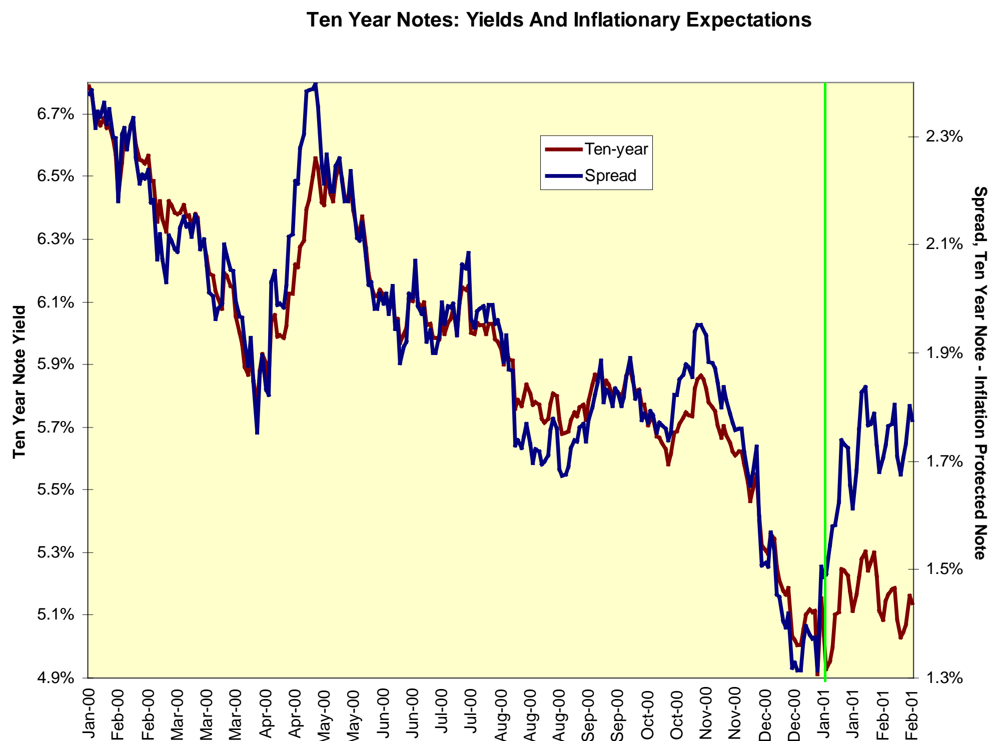
First-time visitors to Chicago's futures pits – and if you haven't stopped by, you'd better do so before they become a Disney World attraction on the order of Pirates of the Caribbean – may be struck how the locals refer to contracts as "cars," a holdover from when all commodities were transported by railroad. A carload of wheat is manageable, but a carload of Treasury bonds is truly a scary concept.

As if the bond traders' livelihoods weren't threatened enough by the inroads of electronic trading, the persistent and growing budgetary surplus prompted a Treasury advisory panel to end the one-year Treasury bill and recommend ending both the 30-year bond and the inflation-protected bonds (TIPs). The total return on TIPs is adjusted for changes in inflation as measured by the Consumer Price Index. TIPs never really caught on with the investing public during the generally disinflationary 1990's, so it is understandable how the Treasury may regard them as more trouble than they're worth. Of course, those gold-colored Sacagawea dollar coins are more trouble than they're worth, too, but don't hold your breath waiting for them to admit that clunker.

I'll miss the TIPs; they made it so easy for economists to measure inflationary expectations and infer other relationships. But the government never had much use for economists poking around the attic, anyway.

The Last Full Measure

Let's compare the yields on a single TIP, the 3.625% coupon due January 15, 2008, with an index yield of ten-year Treasuries as calculated by Bloomberg. This particular TIP is chosen as it most closely matches the maturity of the cheapest-to-deliver against the futures ten-year note, the 5.50% due February 15, 2008.



The expected inflation premium in the TIP mirrored the base level of ten-year yields closely during 2000, with notable exceptions during the March-April NASDAQ collapse and later during October-November NASDAQ re-collapses. In both cases, base yields were rising and inflationary expectations were rising more rapidly.

Inflation Is A Monetary Phenomenon

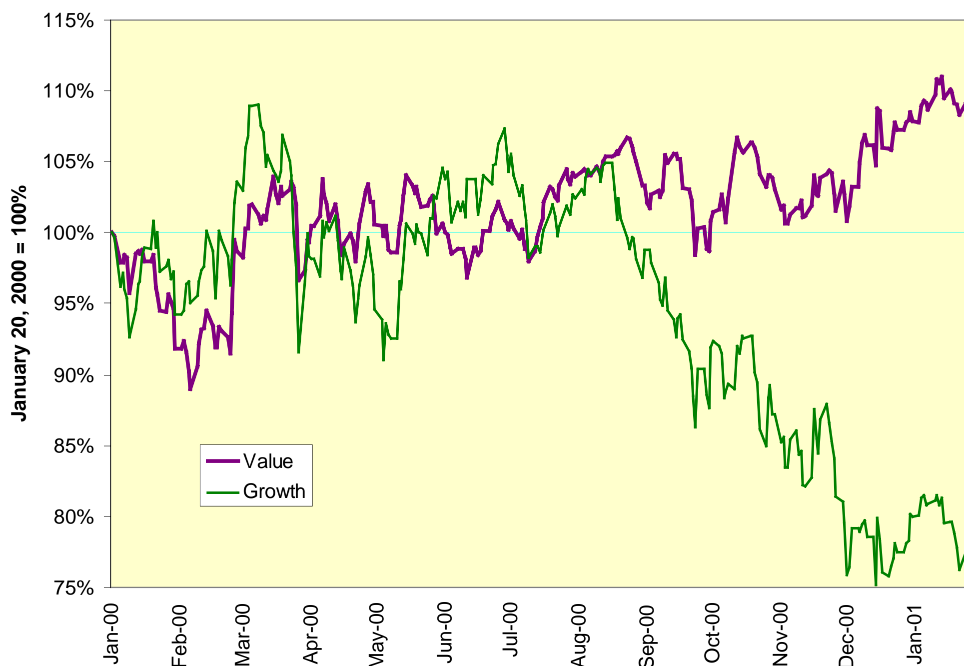
The Fed's two rate cuts in January 2001 were not a quick elixir for stock prices, as predicted here earlier (see "Counting On A Fed Rate Cut To Save The Market? Don't," December 8, 2000). Nor have they done much for

bonds: Since January 2, ten-year yields have risen from 4.913% to 5.200%, and thirty-year yields have risen from 5.341% to 5.504%. Why has the Fed's much-needed and long-overdue action been so ineffectual to-date?

The answer is simple and frustrating: Inflation is defined best as more money chasing goods and services. Unless the supply of goods and services increases apace, the very opposite of what occurs during an economic slowdown, the general price level must rise. To a great extent, this describes the stagflation of the 1970's in the U.S. The yawning gap between nominal and inflation-protected yields that has formed since the Fed's first rate cut is more than a warning light on the dashboard of the economy, to quote the President, it's a bomb going off in the basement.

Bonds have no greater enemy than inflation, so bond buyers must bid prices down at the first sign thereof. It was thought decades ago that stocks have some greater inflation protection, but this, too, was disproven during the 1970's. Not only is the real return on all productive capital diminished by inflation, the returns on growth stocks, issues whose payoff streams lie further in the future, are hurt the worst. Viewed in this light, the stock market's U-turn, especially for growth issues, after the second rate cut shouldn't be so surprising.

TIP A Canoe And Value, Too!
After a year like 2000, it's easy to conclude that bear markets are equal opportunity destroyers of portfolios, but that is manifestly untrue. Value shares, those low P/E unglamorous workhorses of the market, have outperformed the riskier growth stocks rather handily since mid-August of last year. This assertion can be measured by the S&P BARRA value and growth indices and predicted then in this space (see "Volatility: A Yogi For The Barra," August 15, 2000). The divergence in growth/value performance forecast then expanded into this year.



Since we're in the business of forecasting tomorrow, what will it take for the growth/value gap to close? First and foremost, the Fed has to signal that its primary job is maintaining price stability. Not jawboning the market down with inanities about irrational exuberance, not holding off on a rate cut during the fall of 2000 when credit quality spreads were widening out to crisis levels, not surprising the markets with rate cuts, and not pleasing the new administration with obsequious testimony. The bond market now fears monetary largesse could reignite inflation, so if the Fed keeps the NASDAQ on its quote screen all day, we'll all be hurt in the long run.

Second, let's remember what got us out of the 1970's stagflation, a cut in capital gains taxes in 1978, stable monetary policies, and reductions in marginal tax rates. This policy mix worked since it promoted risk-seeking behavior. Finally, we need to remember that we didn't get into this profit slowdown overnight, so let's not expect to get out of

it overnight, either. We've all been spoiled by the gains of recent years, but those weren't normal. The TIP message is clear: In trying to undo their previous depredations, the Fed has stepped on the gas too hard. The battle between value and growth is rather like the race between the tortoise and the hare; we all know who won this race, but who ever fantasizes about being the tortoise?