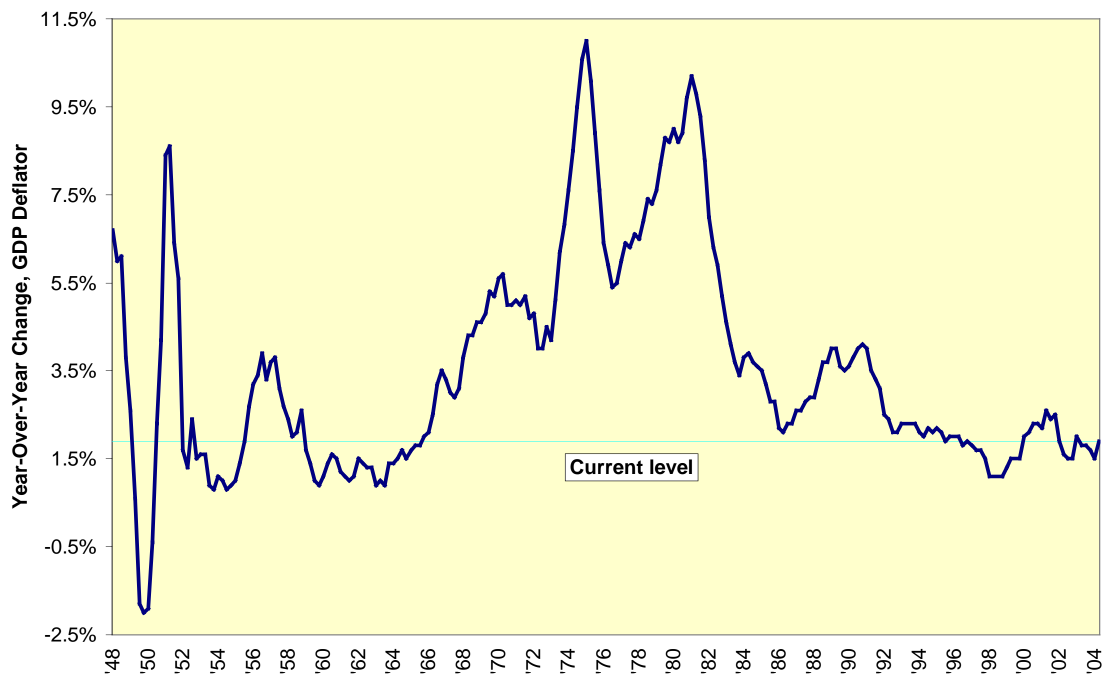
Is Inflation Missing In Action?

At a time when all and sundry proclaim they are reporting for duty, will inflation take the other route and try to sneak out the back door? This was not supposed to happen. Three years of fiscal and monetary stimulus intersecting a recovering economy, a weaker dollar, higher energy prices and resurgent demand for raw materials should have been propelling price indices higher by now.

We can argue, as some have, that we have inflation, just not in the form of higher prices for goods and services but in the form of higher asset prices, especially for real estate. And, there is a gnawing suspicion by many that the monthly reports on the consumer and producer price indices, Laspeyres indices that track price changes in a given market basket, are inaccurate or at least over-adjusted to reflect technological improvement. Few, myself included, feel that their cost of living has increased by as little as the CPI suggests.

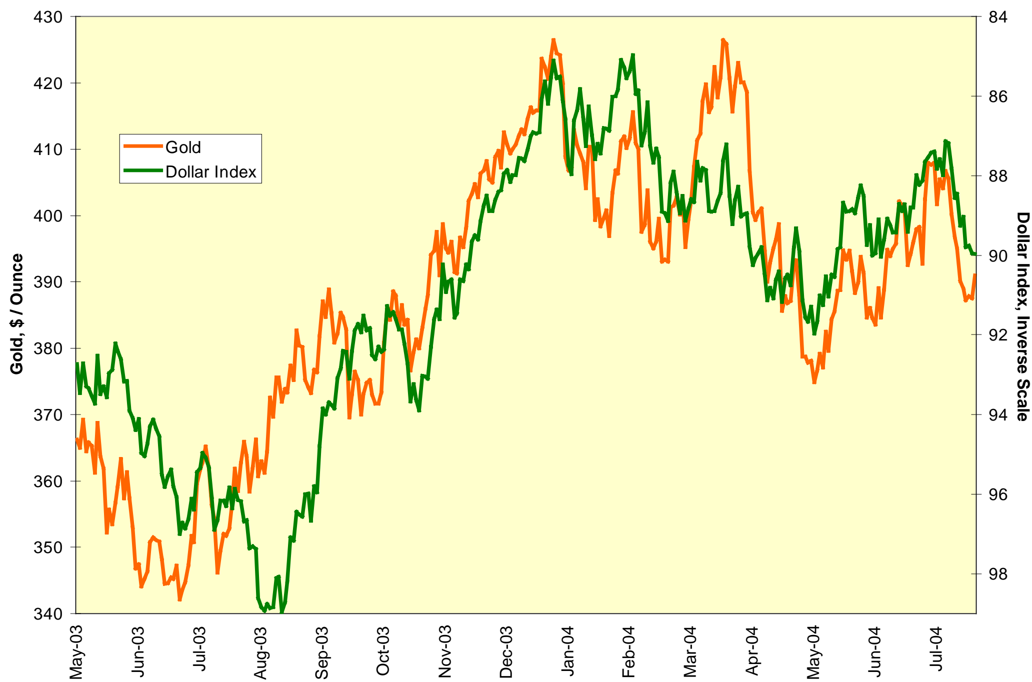
But the quarterly GDP deflator, a Paasche index that reflects changes in the underlying market basket purchased, is ratifying this conclusion. Indeed, the quarterly estimate of a 1.9% year-over-year change released last Friday is still on the low side by postwar standards. At some point we have to ask whether the government data are correct.



Gold And The Dollar

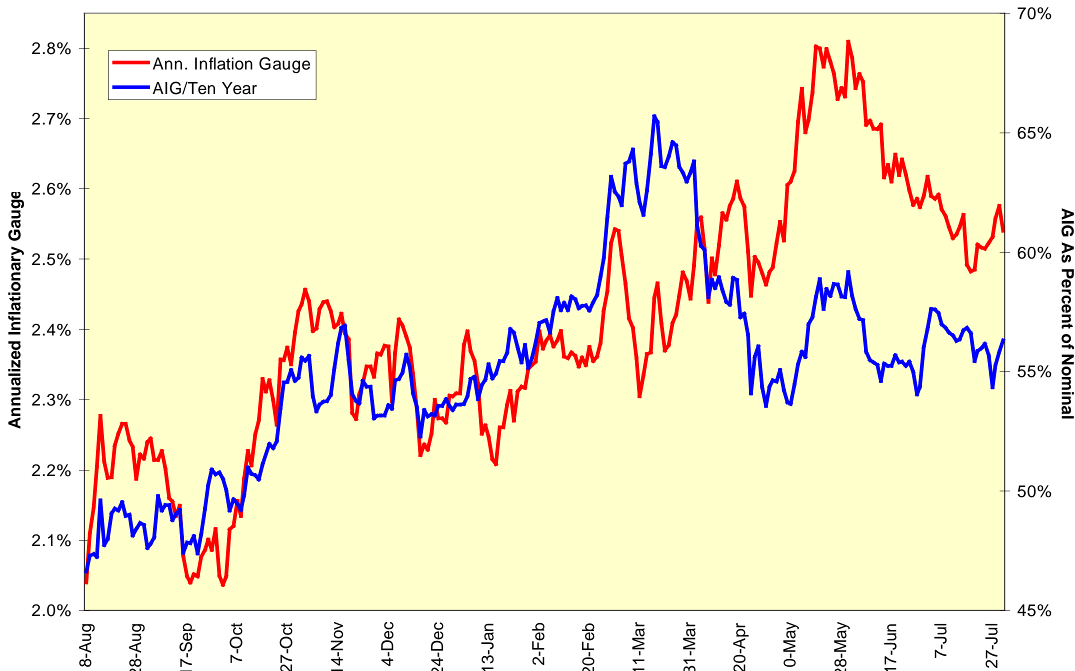
For those so mistrustful of any government data that they have bumper stickers reading "My other car is a black U.N. helicopter," several market-derived measures are confirming the low inflation story. The dollar, which many feared was headed toward perdition at the start of the year, has stabilized off its lows. Gold, whose price reflects both the relationship between expected inflation and its short-term interest rate cost of carry and the strength of the currency in which it is priced, has been struggling below its highs; this interplay and others were addressed in May 2003.

These two markets are telling a consistent story at present and that is one without acceleration in inflation. I might add, parenthetically, the silver chart is far more bullish than gold right now; silver is affected more by industrial demand and actual supply balances than is gold.



Bond Market Confirmation

The spread between TIPS and regular Treasury notes tells the same story. If we annualize this spread to address the lack of time dimension in the non-seasonally adjusted all-urban CPI upon which TIPS are based, we can derive an implied measure of annualized inflation expectations. This annualized inflation gauge, or AIG, has been in decline since the start of June.

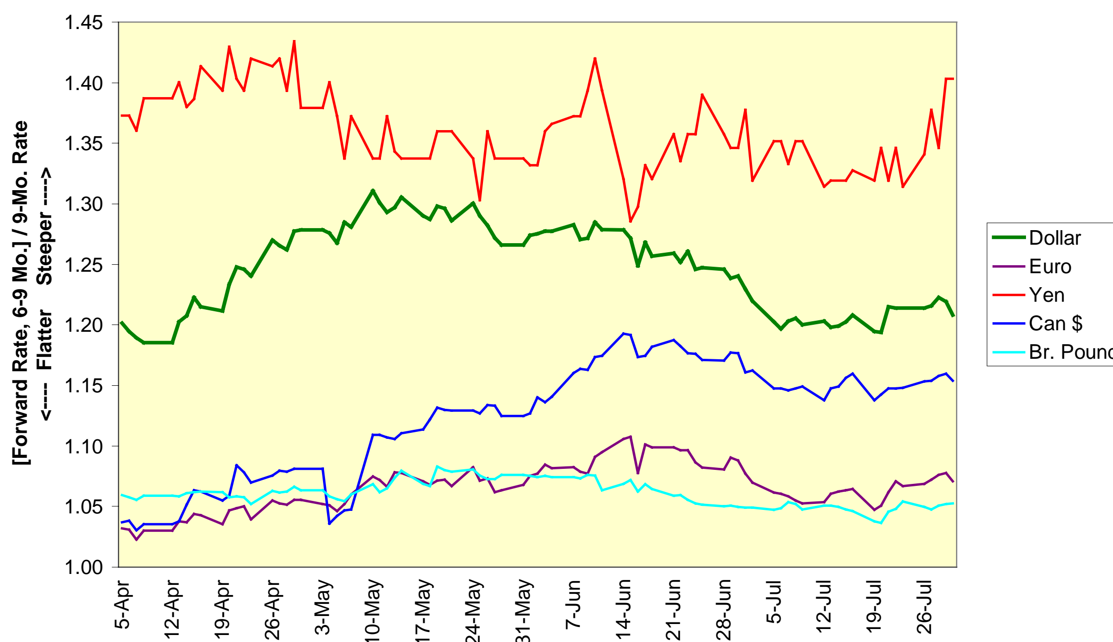


Flattening Curves

An equally critical point in the chart above occurs at the beginning of April, when the strong employment report for March led to a sea change in monetary policy expectations. The AIG plunged as a percentage of the ten-year note's yield itself, and after a second such drop in early May on other strong economic reports stabilized near current levels. The yield curve, which had been instructed by Federal Reserve officials to start pricing in rate increases at the short end, now found itself anchored at the long end by these declining inflationary expectations.

But, as noted here last week, the yield curve still has not flattened very much; the carry trade and all of its various stimulative benefits remains with us. If even the whiff of a flatter yield curve has been sufficient to slow down inflationary expectations, what will happen if and when short-term rates continue the rise to 2% in December embedded in the federal funds futures contract?

If we take the forward rate between six and nine months - the rate at which we can borrow for three months starting six months from now - for LIBOR in various currencies and compare it to the nine-month rate, we can compare the steepness of various yield curves.



For now, the dollar LIBOR curve is flattening faster than those of the euro, yen, British pound or Canadian dollar. A forward rate ratio over 1.00 indicates a positively sloped curve. The dollar ratio has been moving downward from early May onwards, while the curve for the yen has been rising and those for other major currencies have been flat.

As discussed here in June, the massive global tax increase created by higher crude oil prices has been exerting downward pressure on other prices in direct contravention to the experience of the 1970s. The inexorable push toward higher short-term rates in the U.S. is helping lower inflationary expectations as seen in the gold, currency and bond markets. The real risk, as expressed here recently, is that a successful war on rising inflationary expectations also may be a successful war on the economy as a whole.

Given the global nature of liquidity, what will happen if other central banks follow along this tightening course? This can be direct, via tighter credit policies, or indirect, via smaller official purchases of U.S. government debt. In either case, the impact will be negative and may actually produce the deflation talked about but never seen in 2003.

If you are out on patrol with your band of brothers looking for inflation, look behind you as well as in front of you. It may be a past tense phenomenon already.