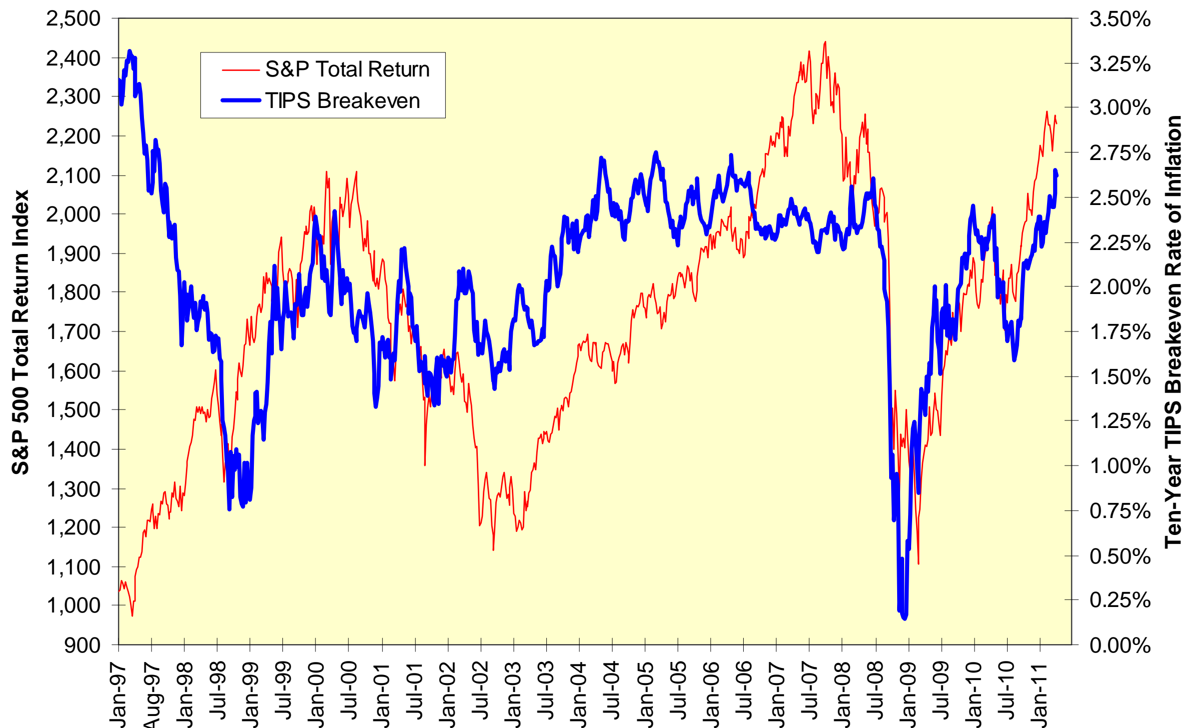
Inflation And Money Illusion

Give a man a fish and you feed him for a day. Give a man a dollar and he will buy stocks with it. This is not quite true, but in the investment sense, it is much truer than we like to think. All you have to do is ask the question which is easier, constructing new plant and equipment or buying its paper representation.

Given this background, should it surprise anyone risky financial assets of all stripes have been on a tear during the latest bout of money-printing? Not only are we dealing with a flow mechanism, we are dealing with something called money illusion, a fancy term for treating a freshly created dollar as if it had the purchasing power of the most recent dollar and for failing to adjust your mental perception of your own wealth accordingly.

Stocks have, over time, exhibited a tendency toward money illusion. If we accept the ten-year TIPS breakeven rate of inflation at face value, which is succumbing to the illusion of TIPS protection while talking about succumbing to money illusion, we can trace the total return of the S&P 500 against TIPS breakevens going back to January 1997.

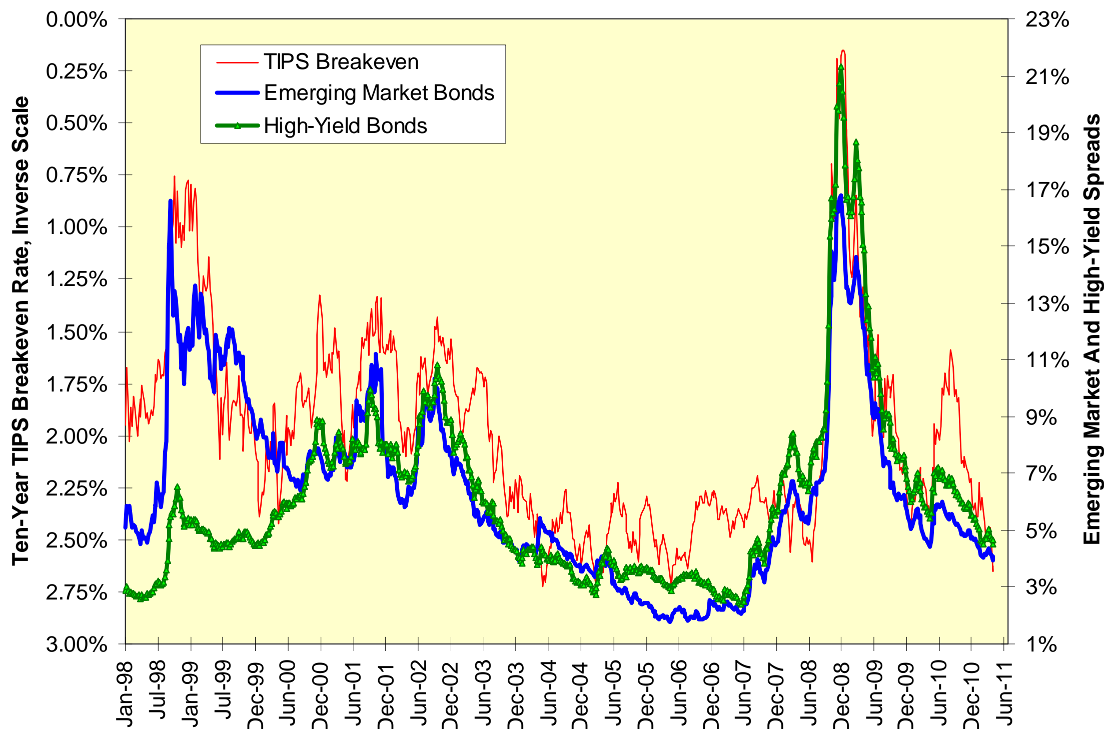
Stock Returns And Inflation Expectations



Please note this relationship is not particularly causal. There are times, such as mid-1998 to early 2002 and late 2008 through the present when the overall correlation is high, but even then the two markets take turns leading and lagging each other. This may be fine for some forms of ballroom dancing, but it is not acceptable in econometric analysis: Causation can go in only direction. Either stock returns lead inflation expectations or vice-versa, but not both.

High-Risk Bonds

A better and more interesting case can be made for the linkage between the option-adjusted spreads (OAS) of both emerging market and high-yield bonds and TIPS breakevens. As inflation expectations rise, the OAS levels of these two classes of bonds narrow. The logic behind this is straightforward and strong: Inflation expectations rise along with financial liquidity and financial liquidity allows the bonds to be carried at a lower cost. In addition, higher inflation diminishes the real cost of debt service.



Now trees do not grow to the sky and credit spreads do not shrink to the ground (In a bout of self-congratulation, I just made up this cliché). Should inflation expectations rise to the point where the market fears a policy response along the lines of asset sales followed by increases in short-term rates, the situation could become "backward-bending." This is a fancy way of saying a little inflation is good but too much inflation might create some real problems.

In the end, higher inflation is poison for all financial markets; anyone who lived through the 1970s can attest to that. That money illusion is a lot of fun until you realize that crisp new dollar bill is not worth the paper on which it is printed. There is a reason why *Cinderella* remains such an enduring childhood tale: We learn the coach can turn into a pumpkin at any time.