Are We Really Uncomfortable With Inflation?

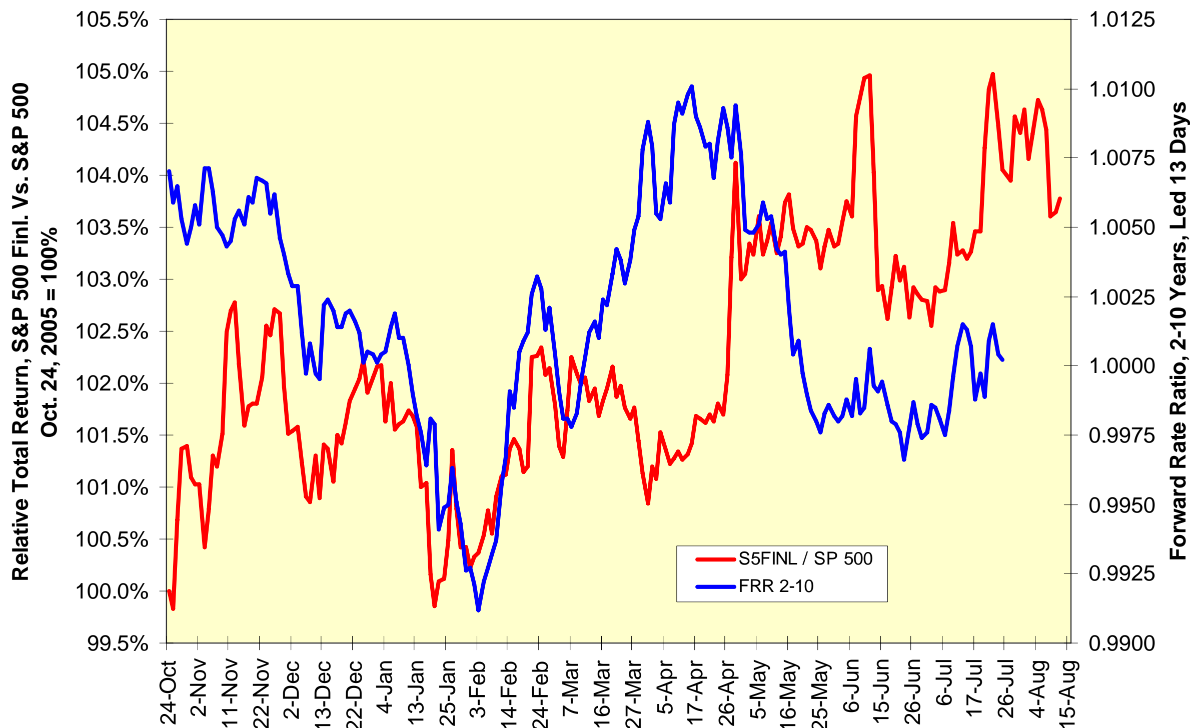
Let's start with the punch line: Do not ask yourself about your risk tolerance, you will get a lie for an answer. Every sell-side broker and financial planner who is reading this must be nodding in knowing assent. Everyone claims to have a high tolerance for risk until you hand them the bill.

What is true for us as individuals is true for us collectively in a market, too. We all claim to fear inflation, but each and every time the Federal Reserve hinted before its decision it was not going to raise rates last Tuesday, all manner of markets rallied. It was party-like-it's-2003 time; it mattered not whether the asset in question was stocks, bonds, real estate, commodities or various proxies for risk, they all went up in unison.

Acceptance Of Inflation

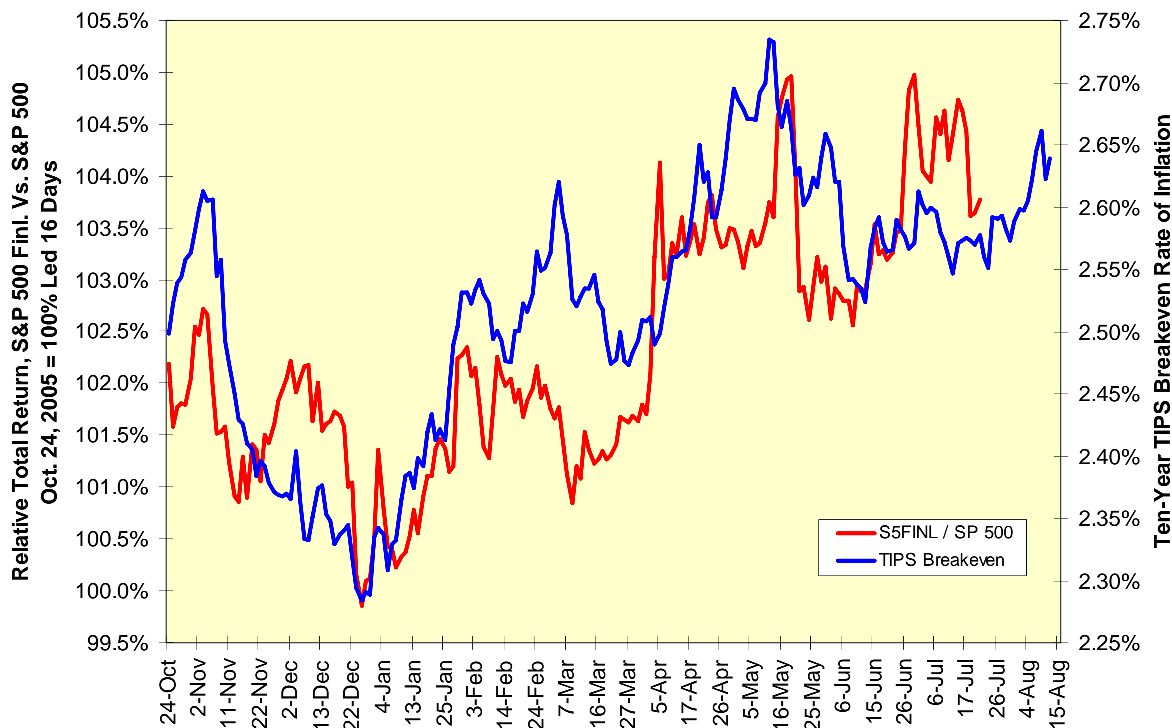
The Standard & Poor's 500 is divided into economic sector indices, one of which is the S&P Financials; this index in turn supports a Select SPDR exchange-traded fund that trades under the ticker XLF. If we compare the total return of this index to the total return of the S&P 500 itself, we obtain a relative performance index useful for analytic purposes, including anticipating changes in the shape of the yield curve as measured by the forward rate ratio (FRR) between two and ten years. This FRR is the rate at which we can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself. The more this FRR exceeds 1.00, the steeper the yield curve is.

A long-term data analysis indicates the relative performance of the Financials leads the FRR by 13 trading days on average. Restated, if financial stocks outperform the broad market they implicitly are discounting a steeper yield curve and looser monetary conditions. The linkages between the yield curve, financial sector profitability, financial sector stock performance and the disaggregated industry group performance within the financial sector were explored here in January. Let's restrict the analysis to October 24, 2005, the day on which Bernanke was nominated to be the Federal Reserve's Chairman, forward.



The FOMC stated, "inflation pressures seem likely to moderate over time" in its post-meeting statement last Tuesday. The market begs to differ in this assessment; the ten-year TIPS breakeven rate of inflation has been rising

since June 12, the very day the Bank of Japan ended its rapid withdrawal of excess liquidity from the banking system. While all charts and graphs, like bar patrons at closing time, are subject to differing visual interpretation, it would be difficult to look at the course of inflation expectations in the TIPS market and see a downtrend.



The course of inflation expectations leads the relative performance of the financial sector by 16 trading days. The chain of causality, therefore, moves from higher inflation expectations to stronger financial stocks to a steeper yield curve. At no point can we begin the analysis by saying, "first inflation expectations rise and then bad things happen."

The Golden Twist

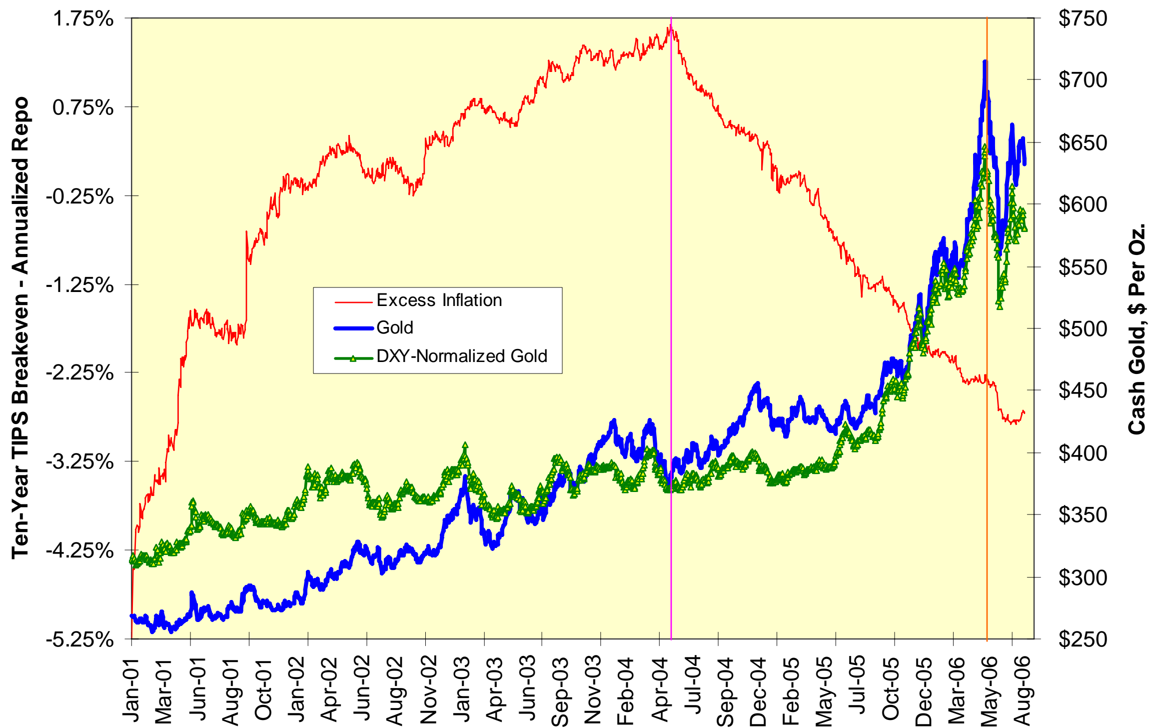
This being the Conundrum Decade, we should expect to see something totally unexpected in the aftermath of this shift in monetary policy. And where better to look than gold, last seen spiraling out of control during the spring and bringing all manner of the usual addle-brained out of the woodwork.

Let's update from June 2005 the central fundamental relationship for gold, the excess of expected inflation over the short-term interest rate cost of carry. If expected inflation exceeds short-term interest rates, any inert commodity, which includes a handful of dirt as well as gold, should rise in price by the amount of this excess inflation before we factor in supply/demand changes.

This measure peaked in May 2004, just before the first of the Federal Reserve's 17 consecutive rate hikes. As this fundamental relationship deteriorated, gold's price rose first steadily and then hyperbolically all the way to May 2006. Its rise peaked on May 12, 2006, the very day when the Bank of Japan started its withdrawal of liquidity.

As an aside, gold's advance had nothing to do with dollar strength or weakness over this period. If we adjust gold for changes in the dollar index (DXY), we get the same answer as before.

The excess inflation measure has stabilized as the Federal Reserve has signaled the end of its rate hike campaign. If gold interpreted monetary largesse in a manner similar to the TIPS and yield curve markets, we should see its price rise, rather than fail at a series of lower highs as it has done over the past two months. Gold is acting more as an economically sensitive indicator and less as a currency or inflation-protection device. That is in direct contravention to the gold bugs' fondest aspirations; it is not enough for gold to rise to satisfy their bloodlust. Everything else must fail.



Let's ignore the gold market as an inflation indicator and focus on the financial markets. They are acting rationally in this environment by pricing inflation risks higher. But financial assets are not suffering. We have made, collectively, the Faustian bargain we can tolerate a little bit of inflation today to forestall immediate economic stress. Think of inflation as a social lubricant in this regard.

The risk, obviously, is one day inflation will be higher than bargained for and the monetary authorities will have to pull Paul Volcker's 1979-1982 playbooks off the shelves and start inflicting some real economic pain. A cry will arise from the masses how the Federal Reserve let inflation get out of control. Nonsense: In risking higher inflation, they gave us exactly what we wanted and exactly what we deserve.