TIPS Market Not Buying Deflation Nonsense

Consider the following exchange from Woody Allen's 1972 *Play It Again, Sam*:

Bogart: Now tell her that you've met a lot of dames, but she is really something special.
Allen: That she won't believe.
Bogart: Oh, no?
Allen to woman: I have met a lot of dames, but you are really something special.
Woman: Really?
Allen: She bought it!

If this does not summarize the relationship between the FOMC and the ever-gullible bond markets, what does? I grew it in an era when a Federal Reserve that argued the need for higher inflation would have prompted a torches-and-pitchfork march up Constitution Avenue where, as the diplomats would say, a frank and useful exchange of views would have ensued.

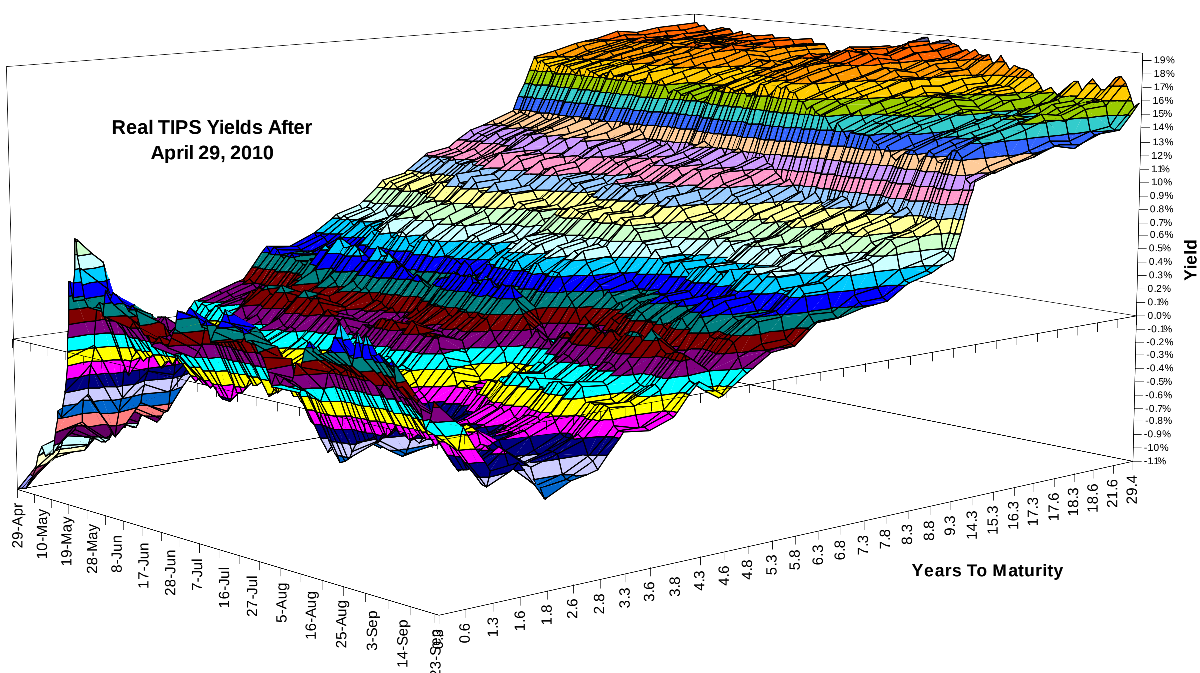
Bogart: Tell them there's deflation!
Benny: That they won't believe.
Bogart: Oh, no?
Benny: I've seen a lot of markets, but you are really flatulent. Oops, I mean there's a danger of deflation.
Bond market: Really?
Benny: They bought it!

Not Buying It

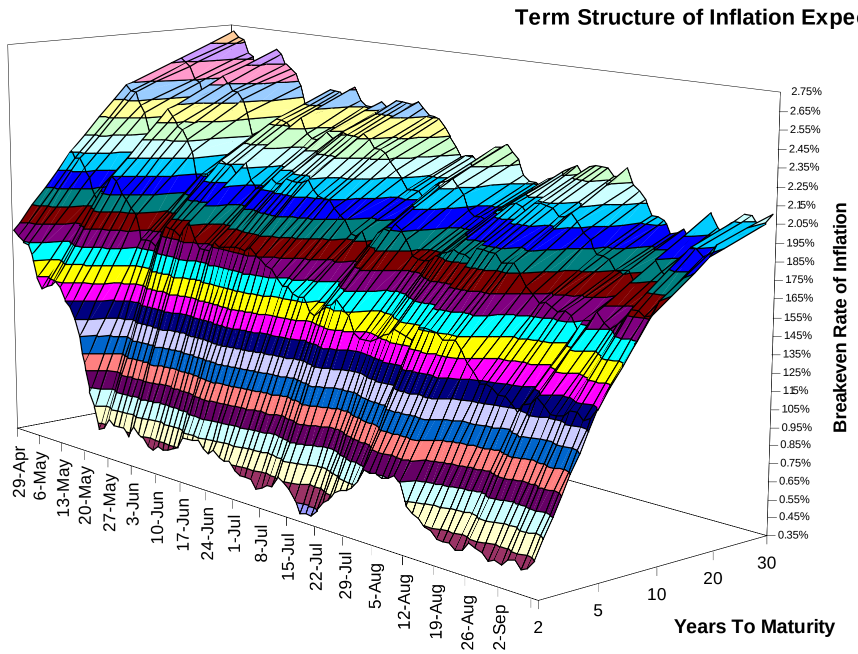
The TIPS market is reacting to all of this by pricing in the risk of higher inflation, as well it should. Even with the commercial banking system not turning the monetary base into credit and expanding the money supply, and even with the fiscal drag from our bloated public sector, the betting has to be sooner or later they can print enough money to make it worthless.

Get me the Dubious Achievement Hall of Fame on Line 2!

We can see this in two ways. First, the term structure of real TIPS yields displayed here on an issue-by-issue basis has remained fairly flat since TIPS breakevens hit their recent high on April 29, 2010. Granted, they have declined somewhat in 2010, but so what? Real generic ten-year TIPS yields have been declining since the dotcom bust in 2000, and no one was fretting about deflation then.



Second, the term structure of inflation expectations for generic TIPS has been flat over the same period save for a decline in thirty-year breakevens. If deflation was keeping the TIPS market awake at night, we would see something akin to the negative TIPS breakevens of late 2008.



The time has come to ask, “Won’t someone stop this senseless slaughter?” Larry Summers had to walk the plank last week for the failures of Keynesian demand management, and justifiably so. The Bernanke Federal Reserve must be held accountable for its policies, continued from the Greenspan era, of printing money to solve every problem. The net result has been the inability of risk-averse savers to earn a return, a dollar that is being saved only by irresponsibility elsewhere, direct monetization of Treasury debt and an expansion of defined-benefit plans’ unfunded liabilities. Gold near $1,300 per ounce is not the markets’ roar of approval of their actions.

The bizarre aspect of all this is bonds are still bullish and if I am correct, we are in for a future bubble therein. If you own mid-term Treasuries directly or in ETF form (IEF, TLT) you will be fine for a while. But once the bond market catches on to the dishonorable intentions of the Federal Reserve, you will not want to be long the things in any way, shape, manner or form.

At least that is the way the world looked in 1972.