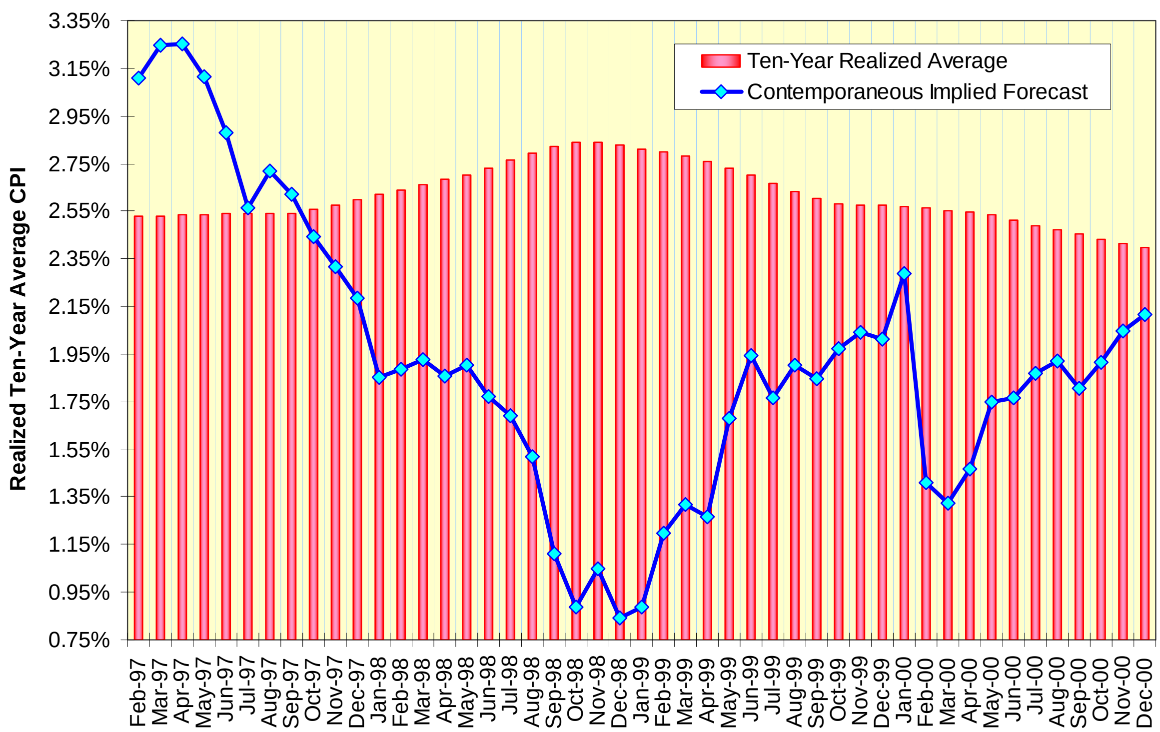
TIPS And Implied Inflation Forecasts

One of the most persistent misconceptions about futures markets is they involve a forecast for where the market will be in the future. If we renamed "futures" to "reservation prices determined by most anxious seller meeting least credit-worthy buyer," we would be more accurate, but the marketing people might kick up a fuss.

Markets measure, they do not forecast. The price at which a corn farmer might sell December corn futures might be far lower than his vision of sugar plums, but it would satisfy his bank. The price at which the hog farmer might buy those futures may be excessive in his mind (sow discontent amongst the sows? Discuss amongst yourselves) but that price ceiling might make all the difference in protecting his economics. Both sides can believe they are wrong, but if that is where the transaction is executed, that is the price the world sees. The forecast content from two unhappy campers meeting and greeting is fleeting.

Forecasts Don't Kill People
Economists, like the Druid priests of yore, are paid to forecast, and most have yet to learn the rule of "Give them a number or give them a date, but don't ever give them both." *The Wall Street Journal* surveys a panel of economists, probably because it just seems like the right thing to do, on a number of macroeconomic variables. Let's take the average six month-ahead forecast for the CPI and compare it to the ten year-ahead average for the All-Urban Consumer Price Index, not seasonally adjusted (CPI-U) implied by TIPS breakevens. As the ten-year TIPS began in January 1997, we can compare the realized ten year-ahead realized average for the CPI-U to the implied forecast for all ten-year segments through the one beginning in December 2000.

Assessing The TIPS Market's Forecasting Ability



A glance at the chart above may prompt the comments, "Wow, realized average ten-year CPI has not changed much," and "Fetch me a Druid." But – and you might hear *Animal House's* Flounder exclaiming, "Boy, this is going to be good," – the root mean square error for the TIPS ten year-ahead forecast of 0.84% was less than the six month-ahead RMSE for economists of 1.11%.

The TIPS market is pricing in a ten-year average CPI-U of 2.325% at the time of this writing. That is wonderful, but everyone should remember TIPS are still bonds and therefore are subject to interest rate risk. They also are at risk to future tax policy and government honesty in reporting the CPI-U. Finally, you do not make money in TIPS by being absolutely correct on your inflation forecast; you make money by buying them 1) before an unexpected rise in reported inflation and 2) during a stable-to-declining interest rate environment. Unless, of course, you believe TIPS sellers underprice inflation insurance systematically.

In the meantime, the TIPS market can claim minor bragging rights, which is sort of like winning the Super Bowl only to find out you are living in Green Bay in February. Winning isn't everything, is it?