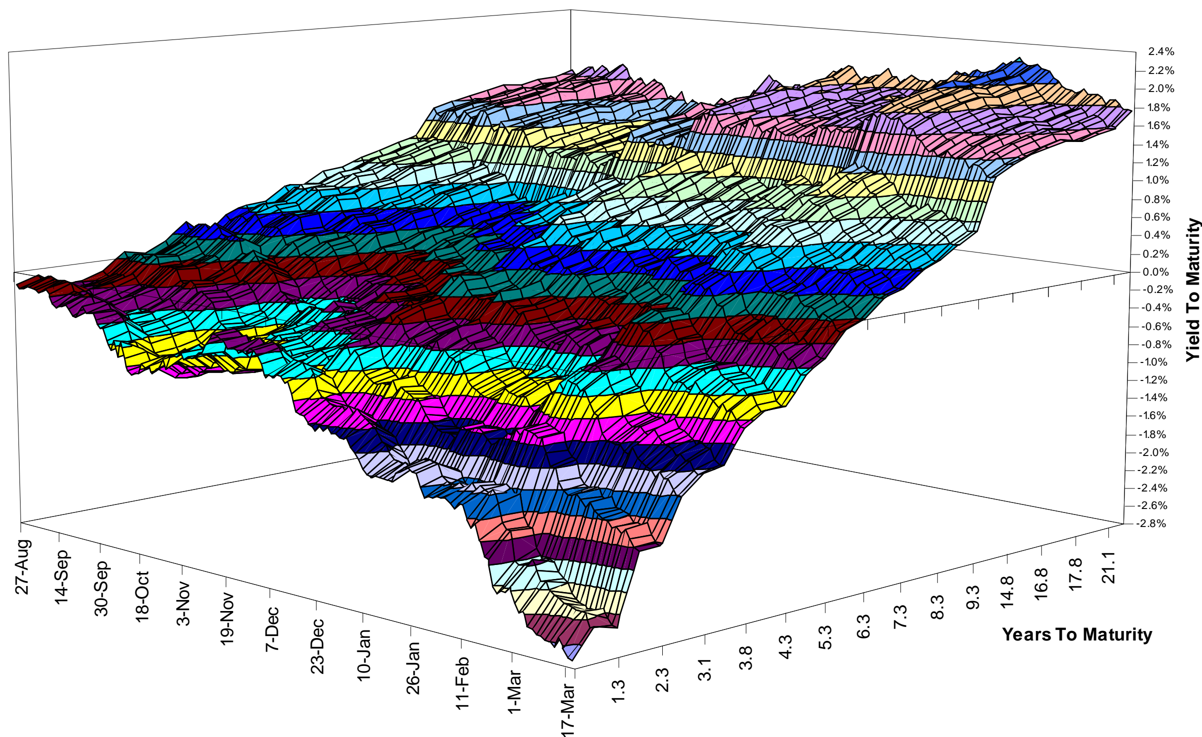
Inflation Perma-Expectations

Every time I sit down to write a story on déjà vu, I keep thinking I have written it before. So it is, I realized, with the story on real interest rates and inflation expectations. I entitled an April 2010 article, “Short-Dated Inflation Expectations To Rise First.” Eleven months later, the same statement could hold true, and then some.

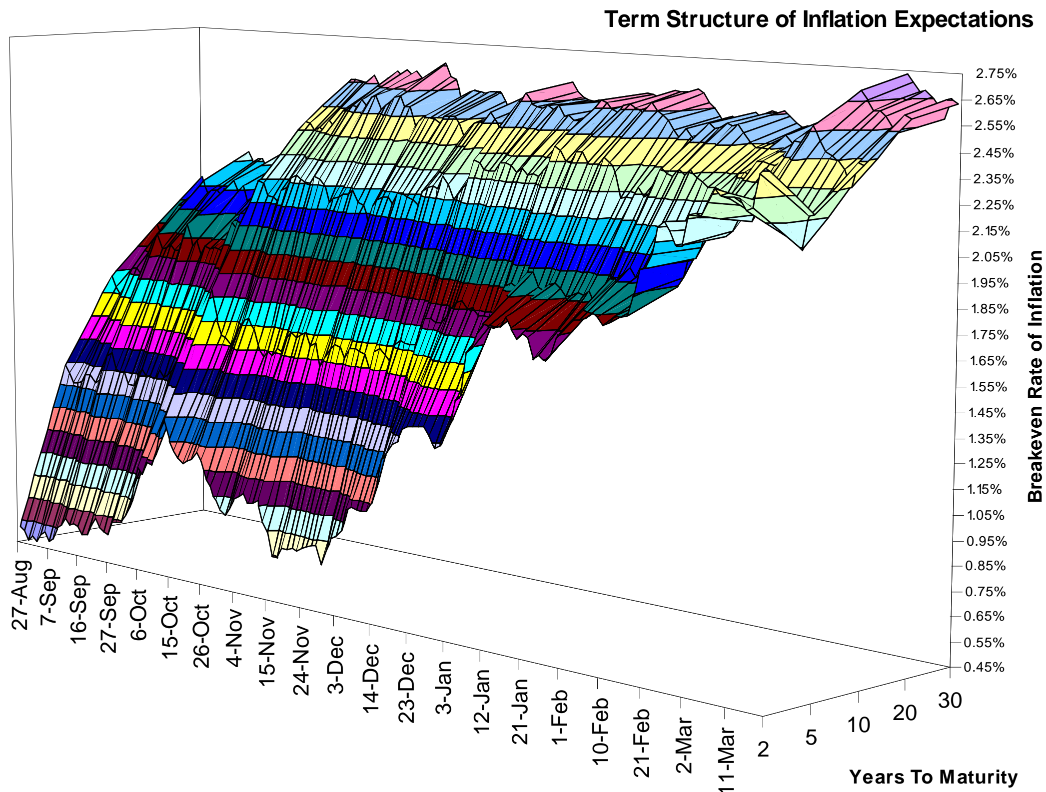
The bond market, for reasons that must remain a mystery, feels comfortable in assigning a path-dependence to future inflation. It believes any rise will be a short-lived affair; Ben Bernanke, in a burst of modesty, is 100% confident the central bank can arrest inflation after the cat is out of the bag and the horses have escaped through the open barn door.

As a result, an issue-by-issue map of the implied real rate for TIPS shows the same pattern seen last April and indeed all the way back to the origins of the financial crisis in 2007. The shorter-term issues’ real rates are declining further and faster than those in the middle part of the yield curve, and long-term real rates are rising. This pattern means a buyer of a middle-dated TIPS could achieve gains by “rolling down the curve” if the present pattern continues to hold.

Real TIPS Yields Since Jackson Hole



Counterbalancing this outlook is the same positively sloped curve of generic inflation expectations. These are rising much further and faster at the short end of the yield curve to reflect the incredible belief inflation, once unleashed, will be a short-lived affair.



Once again, if the present pattern holds, a trade presents itself: Buying a TIPS and selling a conventional Treasury at the middle part of the yield curve opens the door to greater profit potential on the long TIPS as they roll down the yield curve. Remember, as short-term inflation expectations rise, the implied real rate can go negative in a fairly open-ended fashion.

There is no such thing as a free lunch, and the risks to this trade include a reversal of monetary policy, a flattening of the yield curve and a switch in inflation expectations' term structure. If the market starts pricing in the difficulty in arresting inflation once it starts, the two curves seen above will flatten and take away the roll-down part of the trade.

We have seen several short-lived upticks in inflation since the early 1980s and each one of them has failed for reasons discussed here in February, principally the inability of the economy to withstand higher long-term interest rates. However, we never has a $2 trillion Federal Reserve balance sheet before or years of near-0% interest rates before or a combination of central banks printing money as the first, last and only response to every financial problem before. Sooner or later, printed money gets priced at its intrinsic value, which is nothing.

For now, though, take advantage of the market's belief inflation will be a short-lived affair. You will have years to marvel at this belief later.