

TIPS Follow More Than They Lead

As noted [yesterday](#) in discussion of TIPS' economically illogical anticipation of long-term consumer inflation from short-term raw material movements, the Federal Reserve risks tying itself to this market in setting policy. Well, maybe; this is the stated intention, but I think in practice they will use any and all excuses to keep the money flowing until the sun blows up, at which point they might tighten credit.

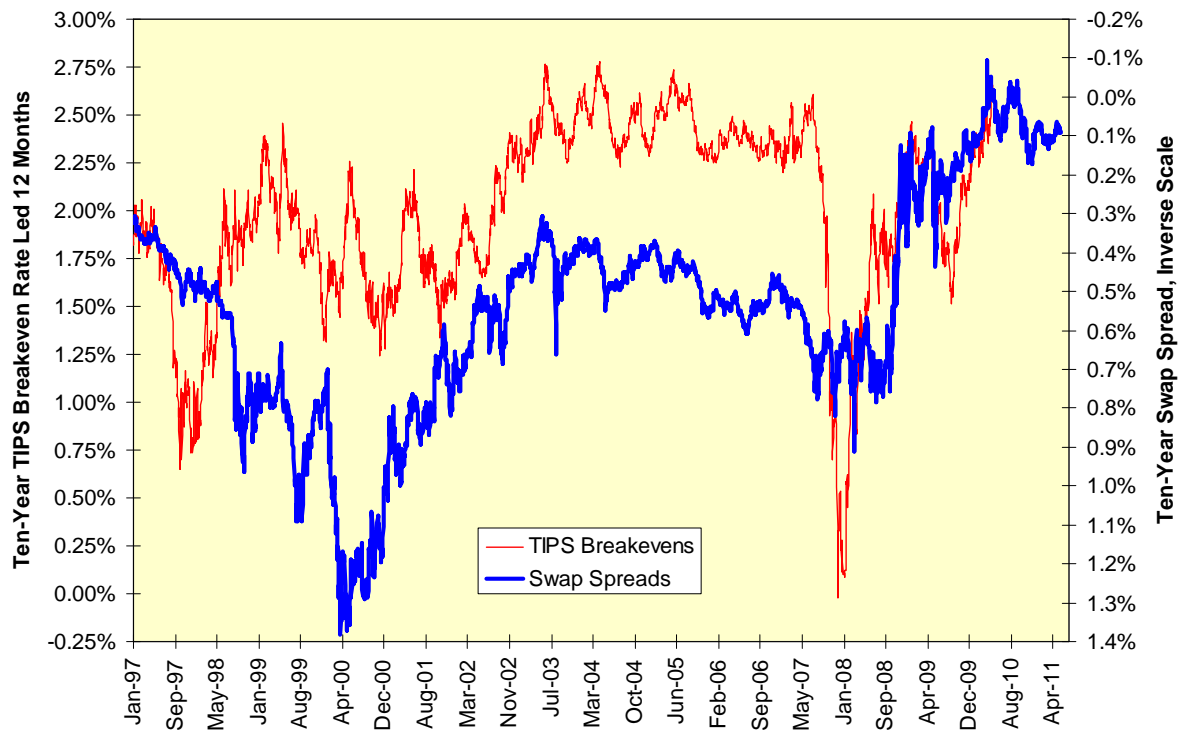
This is not the only case, however, where TIPS could lead us astray. Part of this must be semantic; whenever we use the word, "expectations," what is our expectation? That it is forward-looking and therefore can be used to model where other markets are going. This is enshrined in the descriptive equations for many markets: Stocks are priced off expected earnings; bonds are priced off expected inflation and currencies are priced off expected interest rate differentials. These are nice theories; most are and many took the better part of an afternoon to compile.

Yet if we take two very key financial markets, [swap spreads](#) and the shape of the LIBOR yield curve between three and six months ($FRR_{3,6}$), we find these markets lead, not follow, TIPS and they do so with a minimum of braggadocio. A swap spread represents the premium a floating-rate payor is willing to pay to fix the rate on a loan; a higher swap spread indicates a greater fear of rising interest rates. The $FRR_{3,6}$ is the forward rate between three and six months divided by the six-month rate itself; the higher the number, the steeper the yield curve and the greater the expectation for higher interest rates.

Lead, Follow Or Get Out Of The Way

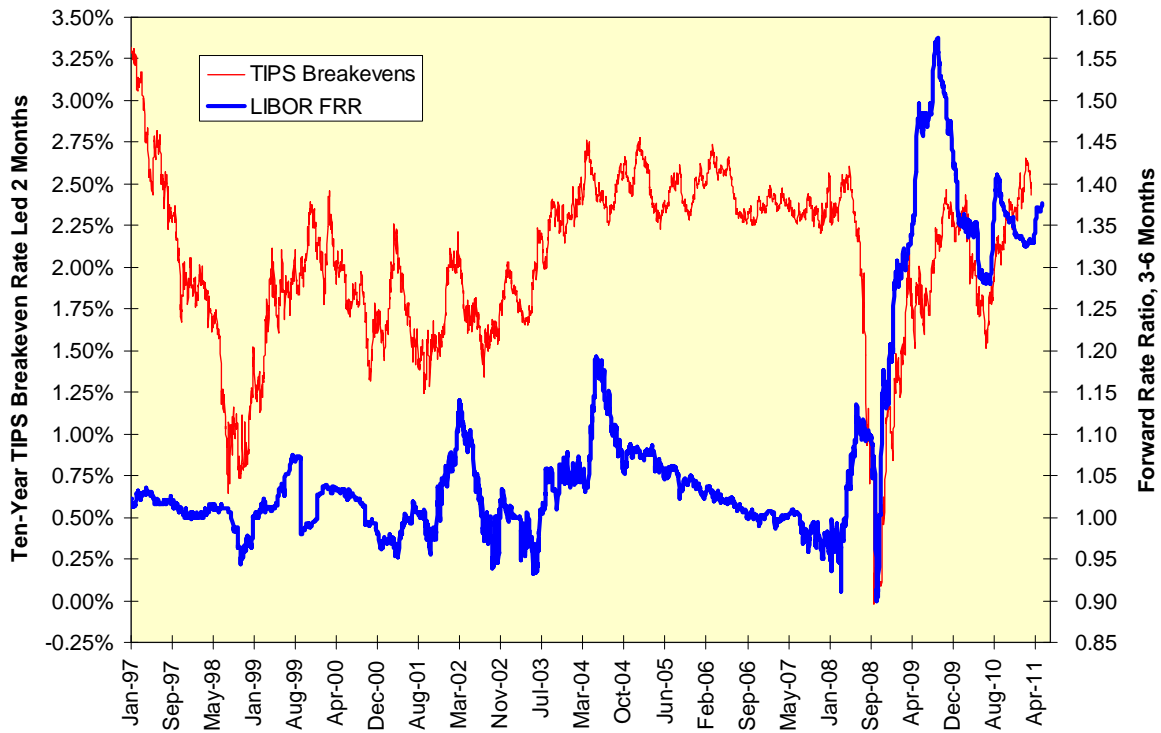
What do we see? If we map the ten-year TIPS breakeven against the ten-year swap spread plotted inversely, we find a drop in swap spreads leads higher inflation expectations by 12 months on average. Restated, a decline in fear of higher interest rates leads to a rise in inflation expectations. The rise in inflation expectations does not lead in this situation.

TIPS' Breakeven Still Following Swap Spreads



What about the relationship to the $FRR_{3,6}$, you ask (OK, you did not ask this, I did, but work with me here)? A steeper money-market yield curve leads ten-year TIPS breakevens by two months on average. Once again, TIPS are following, not leading, another monetary variable.

TIPS' Breakevens Linked Weakly To LIBOR Curve



I have to reach the same conclusion here today I reached yesterday: If monetary policy is to be set on the Federal Reserve's reading of inflation expectations, it will be trying to follow an indicator that in turn follows, not leads, other markets. It is true the TIPS market is a [better forecaster](#) of inflation than are the nation's economists, but that is damning with faint praise when a simple damning would suffice. Let's not get started on survey-based measures of inflation in this regard.

All of this confirms Milton Friedman's dictum the FOMC should be replaced with a computer whose target should be growth in the money supply equal to the economy's capacity growth rate. Anything else borders on witchcraft and has helped us arrive at our present state of affairs.