

Inflation Expectations And The Yield Curve

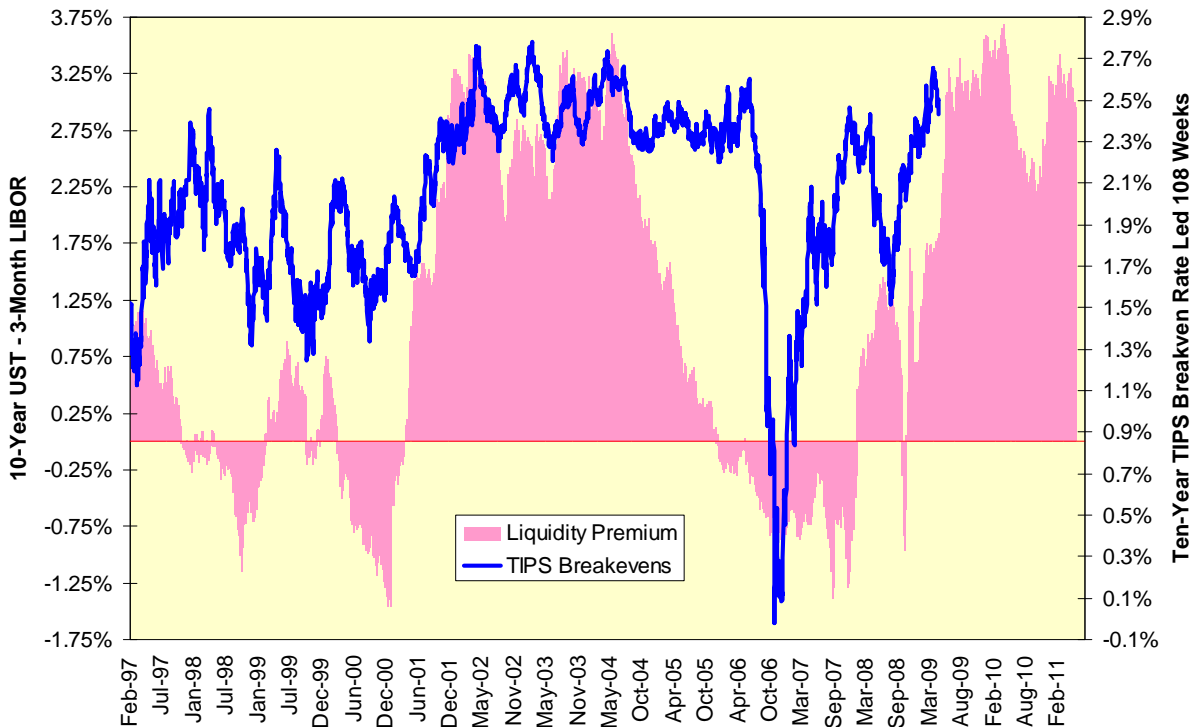
At the risk of beating the subject into the ground, I am going to follow up on [Monday's](#) discussion of the TIPS market reacting prematurely to commodity price movements and to [yesterday's](#) discussion of how the TIPS market lags, not leads, key financial measures with a discussion of inflation expectations' role in forming the yield curve.

The financial theory is enshrined in every textbook and pickled in every jar of MBA formaldehyde as Fisher's Law: Nominal interest rates are the sum of real interest rates plus expected inflation. The spread between long-term nominal rates and short-term rates, or liquidity premium, can be approximated by the difference between the ten-year Treasury rate and three-month LIBOR.

There are two problems here. First, no one can assess with any degree of accuracy what the "real" rate of interest is for any maturity or at any given point in time. Second, as there can be only one real interest rate at a given maturity worldwide because of the ease of interest rate arbitrage via the currency market, currency volatility and global yield curve differentials are more important determinants of the liquidity premium than are inflation expectations.

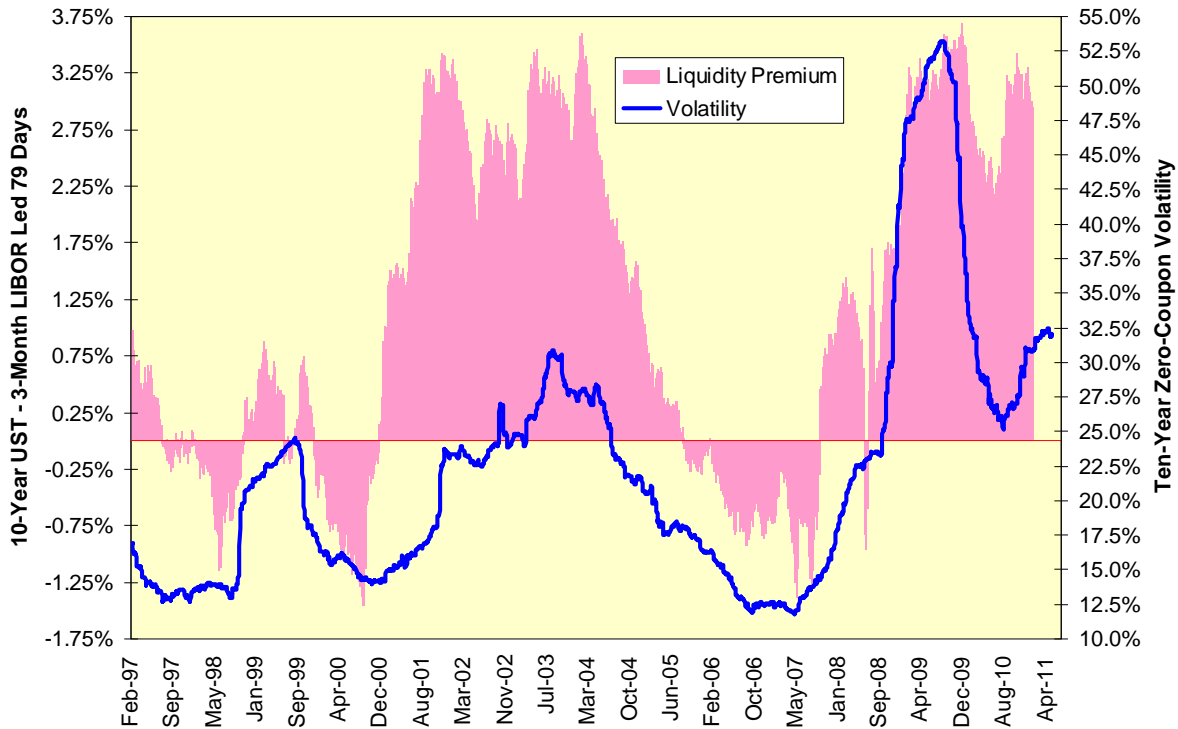
Let's take a look at the liquidity premium and ten-year TIPS breakevens and see who is leading whom. If Fisher's Law is correct the answer should be neither. If the FOMC is correct, we might see a bias toward TIPS breakevens leading the liquidity premium. However, neither is correct: Not only does the liquidity premium lead TIPS breakevens, it does so by a whopping 108 weeks. While TIPS over-react instantaneously to commodity prices and are led by financial variables at relatively short lags, it takes them a while to accommodate changes in the liquidity premium.

Are Expected Inflation And The Yield Curve Related?



As fixed-income volatility, like currency volatility, is a major contributor to the liquidity premium, let's see whether TIPS trail this one, too. Yes; ten-year zero-coupon implied volatility leads TIPS breakevens by 79 days on average.

Volatility And The Yield Curve



The results presented here this week should give everyone pause. We have a central bank committed to ease and looking for reasons to keep its foot on the gas pedal. It claims, perhaps because it sounds fair and market-driven, it will use the markets' assessments of when inflation is getting out of hand to adjust policy, wink-wink. However, these market-derived measures of expected inflation do not lead, but rather follow, almost everything else.

This may not be the perfect recipe for a policy blunder of being behind the curve if and when inflation ever rises, but our lives are not filled with perfection too often, are they? Looking at TIPS is looking in the wrong place.