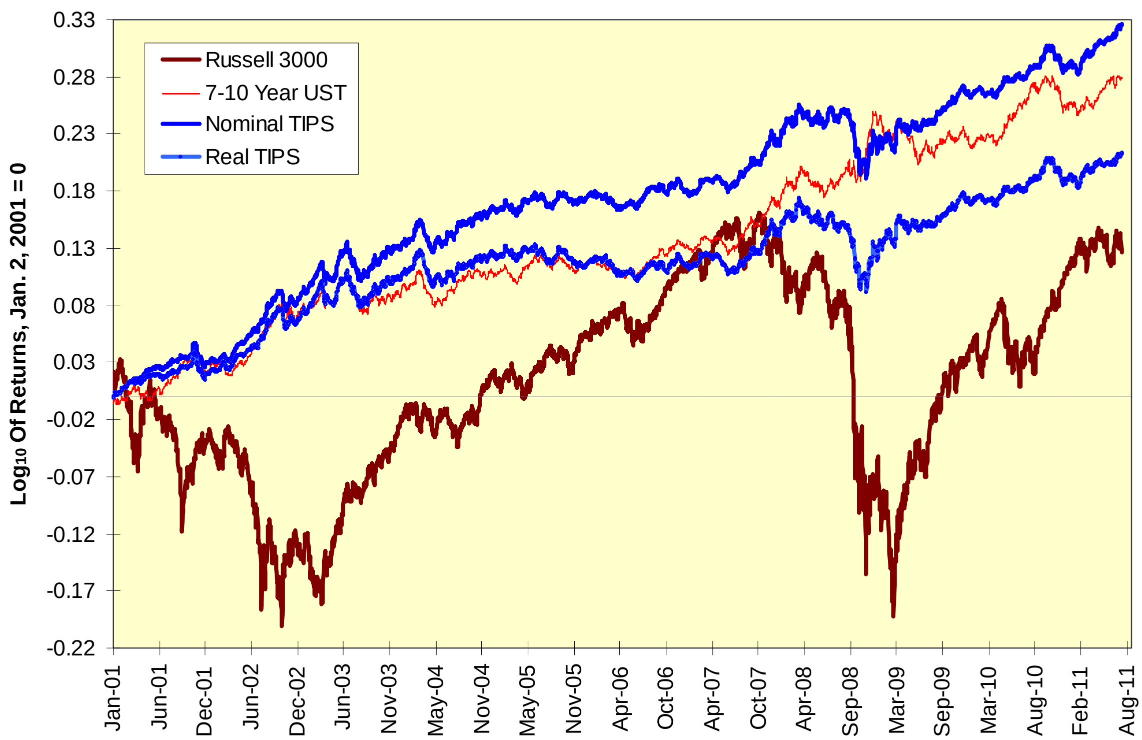
Money Illusion And Stocks

A nagging worry for investors is how much of the rallies in risky assets since March 2009 have been attributable to money-printing. Viewed in this light, the question becomes whether bull markets in stocks, convertible bonds, high-yield bonds, etc, are nothing more than a proxy for rising inflation expectations.

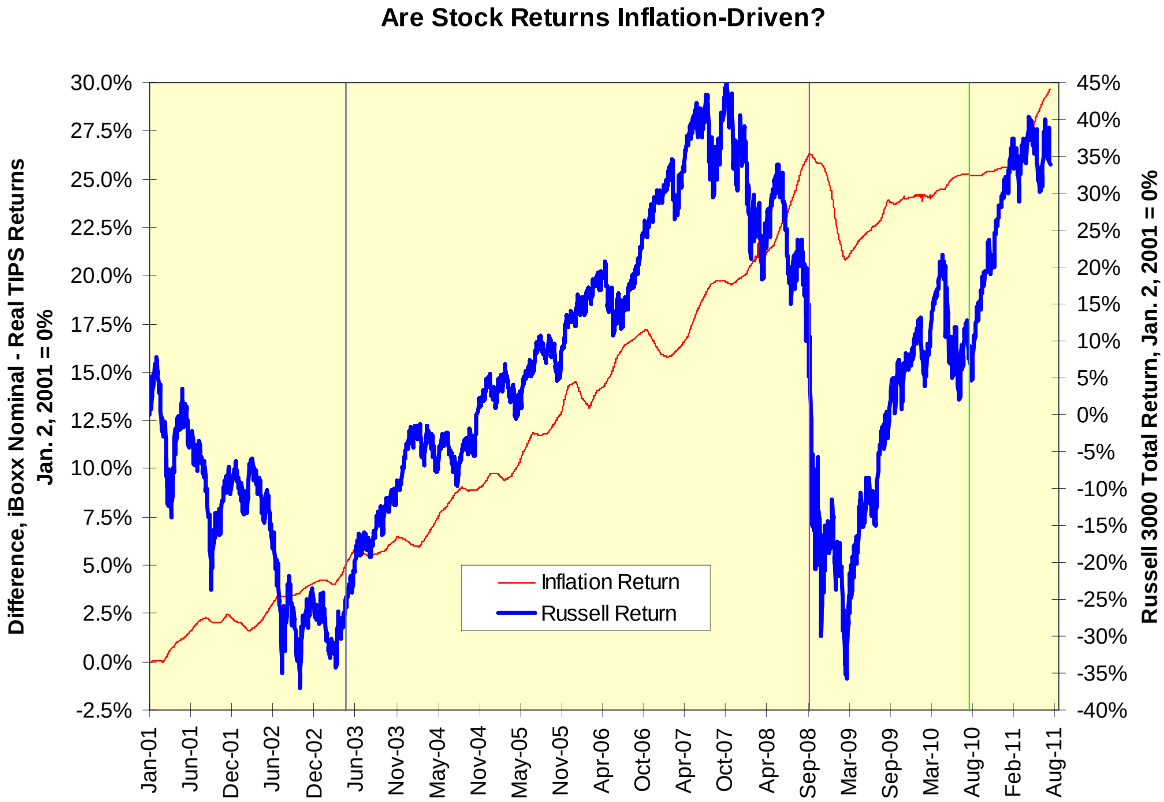
This was brought to light, again, by a simple chart overlaying the S&P 500 (Motto: One more word out of you, pal, and it is downgrade city) against the ten-year TIPS breakeven rate since Jackson Hole. The simple correlation was 0.91; the implied conclusion was the bull market was just a lot of loose money seeking a home.

That seemed unsatisfying, so I decided to complete the analysis by taking two TIPS total return indices produced by iBoxx, one for the instruments' nominal returns and one for the "real" returns after the inflation accrual was removed. If we map these two indices against the total return for the Russell 3000 (Motto: We have 2,500 more stocks than you-know-who) and, for good measure, the Merrill Lynch index of 7-10 year Treasuries (Motto: You will get paid someday. Scout's honor) going back to the start of the data in 2001, we can see the Russell 3000 does not look like any of the bond indices.

Comparative Return Paths



Now let's rearrange the iBoxx TIPS data to isolate the inflation accrual portion of the return and map that against the Russell 3000. Four separate regimes are suggested, one ending with the first declaration of war on deflation in May 2003, one ending with the depth of the financial crisis in October 2008 and another ending with Jackson Hole (Memo to self: When did 'Jackson Hole' become a date as well as a place?). These breakpoints are marked with vertical lines.



A statistical analysis confirmed each of these segments' stock return-inflation accrual return relationship was different from its predecessor's at near-100% confidence. The most consistent dual rise occurred between May 2003 and October 2008, not during the post-Jackson Hole era.

Second memo to file: If Ben Bernanke says something major at Jackson Hole this year, will we have Jackson Hole II? Inquiring minds do want to know.

Finally, if we construct the rolling three-month correlation of returns between the two indices, we find they oscillate from 1 to -1 with great regularity. The correlation is cyclical with an irregular phase. At present, the correlation of returns is negative and has been so since mid-June when inflation expectations continued to move higher and stocks stalled.

At the end of it all, we can conclude that while excess liquidity flows into financial assets first, it is disingenuous and methodologically sloppy to conclude stock returns are nothing more than the artifact of inflation expectations.