The Fed Broke Its Inflation Thermometer

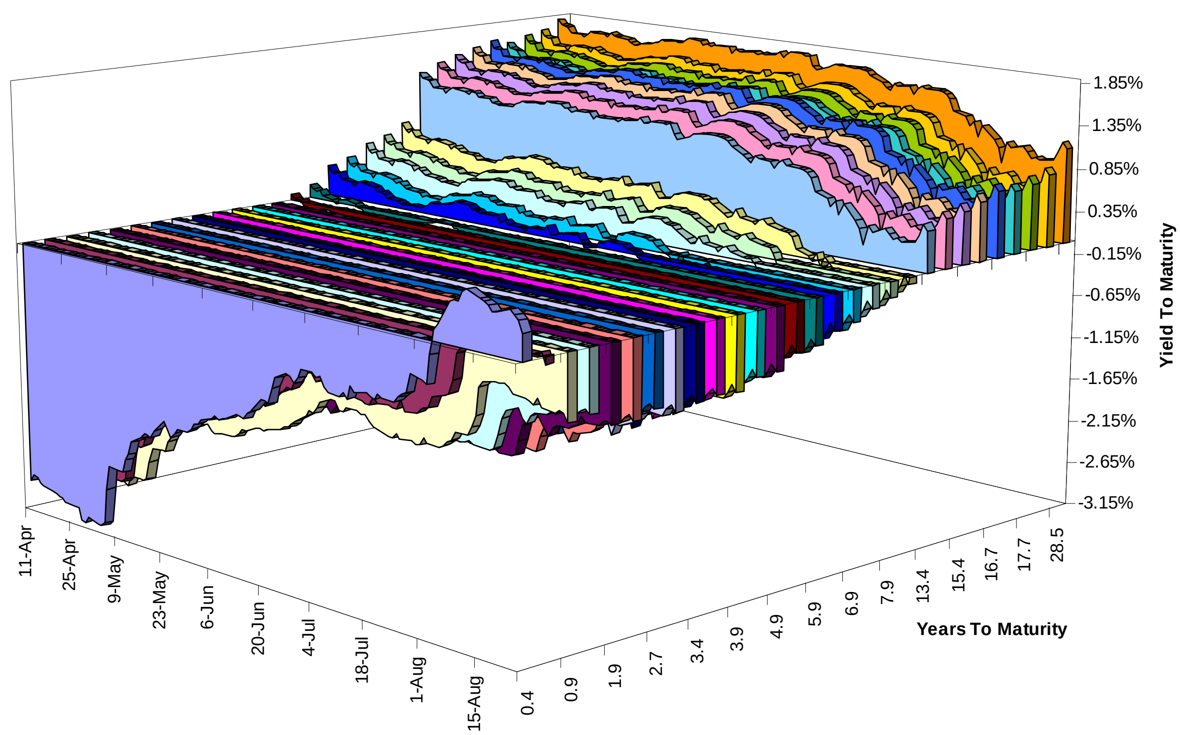
The purpose of razzle-dazzle is to deceive others, not that I would ever stoop to such depravity. When you deceive yourself; well, that is another matter. It is a spiritual cousin to the celebrated Darwin Award in the sense you soon will render yourself diminished in one form or another.

The Federal Reserve never has hid its focus on the TIPS market despite all of its faults. They are relying on what I long ago dubbed Simons' Law in honor of its creator: Some numbers drive out no numbers, and computer-generated numbers drive out other numbers. They cite inflation derivatives in justification of what they want to do; they actually claim with something of a straight face a derived 33% probability of deflation in inflation options during the summer of 2010 was the reason behind QE2.

Yield Curve Compression

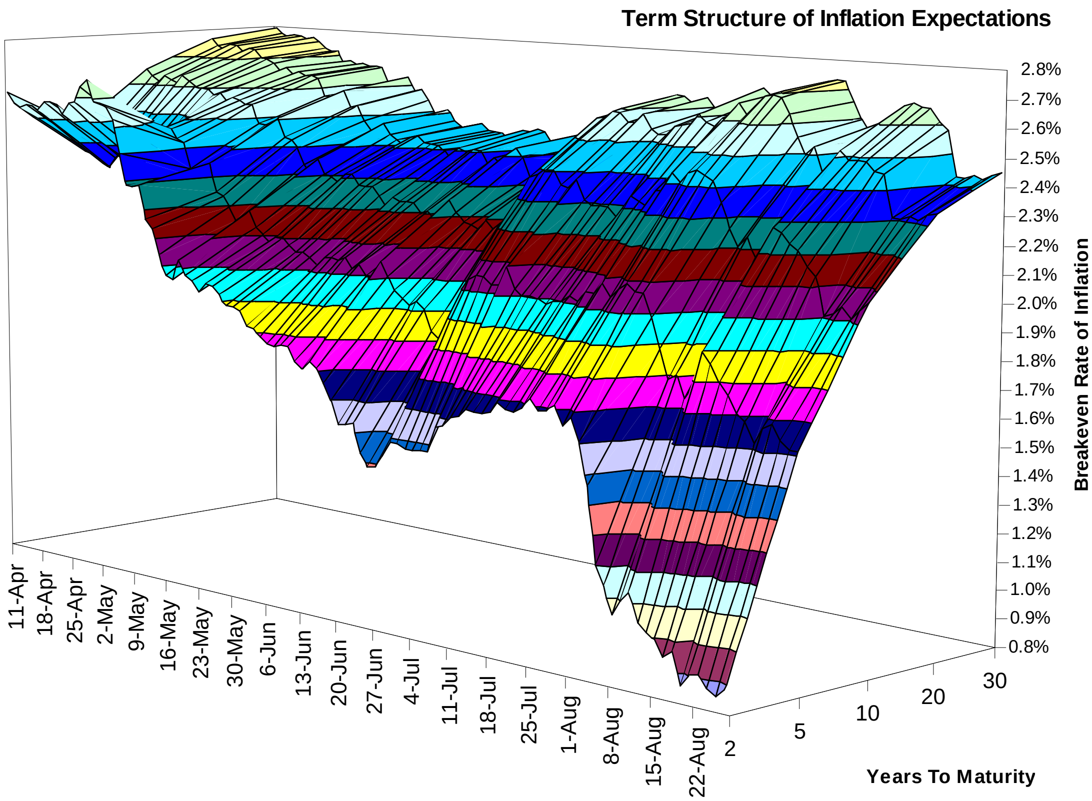
As the Federal Reserve has compressed the yield curve in a monetary technique called "squishing" and has put yields out to five years' maturity below 1.00%, they have distorted the nature of the TIPS market, both for implied real rates and for the term structure of inflation expectations. As implied real rates are the difference between nominal yields and inflation breakevens, it stands to reason shorter-term implied real yields have been negative.

Real TIPS Yields Since April High In Breakevens



What we saw in recent weeks went beyond that a little. The negative implied real rates started to become less negative, and the positive real rates started to become less positive until the middle of last week. All of this frenetic juggling of implied real rates over a very short period of time and over issues spaced narrowly in maturity is more than a little nonsensical economically. It implies some exquisite long-term fine-tuning of the supply and demand for capital; markets just do not change this rapidly. What we are seeing is the residual of yield curve compression.

If we look at generic breakevens, we see the same sort of distortion. As the yield curve got squished, short-term breakevens collapses while long-term breakevens barely budged. If we think about what is going on the in the monetary world, we should see longer-term breakevens rising; never in human history has so much money been created out of thin air without an inflationary outcome. It is not on the immediate horizon, but for 20-30 years from now, it should be. Thirty years ago, ten-year Treasury rates were greater than 16%, and who can say it will not happen again?



We are left with the conclusion both implied real rates and inflation expectations have been distorted by the Federal Reserve's money-printing. As a result, the Federal Reserve has distorted the information it relies upon and has bamboozled itself. I have a synonym for "bamboozled," but this is a family Website. The first rule of propaganda is never listen to what you say; that rule has been violated and then some.