

Inflation Expectations Declining Still

Medieval theologians argued how many angels could dance on the head of a pin (Five; thanks for asking). I lie awake at night and occasionally during the daytime wondering how future economic historians will regard our era. They will note, surely, we spent trillions of dollars to achieve little in the way of tangible goals; at least during the Great Depression, we constructed Hoover Dam and made Las Vegas possible, as if that were an accomplishment.

They certainly will not as well how we collectively wrote a check to ourselves and declared, at least while the stock market was rising, "Huzzah! We are rich!" No; as I have noted time and again, this is more a sign of a mental disorder than of a sound economic policy.

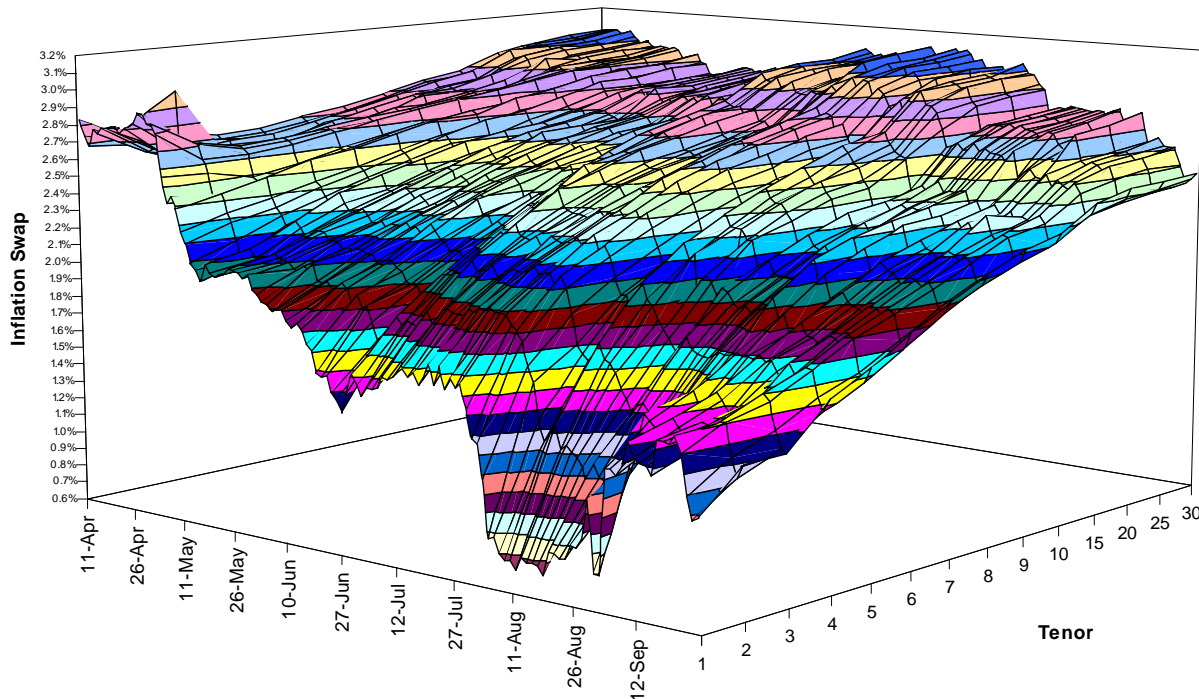
And our future chroniclers will note how the price of a metal with few actual uses rose skyward in anticipation of a future inflation that not only has yet to arrive but is not anticipated to arrive in government bond and inflation-linked bond markets such as TIPS.

Some might recall from their American history classes, at least back in the day when they taught actual history, the Monroe administrations were dubbed, "The Era of Good Feelings." No one remains today to attest how good they felt, but let's accept it for whatever it was. Our times might be called, "The Age of Thrashing About."

Pointing Lower

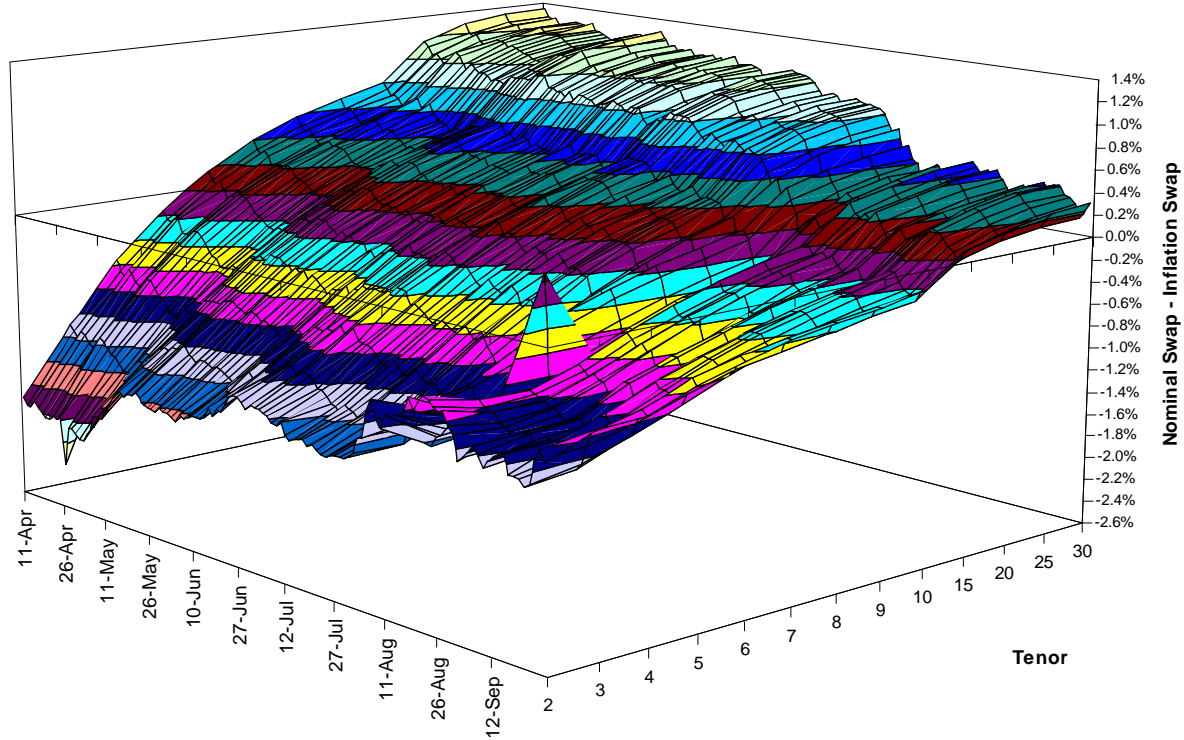
We might also be called, "The Era of Inflation Swaps," which sounds better than, "The Era of Too Flipping Many Derivatives That Serve No Useful Social Purpose," but I digress. These swaps peaked, to the surprise of many who thought QE2 was going to lead to much higher inflation, between late March and early May of this year. They declined particularly rapidly for short-dated swaps as it became apparent during the summer the next two years would be no economic garden party and the Federal Reserve would keep [short-term interest rates low](#) over that period.

Inflation Swap Rates After April High In Breakevens



If we subtract these inflation swap rates from nominal swap rates, we get breakeven swaps, and those are pointing lower as well.

Swap Breakeven Rates Of Inflation After April Peak



Those breakeven rates are [distorted](#) somewhat by the suppression of the Treasury yield curve, as I discussed last month. However, even if the breakeven rates are distorted, the expected consumer inflation rates themselves are a best-case estimation of where the CPI-U will be.

Are these lower inflation expectations good news? Not necessarily: They are an artifact of an impaired commercial banking system unable to convert free reserves into credit and to a very high demand for cash balances in the face of lackluster financial prospects. The real danger in all of this is the Federal Reserve and its sister central banks might think they have a license to print money in perpetuity and without inflation consequence. The first rule of reality is never believe your own propaganda.