TIPS and the Bond Market Anti-Vigilantes

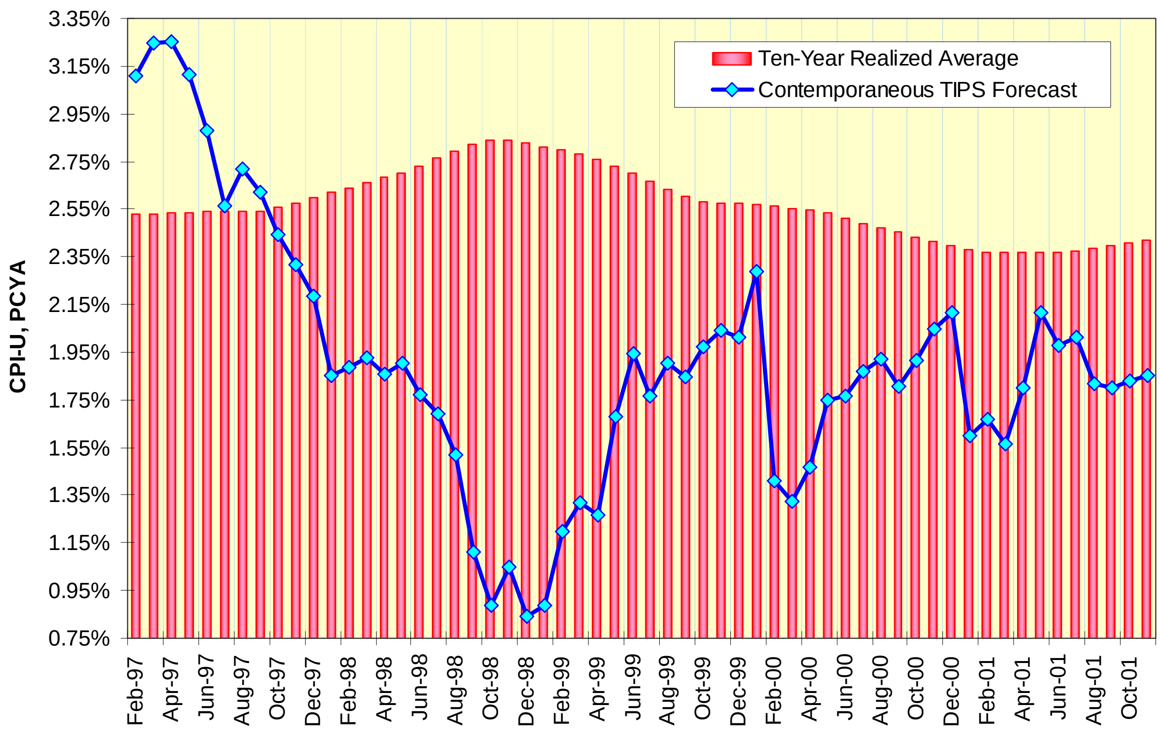
The TIPS Market Is Biased, But Not in the Direction You Think

An amusing e-mail was making the rounds a while back with images of how financial firms' traders, analysts and salespeople viewed each other and themselves. For example, the economists who sit on top of the firms' intellectual food chain and employ gravity to dribble who-knows-what onto the hapless grunts below, view themselves as Einstein clones and the salespeople as undisciplined frat-boys and expense account abusers.

Bond traders, as I noted in October 2011's Why Corporate Bonds Do Not Lead Stocks, tend to view themselves as flinty-eyed assessors of things as they really are and stock traders as gullible consumers of corporate press releases. This extends to assessments of inflation; bond traders view themselves as the first line of defense against wayward central banks' money-printing. These self-appointed bond vigilantes stand like Horatio at the bridge as the first line of defense against Ben, Mario and for all I know the complete Khanate of the Golden Horde.

Oh, piffle. Rather than sounding the clarion call against future inflation, the TIPS market's implied forecast, last discussed in February 2011's Assessing the TIPS Market's Ability to Forecast Inflation, has undershot the actual realized ten-year average of consumer inflation for each and every ten-year period starting with October 1997. As TIPS began trading at the very end of January 1997 and as the CPI is updated through November 2011 at the time of this writing, I can calculate the ten-year implied forecast and compare it to the ten-year realized CPI-U for the period ending with November 2001.

Assessing The TIPS Market's Forecasting Ability



The chart above always strikes me as astounding. The average breakeven rate of inflation implied by the TIPS market each and every month has at least two interesting attributes. The first is how low it has been since the late 1990s. In December, it implied an average annual change in the CPI-U of 2.017% for the next ten years; I would be happy to walk out of the grocery store some week and feel prices increased less than that since my last trip. Second, the TIPS market's forecast tends to be more of a reaction to current market conditions than a projection of future consumer inflation; please note how it has dropped during each and every bear market as noted in May 2010's TIPS Distortions During a Panic.

What this means in practice is the TIPS market systematically underpriced inflation risks between October 1997 and November 2001 and thus gave TIPS buyers a gift as the only way TIPS should outperform nominal Treasuries is for the realized CPI-U to exceed the TIPS market's breakeven rate. As I noted in March 2010's Free Inflation Insurance. Inquire Within, this is a bad way for you, the individual investor, to bet over the long-term.

A second, policy-related, implication is raised, and that is the Federal Reserve relies or claims to rely on feedback from the TIPS market and from related inflation-swap markets. If TIPS are not forward-looking but rather a coincident vane of market conditions, they will not signal policymakers of the error of their ways in time. A watchdog that barks at the burglar as he leaves the house is not worth all that much.