

Stock Returns And Inflation Expectations

Financial Liquidity Affects Both Markets Differently

I concluded in August 2011's Are [Stock Returns Inflation-Driven?](#) when speculation about Ben Bernanke announcing QE3 at Jackson Hole II was rife:

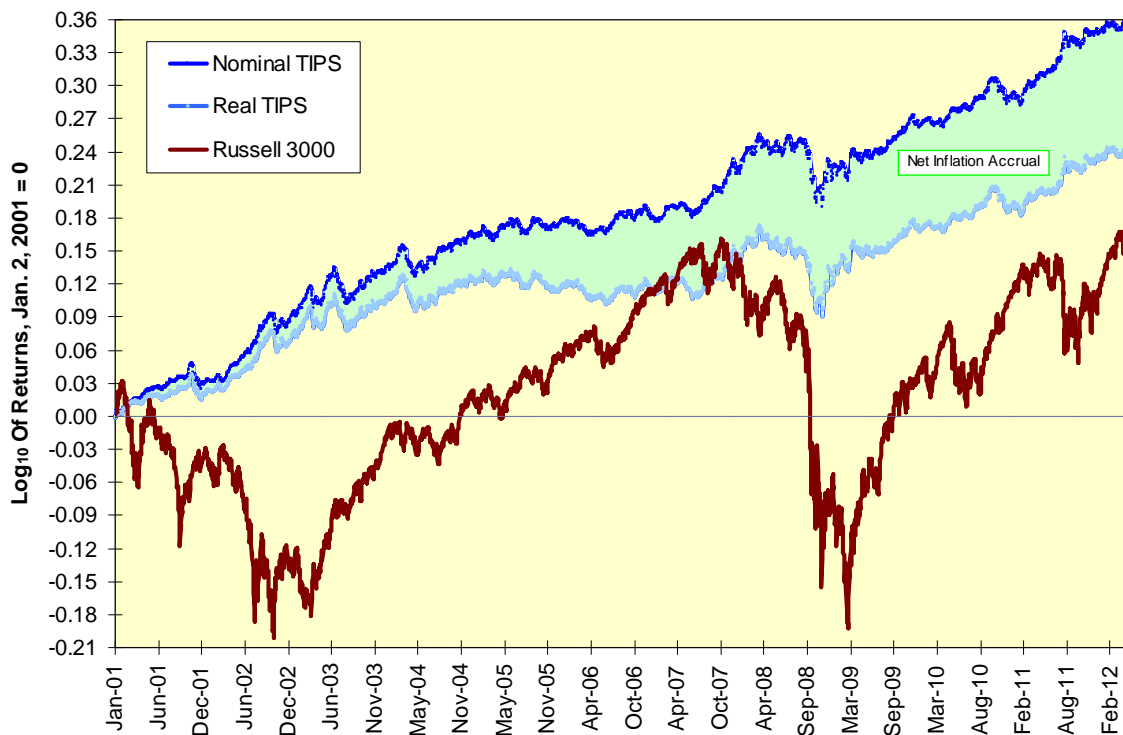
At the end of it all, we can conclude that while excess liquidity flows into financial assets first, it is disingenuous and methodologically sloppy to conclude stock returns are nothing more than the artifact of inflation expectations.

As the world has moved, more or less, back into a "risk-on" mode as discussed [Monday](#), and that move has been attributable, more or less, to the flood of ersatz money flowing from central bank spigots (at least that is where I hope it is flowing from) let's update that outlook.

Net Inflation Accrual

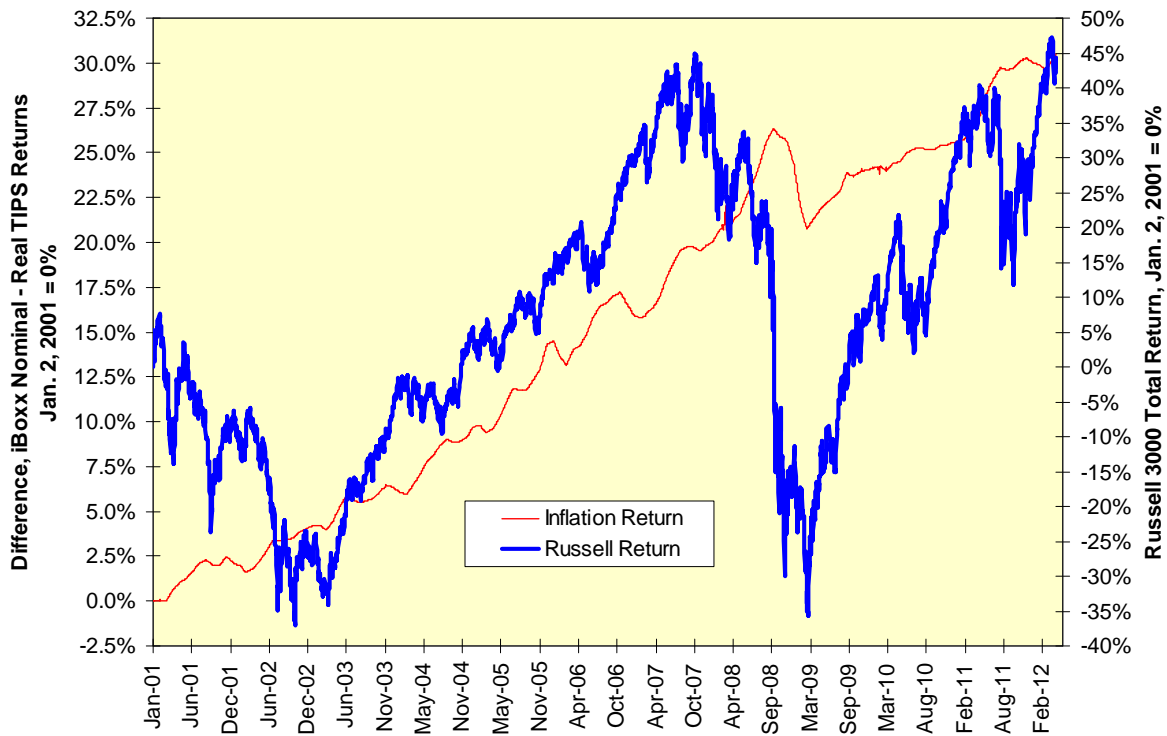
First, let's map the total return paths of two TIPS indices created by iBOXX, one for the instruments' nominal returns and one for the "real" returns after the inflation accrual was removed against the total return for the Russell 3000; all are re-indexed to January 2, 2001 and presented on a common logarithmic scale. There is no direct way I am aware of to trade the real TIPS return; there is no shortage of mutual funds and ETFs to trade nominal TIPS. A simple way to trade the Russell 3000 is through the iShares ETF (IUV).

Comparative Return Paths



Now let's isolate the net inflation accrual. This is different than plotting any breakeven rate of inflation against a stock index for the simple and yet easily overlooked reason each basis point in a bond investment has a much greater dollar impact as interest rates drive lower. If we plot the total return represented by this inflation accrual, the same concept as the return on the weighted-average breakeven rates in the index, against the total return on the Russell 3000, the differences appear in stark contrast.

Are Stock Returns Inflation-Driven?



Stock returns have been more volatile since the March 2009 market low, and the r^2 or percentage of variance explained in stock returns by inflation accrual since that time has been a so-so 0.675. The r^2 since the Jackson Hole speech at the end of August 2010 has been a trifling 0.10. If excess money and rising inflation expectations were the drivers behind equity returns, the r^2 levels would be much higher.

The TIPS Mystery Continues

One of the stranger aspects of TIPS breakevens is how they rise and fall quickly within a trading range and appear to convey a great deal of information in the process and yet have remained confined within a multiple year range with the very significant exception of the 2008-2009 crisis. They may be the most over-analyzed numbers for their actual significance we have.

What is or should be clear right now is the Federal Reserve's profligacy has yet to propel these numbers higher. Worse, as nominal rates decline, a near-constant breakeven implies negative real rates for TIPS. If you buy stocks, you are buying a set of embedded call options on earnings growth and you have an alternative to the known real losses in the bond market. Why anyone should compare the two markets and posit an equivalence between TIPS breakevens and stock returns is unclear.