

Bond Market Accepts Higher Inflation Expectations

All those presently decrying the plague of derivatives upon the land and offer the good offices of the federal government, including but not limited to the SEC, the CFTC, the FDIC, the OCC and, of course, the BFD (OMG!) as a solution should do the sensible thing, defined herein as sitting down, shutting up and listening to me in whichever order they choose. The simple fact of the matter is we do not have enough derivatives and indices to suit my analytic purposes. For example, even though we have inflation-linked bonds and inflation swaps, we could really use some inflation options so I could derive implied volatilities of expected inflation. Life can be so cruel.

For now, however, I will have to use a backward-looking historic inflation measure, if for no other reason than to avoid the messy metaphysics associated with a forward-looking historic measure. This measure is constructed by converting the expected inflation measure derived from TIPS into a bond-equivalent price, taking the returns from that price series and calculating a 21-day historic volatility therefrom.

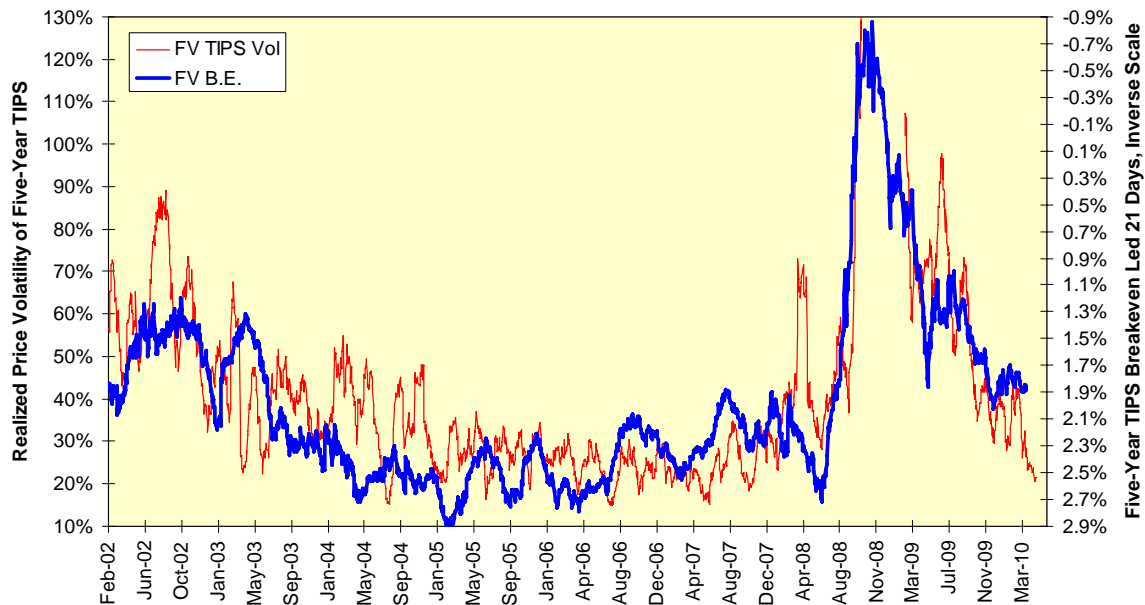
The results confirm the oft-cited principle of bond market implied volatility: While the implied volatility of stocks rises when prices fall, the implied volatility of bonds rises when prices rise. Bond traders are inherently distrustful of rallies and believe low yields are intrinsically unstable. In addition, as bond traders are born worrying about inflation, any whiff of higher expected inflation confirms their fears and, paradoxically, results in both lower implied and historic volatility.

Bonds: One market but every psychological disorder.

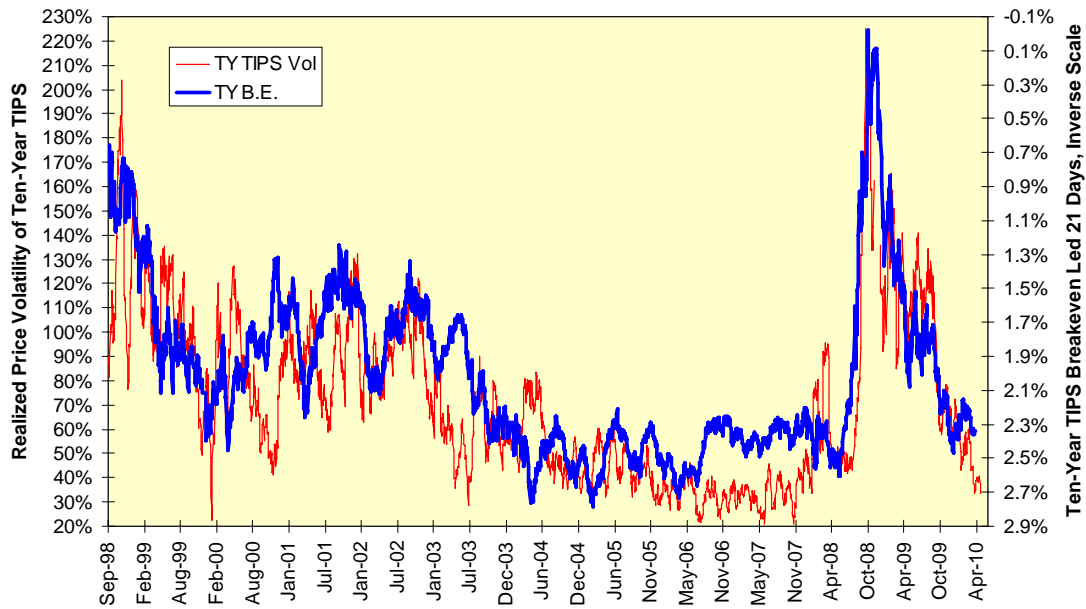
The Evidence

If we map the realized price volatility of the inflation component of the TIPS against the breakeven itself plotted inversely and led by 21 days to account for the nature of the calculation, we find a very strong and unusually symmetric correlation. This holds true at both the five- and ten-year horizons.

Five-Year TIPS Inflation Volatility Declining As Breakevens Rise



Ten-Year TIPS Inflation Volatility Declining As Breakevens Rise



We should remember this lower realized volatility is not causative per se; we cannot claim lower realized inflation volatility must lead to higher expected inflation. However, there are no instances on record where the opposite obtained; we cannot find lower volatility leading to lower expected inflation.

If this seems like a biased and asymmetric outcome, it most certainly is. The bond market seems perversely at ease with the fulfillment of its negative view of the world that higher inflation and higher interest rates are on the way. Will they be happy if and when this view materializes? Absolutely not: They will find something else about which to worry.