

Where Inflation Works For You

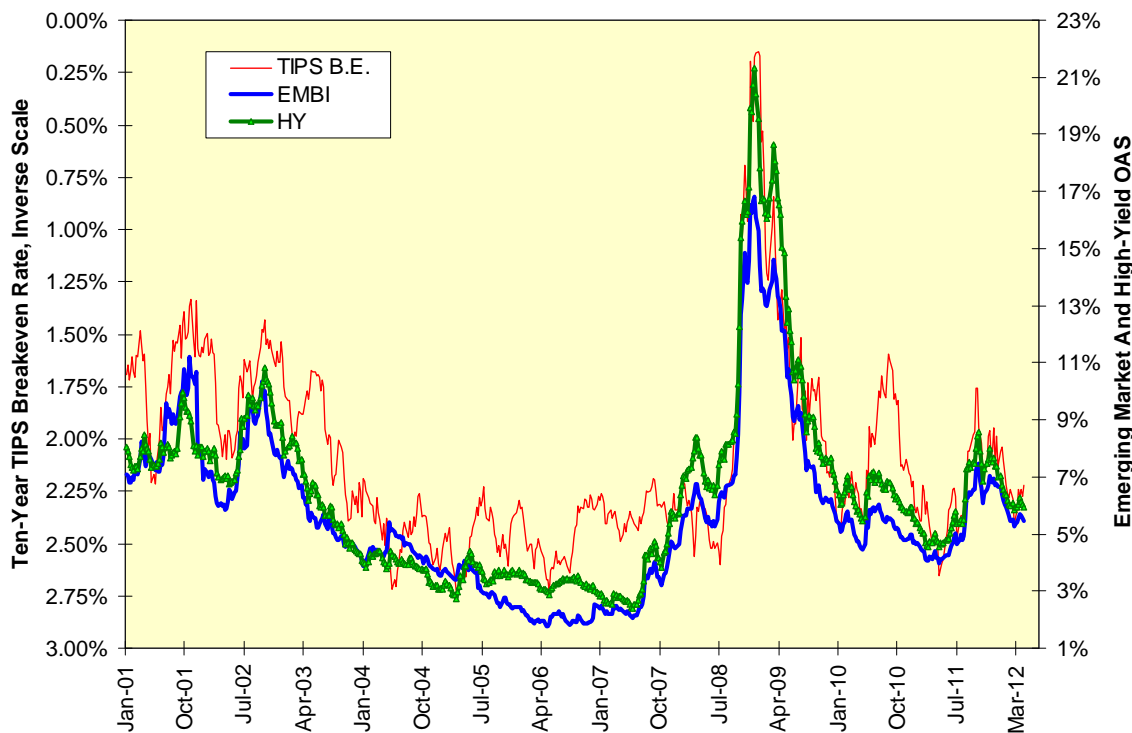
Higher-Yielding Bonds' Spreads Narrow As Inflation Expectations Rise

It is confusing, yes it is: Should I be proud or embarrassed to live in a country wherein all of my best-intentioned advice on how to be a mogul of one sort or another tends to be rejected by the squeamish and their virtuous self-images? When the price of various food products rise and I tell the chronic complainers they can join the ranks of Big Pork by buying ConAgra (CAG) or they can join the ranks of Big Krispies by buying Kellogg (K), they kind of shuffle, look at their feet and demur.

If, as I suggested [yesterday](#), the only mission the Federal Reserve has succeeded in accomplishing is lowering the federal government's cost of debt service then it would stand to reason you could join Big Print by finding something that would benefit from the debasement of the currency. Two of the better alternatives lie in the category known as "risky bonds" to distinguish them from the "safe" sovereign bonds of various European countries, emerging market and U.S. high-yield bonds.

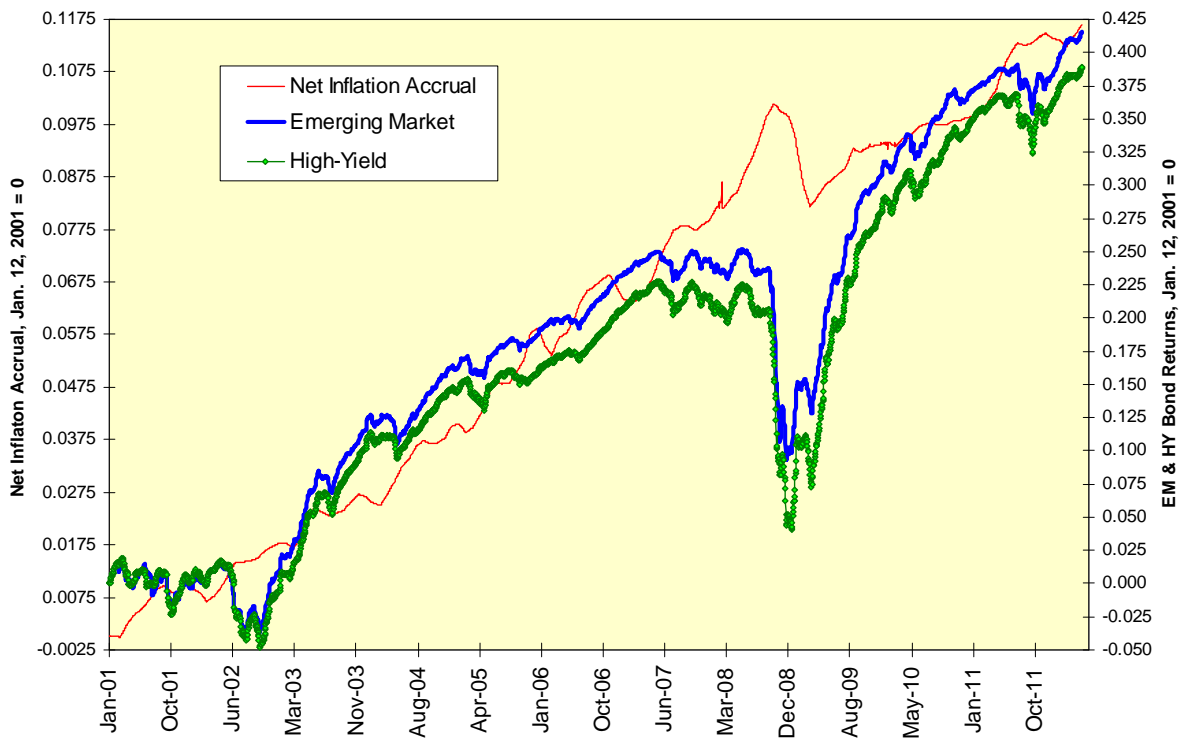
Let's take a look at this two ways. The first is to compare the ten-year TIPS breakeven rate of inflation, a measure I regard as having at least as many flaws as virtues, against the option-adjusted spreads (OAS) for the Bank of America-Merrill Lynch Emerging Market Plus and High-Yield Master II indices, respectively. The OAS measures move inversely to the TIPS breakeven rate, which means the more inflation expectations rise, the lower the credit risk of the emerging market and high-yield bonds become.

Inflation Expectations And Risky Bonds



We should never just slap a couple of lines down on a chart that sort of resemble one another and pretend we have discovered either correlation or causation or both. A second, and for me preferred way of looking at this relationship is to map the total returns of the two bond indices against the net inflation accrual index (see [Stock Returns and Inflation Expectations](#)). These returns are plotted on a logarithmic scale going back to the start of the iBOXX TIPS indices in January 2001.

Risky Bonds' Returns Following Inflation Expectations Post-Financial Crisis



Here we can see the bonds' returns sometimes have led and sometimes have lagged those of the net inflation accrual measure; this rules out causality. More important, the credit-risk induced divergence during the financial crisis underscores there is much more to risky bonds' returns than inflation expectations. However, what is and has been true during the entirety of the quantitative easing era is higher net inflation accrual leads the bonds' returns. As this should remain true for however long the threat of additional money-printing remains with us, it behooves you to stay with both emerging market and high-yield vehicles. Unlike Goldman Sachs (GS), you may not be doing God's work, but you are not fighting the Fed.