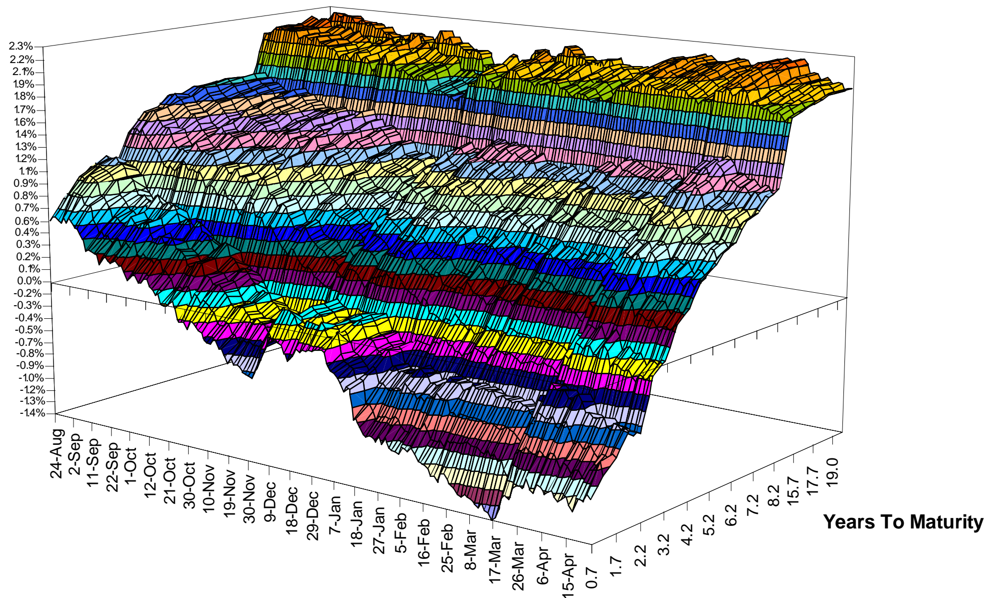
Short-Dated Inflation Expectations To Rise First

If, as suggested yesterday, we have to reason to expect TIPS breakevens to decline, and if U.S. short-term rates are artificially low, can we learn something from the term structure of the TIPS market about the time-dependence of how and when inflation expectations will change?

Of course; as some might say, it is a market of TIPS, not a TIPS market (it is amazing what is allowed to pass for wisdom on Wall Street. Stocks did not crash; they gave you a buying opportunity, etc). We can map the real yield on each individual TIPS bond going back to the August 24, 2009 date when three-month dollar rates went below three-month yen rates and established the greenback as the cheapest currency to borrow for purposes of investment and general merry-making.

Real TIPS Yields After USD LIBOR Traded Below JPY LIBOR

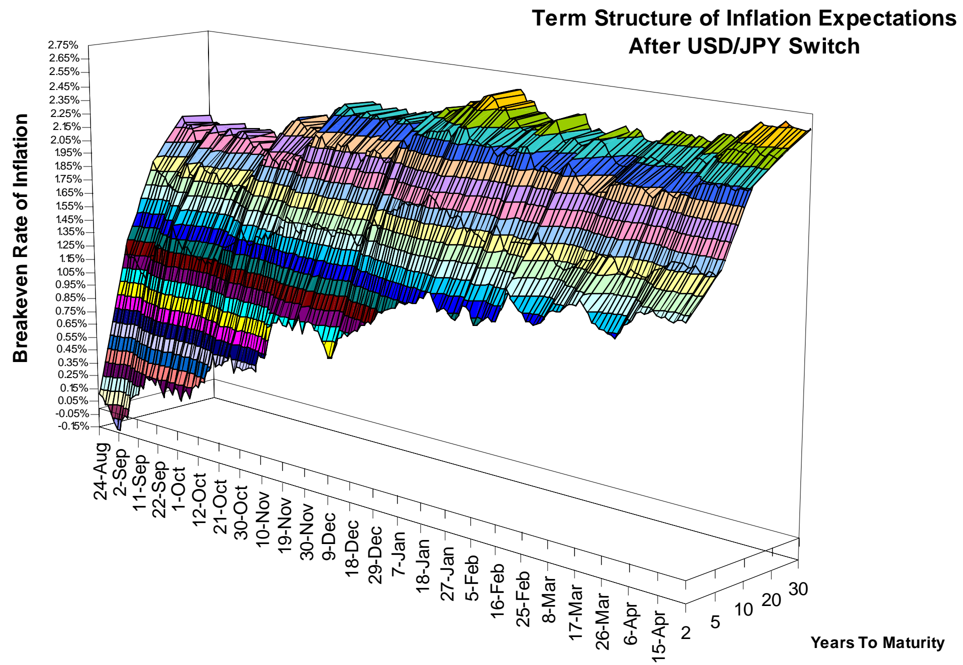


Please note the time-dependence in this chart. Long-term TIPS yields have been stable, but real yields at the short-end of the curve went negative as early as the end of October 2009. Part of this negative-yield picture is attributable to the threatened loss of the bonds' accrued inflation index as maturity approached in a low-inflation environment, but much of the negative real yield is attributable to the simple flood of dollars rolling off the printing presses. If there is a better way to demonstrate there is too much free cash available, I am unaware of it.

The negative real returns on cash and the stable long-term yields have created a very favorable environment for the aforementioned merry-making in risky assets. While we have moved past the point of debate as to whether the economy is in a full-bore recovery, this artificially steep yield curve for real rates has been behind the sense of unease many investors have about the rally being built on a house of cards.

Expectations

If we now shift from a real-rate map to an inflation breakeven map using generic two-, five-, ten-, twenty- and thirty-year TIPS breakevens, we see another strongly time-dependent pattern. The seldom-examined thirty-year breakeven has increased by almost forty basis points since last August, but the ten- and twenty-year breakevens have increased by only a trivial amount. The real action, once again, is at the short-end of the yield curve. The five- and especially the two-year breakeven rates have shot higher as the flood of money coming into the banking system has burst over the levees – see those negative real yields above – and is threatening to push inflation higher over the next two to five years.



That is the bad news. The good news goes to the merrymakers once again: As there is no evidence yet of the monetary taps being turned off, the real returns on cash will remain negative and that will drive money out along the risk and maturity curves. Short-term inflation expectations will rise, but outside of a few financial writers and other assorted dyspeptic scolds, who cares? Remember, if you are the world's largest debtor, your interests do not lie in seeing inflation fall and drive up the real value of your debt.