News Flash: Inflation To Drop In Five Years

If Albert Einstein could run "thought experiments," then so can I; my thought experiments could not do half the damage the Federal Reserve has been doing with its monetary equivalent of the Gilbert Chemistry set. Here goes: Could the Treasury sell the opposite of its Treasury Inflation-Protected Securities (TIPS)? And, if they could, what would their catchy acronym be? DIPS?

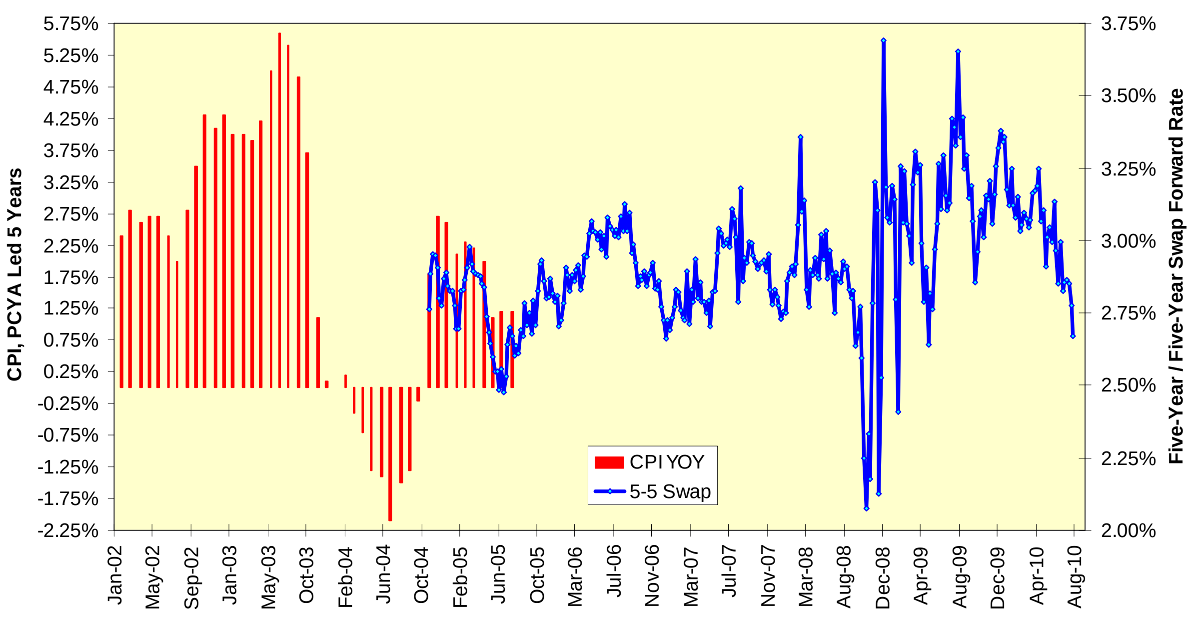
While you are pondering that, let's turn our attention to another one of those esoteric indicators designed to separate the cognoscenti from the riff-raff, forward-starting inflation rates. There is an inflation swap market for things such as what will inflation be for a five-year period starting five years from now; known as the five-year/five-year, it produces much thoughtful introspection amongst people who, if they lived in Mao's China, would be sent out to the countryside to do something socially useful such as clean the hogs' latrine.

Five-year/five-year; give me a break. I really want to see the list of people who in August 2005 predicted any of the major moves we have seen individually, much less in conjunction. But these markets are not about prediction so much as they are about providing a trading instrument where real dollars, should any of those actually exist, can change hands once the settlement periods start five years from now.

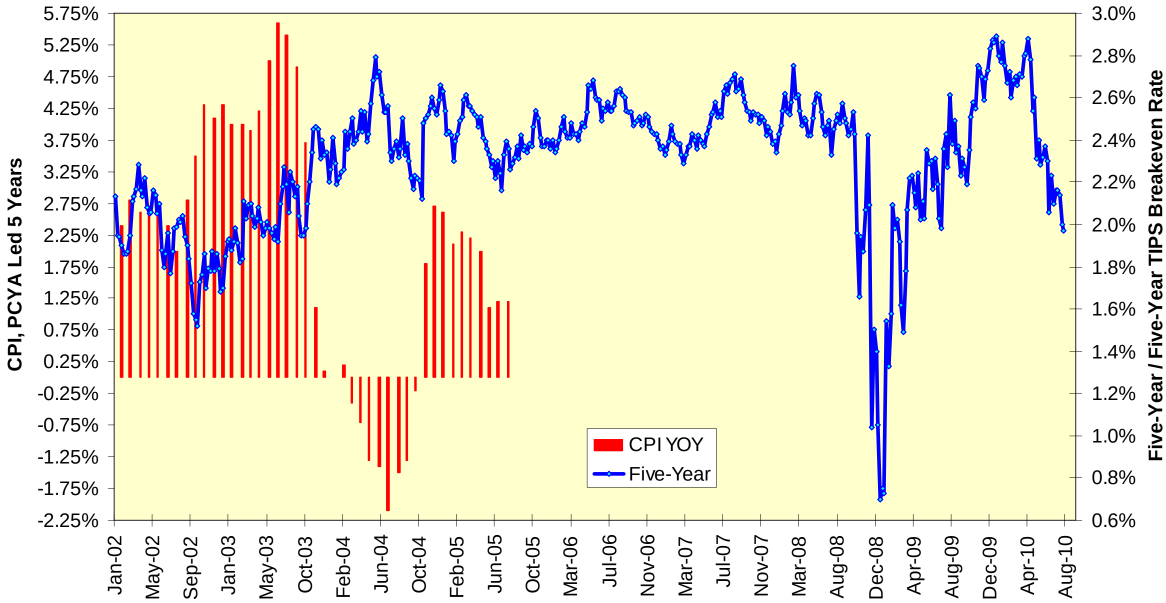
Look Out Below

Even it these markets do not prove correct in their eventual assessment of where the CPI will be they do a good job of measuring where current expectations are. We can construct five-year/five-year markets from the forward rate between on-the-run five- and ten-year TIPS, a measure we can take back to the start of 2002, or from the forward rate between five- and ten-year inflation swaps, a measure we can take back to November 2004. Those measures can be mapped against actual year-over-year changes in the CPI led five years.

Five-Year / Five-Year Inflation Swap Forward Rate & Realized CPI



The TIPS Market Is Not A Perfect Forecaster



Both forward-starting inflation measures started collapsing this past spring. Is it any accident this is when the present bond rally started to take off? If you start to price the risk of inflation out of long-term bonds, the yields on those bonds fall; the question of whether the market is any better in its assessment than a Roman entrails-reader or some blue-painted Druid priestess is irrelevant.

Time For DIPS

On second thought, let's go back to the question above whether Uncle Sam should sell deflation-protected securities. As any designed of financial products can tell you – but few will – you need a story to sell the product. The U.S. Treasury is the largest debtor and therefore has the most to fear from deflation, so it needs to declare another war on deflation and enlist the support of you, the patriotic citizenry. Sell the chumps, er, patriotic citizens doing their part zero-coupon DIPS that will pay back at par if the CPI rises and will pay a taxable accrual on declines in the CPI. In other words, borrow at 0% and never pay them anything.

If this scam, er, financial product grows to the size of the TIPS market, fudge the CPI so that the Treasury's net payout on the accrual will be $0 before tax and negative after tax. Sound far-fetched? Have you check the economics of Social Security recently?