Remembrance Of High-Inflation Past

And I have led you forty years in the wilderness: Your clothes are not waxen old upon you, and thy shoe is not waxen old upon thy foot. – Deuteronomy 29:5

While Bible scholars are a notably disputatious lot and are perfectly willing to whack each other upside the head with the Good Book, they generally agree on the lesson of wandering in the wilderness for forty years: It takes two generations to forget the sins of their elders and thus to be increasingly vulnerable to repeating them.

It was forty years ago this August that President Nixon devalued the dollar, increased tariffs and began the first of what were to be a disastrous series of wage and price controls. The year-over-year changes in the Consumer Price index in July 1971 was 4.4%; by the time the inflation cycle peaked in March 1980, the CPI was rising at a 14.8% clip.

As more than an aside, the Great Inflation of the 1970s was born during the 1960s with such developments as the creation of Special Drawing Rights at the International Monetary Fund, a too-loose Federal Reserve and unwillingness on the part of President Johnson to finance the combined costs of the Vietnam War and Great Society with higher taxes. If any of this sounds analogous, it should.

Moreover, all of these developments preceded the jump in grain prices in 1972, the jump in cattle prices in 1973 and, finally, the jump in crude oil prices in 1973-1974. Yet the Great Inflation is linked inextricably in the public mind with higher commodity prices in general and higher crude oil prices in particular, as if something in 1974 could have caused the imposition of wage and price controls in 1971. Very strange.

Bonds During The Double-Digit Era

The term "double-digit inflation," meaning annualized changes in the CPI of 10% or more, is more descriptive of an era than "NASDAQ 5000," which lasted for all of two days in March 2000. Technically, we could limit the era to March 1979 – October 1981. But inflation is a state of mind as much as it is a state of economics, and if we look at the heavy black line in Charts 1 and 2, we can extend the era both backwards and forwards to December 1976 – July 1983. Trailing one-quarter returns for both Treasuries and corporate bond indices over a range of maturity segments are overlain against the CPI's changes.

Chart 1: Government Bond Performance During Late 1970s / Early 1980s Inflation

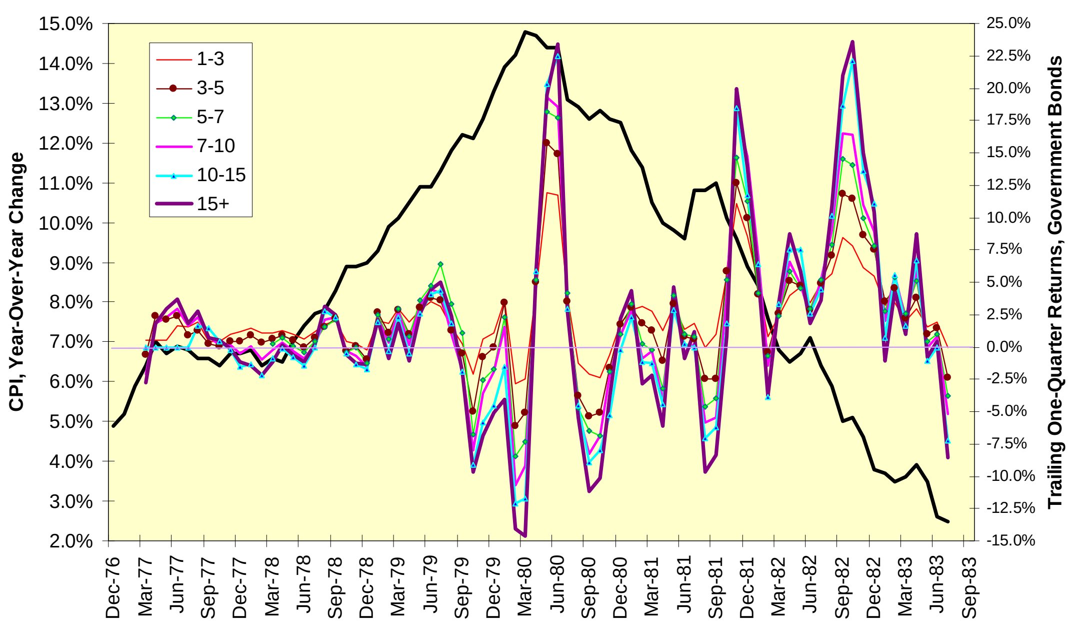
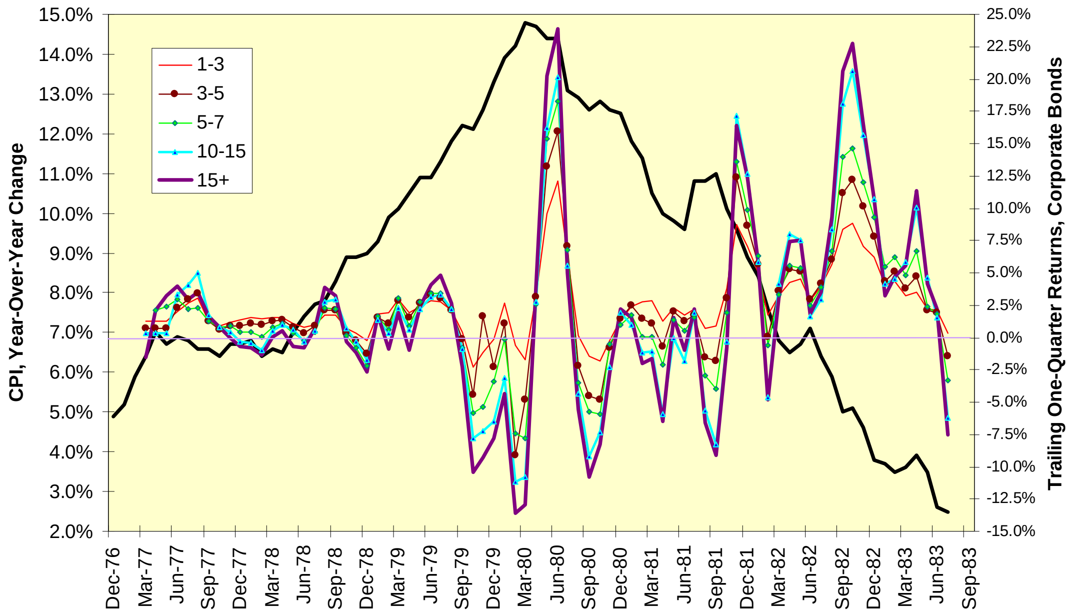


Chart 2: Corporate Bond Performance During Late 1970s / Early 1980s Inflation



The high-inflation era was characterized by large swings in both the ordinal level of interest rates and in the yield curve as measured by the forward rate ratio ($FRR_{2,10}$) between two and ten years. This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more the $FRR_{2,10}$ exceeds 1.00, the steeper the yield curve. Inverted yield curves, which were common during the period and which reflect the attempts by the Federal Reserve to rein in inflation by raising short-term interest rates, have $FRR_{2,10}$s less than 1.00.

The three month-ahead total returns for both 7-10 year Treasury bonds and 5-10 year investment-grade corporate bonds are mapped against inflation and the yield curve in Charts 3 and 4. Positive returns are depicted in color; negative returns in white. The absolute magnitude of the return is reflected in the diameter of the bubble.

Chart 3: Three Month-Ahead Returns For 7-10 Year Treasury Bonds
As A Function Of Yield Curve And Inflation

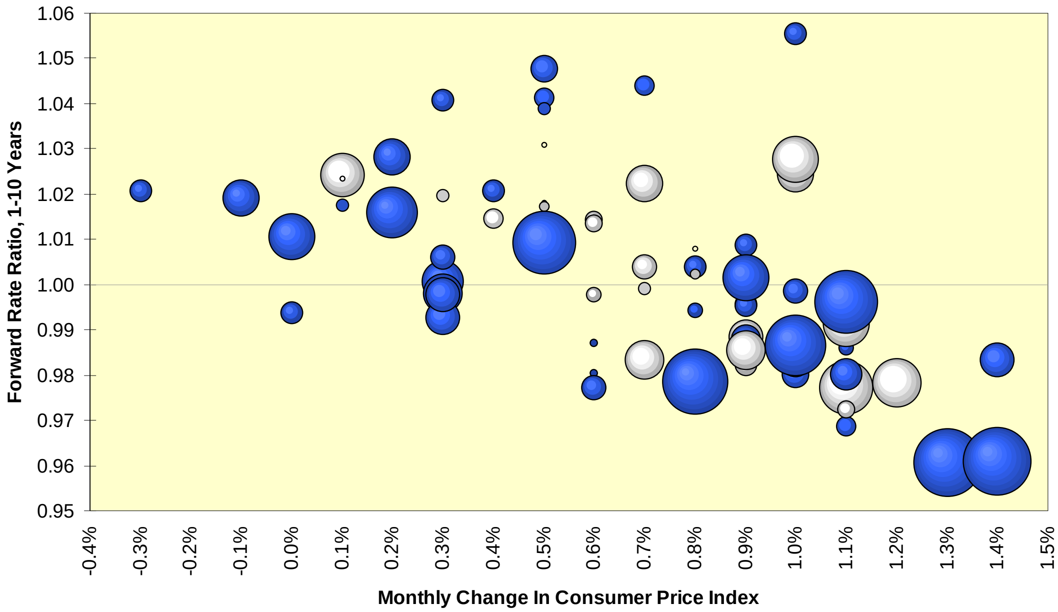
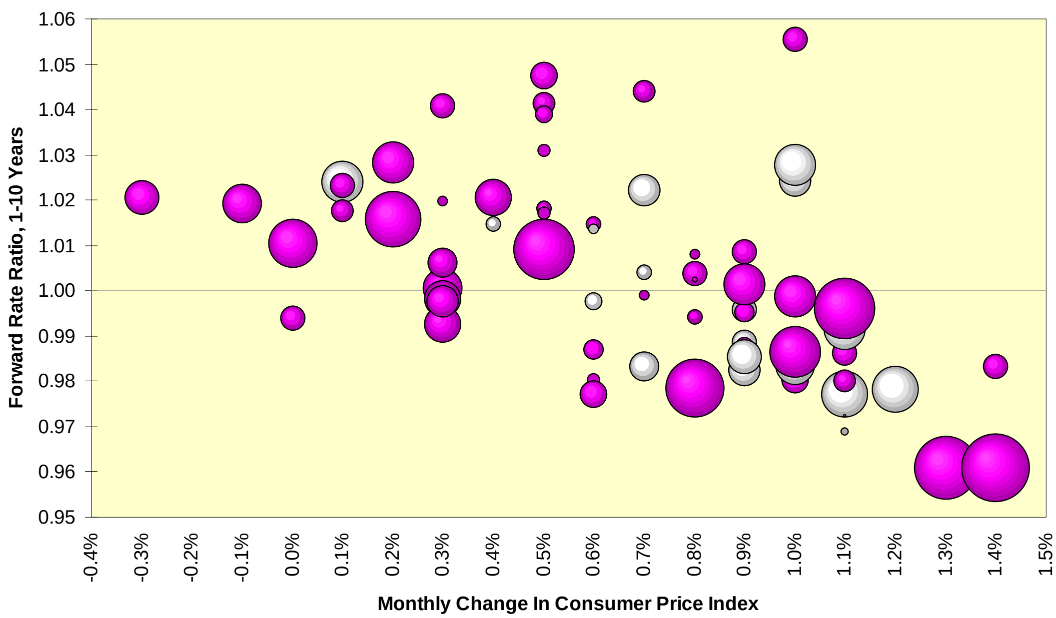


Chart 4: Three Month-Ahead Returns For 5-10 Year Corporate Bonds
As A Function Of Yield Curve And Inflation



Charts 3 and 4 can be duplicated across the spectrum of maturities shown in Charts 1 and 2; we will not show all of them here in the interests of time and space, but simply will summarize their results and offer several conclusions. First, higher-yielding corporate bonds had consistently higher returns in the high-inflation era than did Treasuries. Second, high short-term interest rates and the inverted yield curves common to that era made shorter-maturity bonds a better investment as they had less duration risk.

Third, the near-mechanical policy of that era was to flatten or invert the yield curve in response to high inflation. If the yield curve was steep at the start of a period, prospective returns suffered. Investors fled in fear of higher short-term interest rates. Finally, the principle of buying when other people are selling was honored then as now. The best returns, especially for shorter-maturity bonds, emerged from those periods when the yield curve was most inverted and when the current inflation readings were highest. This trade is easier said than done.

What Do We Learn From History?

Bond investors fancy themselves a cut above other investors; this is especially true at the institutional level. They see stock traders as a bunch of story-swapping touts who trade on a wing and a prayer and rely on what had been a long-term secular bull market to bail themselves out of bad trades.

This is grossly untrue; research done by the author and involving tools such as Granger Causation analysis finds no sophistication advantage between stock and bond traders. In fact, bond traders often are notably slow on the uptake when they are getting beaten to a pulp. It took fixed-income investors until the late 1970s to grasp the damage produced by rising inflation during the early 1970s. In reverse, it took them several years into the disinflation of the 1980s to embrace bonds and bid yields lower; this was after a false start in 1980 when bonds shot higher only to be clobbered once again when Paul Volcker raised rates a second time.

Markets are supposed to look forward, not backward; in either event, we should expect self-proclaimed Masters of the Universe to catch on to trends after a few years.

The policy uncertainty created by Paul Volcker went a long ways toward maintaining a higher cost of capital than would have existed otherwise. One of the largest determinants of the liquidity premium, or spread between long- and short-term interest rates, is interest rate volatility. Currency volatility is critical as well; foreign investors facing wide fluctuations in the dollar demand higher yield in recompense. Investors demand compensation for these risks in the form of higher long-term yields.

The net result of all of this was the U.S. did not escape the true costs of high inflation until the very end of the era. The great bull market did not begin until August 1982, nearly a year after ten-year Treasury yields peaked in September 1981. The herky-jerky Volcker was replaced by the gradualist Greenspan who both raised and lowered short-term rates slowly until he started to believe his Maestro propaganda and left us with a string of disastrous bubbles. The next inflation may be greeted with a gradualist response at first. This will give you time to exit. Then whoever is in charge might have to start pushing rates higher, provided they have the political cover to do so. We need to remember inflation had been a scourge upon the land for more than a decade when Volcker first received political cover from President Carter to wring inflation out of the system with very high short-term interest rates. How long will Americans tolerate high inflation the next time it arrives? After wandering in the wilderness for forty years and observing the behavior of the 1970s, the guess here inflation will be tolerated for a decade at least after it arrives in force.