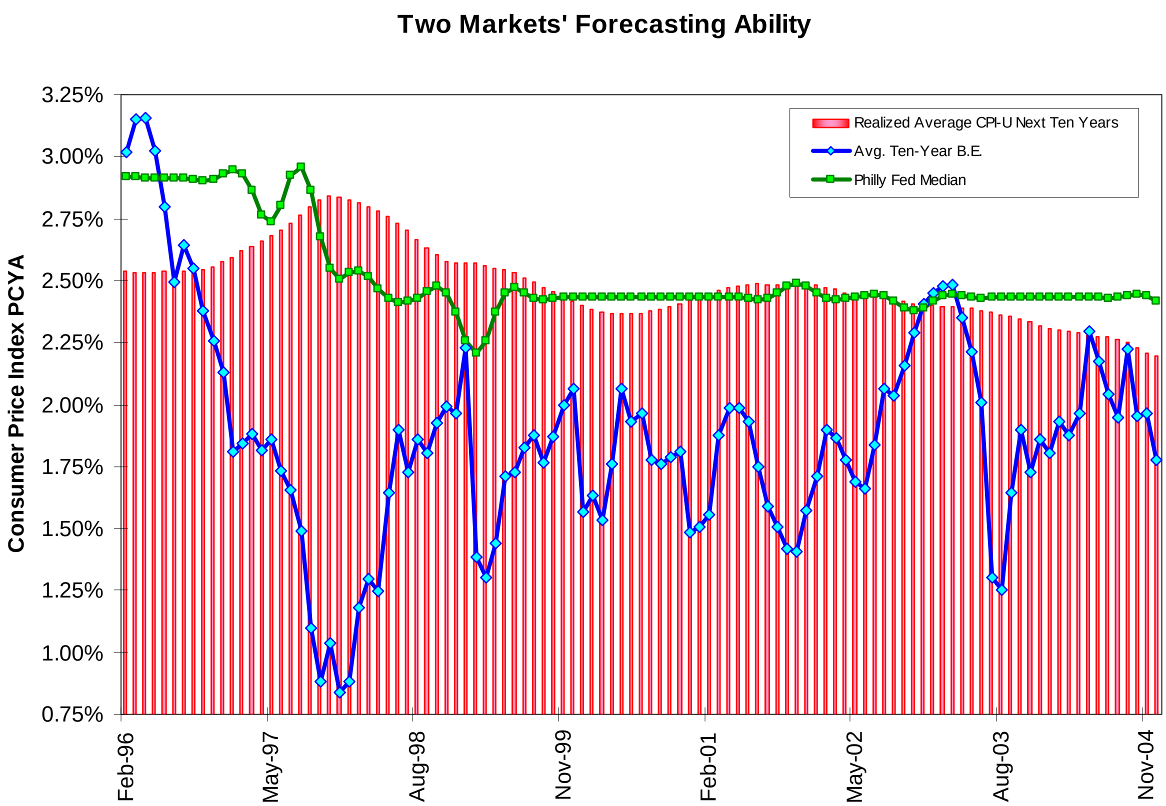
Score One For The Economists

Back in the days when the U.S. and the Soviet Union were going toe-to-toe in the Cold War, the annual May Day parade through Red Square was kind of a Woodstock for scary people. Grey men in cardboard suits would stand on top of Lenin's Tomb in a pecking order studied with the intensity of an FOMC communiqué and watch the troops and toys go by; this was also their version of the Las Vegas Consumer Electronics Show where new products were introduced on their short path to obsolescence.

One year as the parade was about to end, Brezhnev saw a figure sauntering all by himself at the end of the show, hands in his pockets, whistling and taking in the sights. At once angered and perplexed, he demanded of the commanding general, "Who is that?" To which the general replied, matter-of-factly, "That's an economist, Comrade Secretary. Do you have any idea how much damage they can cause?"

Implied And Actual Inflation Forecasts

It might surprise you, then, to learn the ten-year median forecasts of economists surveyed by the Philadelphia Federal Reserve has beaten the pants off the TIPS market's implied inflation forecast. I took their quarterly forecasts, knocked them down to a monthly frequency using cubic spline interpolation (come on, you would, too) and matched them to a series of monthly average ten-year breakevens. I then compared those two forecasts to the actual rate of consumer inflation over the next ten years.



The results are unequivocal. The average forecasting error for the TIPS market of 0.64% represents 25.89% of the realized ten-year forward average of the CPI-U; the comparable numbers for the Philadelphia Federal Reserve panel are 0.17% and 6.81%. The TIPS market's implied forecasts were biased lower, giving them a skew of 0.25 as opposed to the economists' forecast error skew of -0.72.

Of course, the comparison is somewhat unfair and irrelevant. The TIPS market's purpose is trying to make money by capitalizing on small moves in inflation expectations. This forces a short-term focus. A trader in inflation derivatives is not charged with being right but rather with navigating the short-term noise produced in large quantities relative to the long-term signal. But a win is a win. Next time you see an economist, buy him or her a free lunch.