TIPS Breakevens Do Not Track Energy Prices

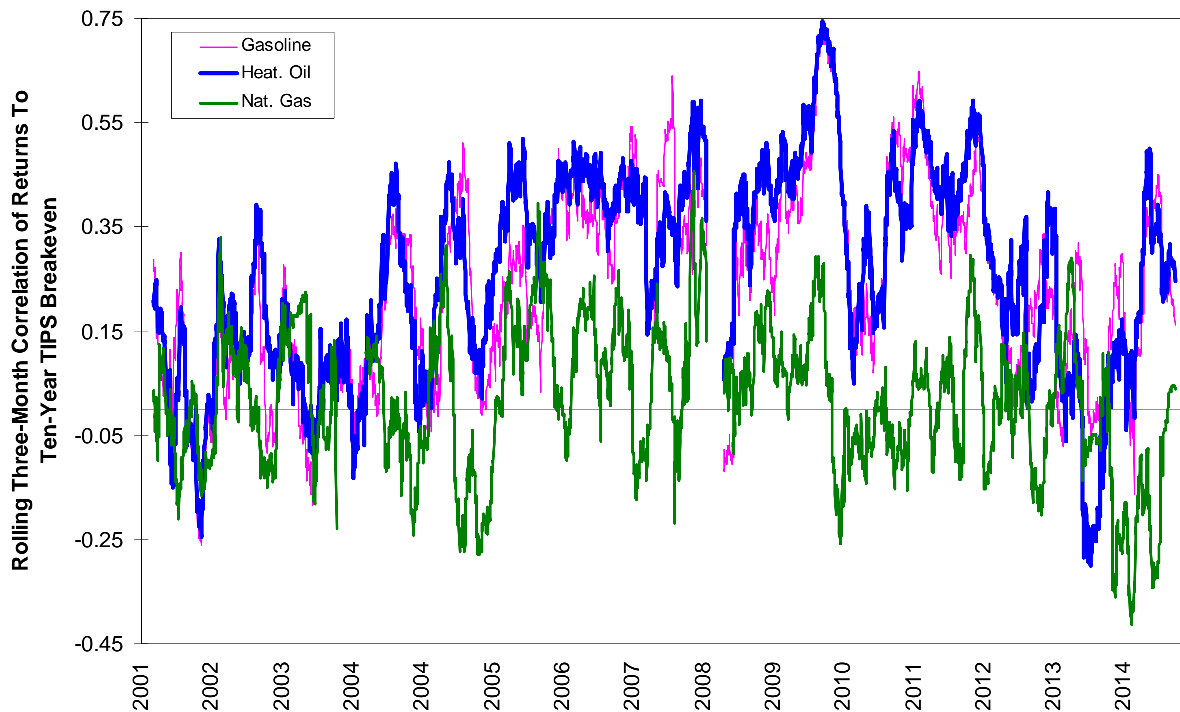
Holding truths to be self-evident may be a fine way to write political documents, but it has no place in market analysis. Check that; it seems to have a lot of place in market analysis judging from the number of times you will see reference made to energy prices in a discussion of inflation expectations.

While that last sentence may have passed before your eyes without much dissection, it contains two generalizations. The first is "energy prices." The common practice is to look at changes in front-month crude oil prices as if these have a direct effect on the Consumer Price Index for urban consumers (CPI-U) upon which the inflation accrual measure for TIPS is based. Unless you are a refiner or one of those strange get-back-to-nature types who wants to camp out in the woods and use naturally occurring asphalt seeps as either an insect repellent or waterproofing for your birch-bark canoe (Don't laugh too hard; this is how the early oil fields in Pennsylvania, Ohio and southern Ontario were located) you will pass through your entire life without once having purchased crude oil and you will smell better for it.

The second is TIPS breakevens are an unbiased measure of inflation expectations. To keep a very long story a little shorter, this has not been true during the entirety of the post-crisis era. Central bank purchases of bonds, deliberate twisting of the yield curve, competitive currency devaluations, regulatory preferences for nominal sovereign bonds and central bank purchases of inflation-linked bonds such as TIPS themselves have distorted the spread. The tragicomic aspect of all this is central banks read the results of their own distortions to assess inflation expectations.

Wholesale Product Markets

Instead of using crude oil prices, let's take a look at the wholesale prices of two refined petroleum products, heating oil in New York Harbor and 87-octane gasoline at the U.S. Gulf Coast, and of natural gas at the Chicago city gate. A rolling three-month correlation of returns between these markets and ten-year TIPS breakevens shows long periods when then correlations were negative and only one brief period, the summer of 2010, when the correlation between the petroleum products and TIPS breakevens even exceeded 0.70.



The post-2001 r-squared levels between ten-year TIPS breakevens and gasoline, heating oil and natural gas markets are trivial, 0.191, 0.136 and 0.094, respectively. None of these markets should be considered explanatory for inflation expectations.

Will this stop anyone from fretting the post-January rebound in energy prices will lead to higher inflation expectations? Not a chance; this response is Pavlovian and had been since the 1970s.

You do remember the 1970s, don't you? That is when the Nixon administration imposed wage and price controls in August 1971 in response to rising inflation and, more than two years later, the first oil shock arrived. This exercise in time-travel was interpreted as higher gasoline prices causing the inflation that was a problem already.