Inflation Expectations Stand Like A Stone Wall

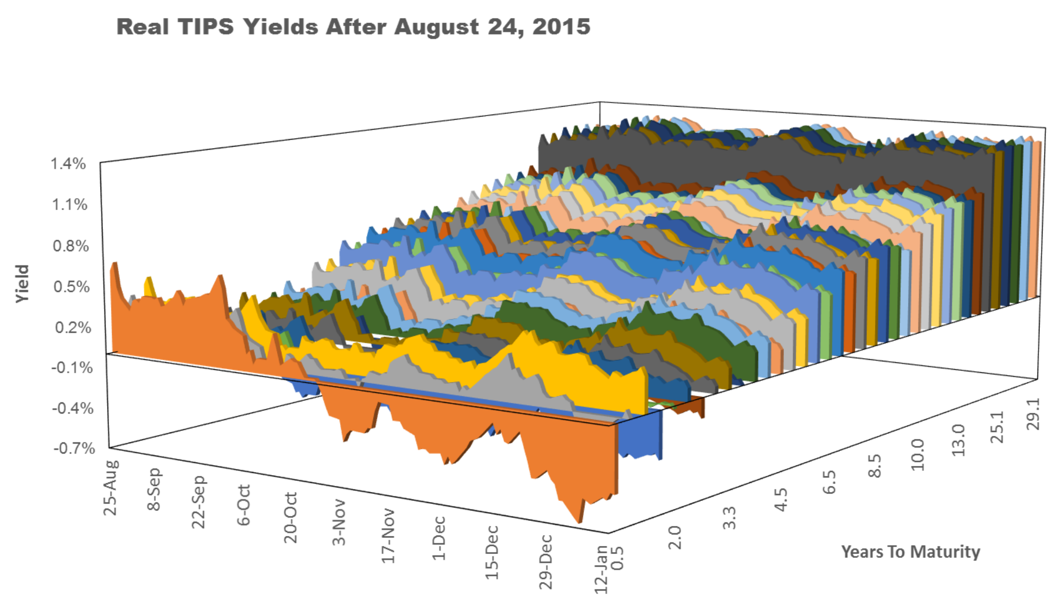
One of the most famous nicknames in American history, that of Thomas “Stonewall” Jackson, is something of a cipher. At the first battle of Bull Run in July 1861, South Carolina commander Bernard Bee called upon his troops: “There stands Jackson like a stone wall! Rally behind the Virginians!” Military historians long have puzzled whether this was a compliment to Jackson’s imperturbability in the face of fire or a reference to a thumb placed inappropriately during the heat of battle.

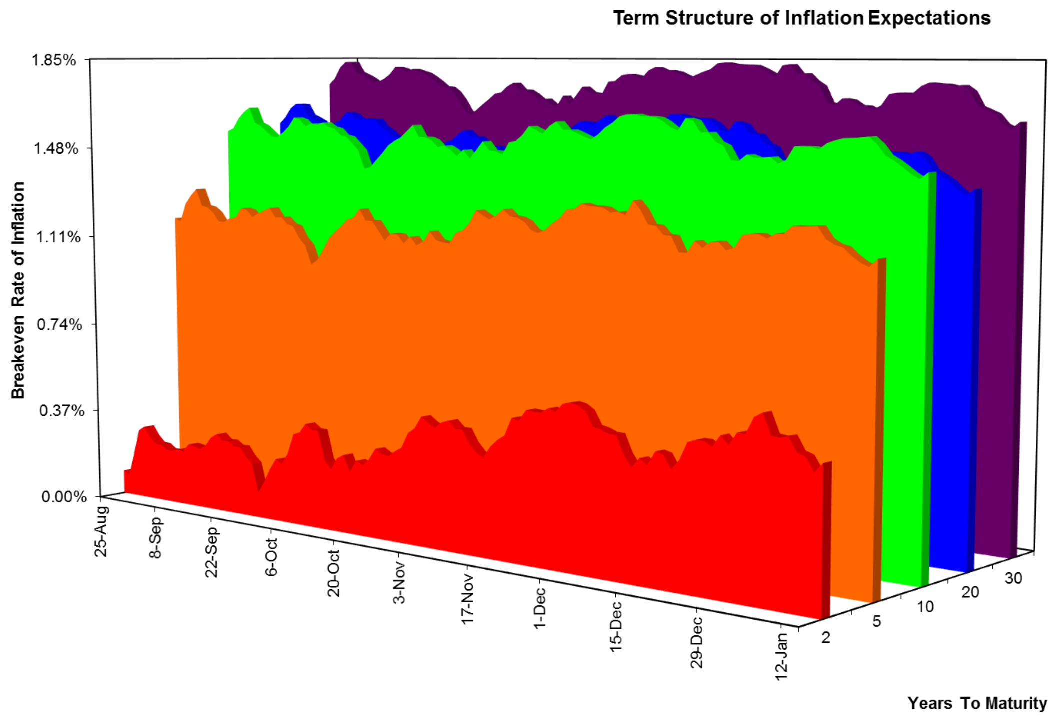
Inflation expectations and implied real interest rates derived from the TIPS market are similarly enigmatic. The communications wizards at the Federal Reserve claim, whenever it suits their convenience to do so, they focus on inflation expectations and occasionally share their auguries with the non-priestly castes with utterances to the effect they are “well-grounded,” whatever that means. What they should be saying is nothing the Federal Reserve does seems to affect these implied real interest rates and inflation expectations in any manner intended beforehand.

For those of you keeping score at home, this disconnection between frenetic activity and subsequent results can be compared to World War II cargo cults, with the critical exception mistakes made by New Guinean tribesmen did not have the potential for serious consequences for those not standing on the runway.

Recent Experience

The period following the August global equity selloff has included a retest of that selloff in September, speculation the Federal Reserve would not raise rates followed by a fulfilled consensus those rates would be increased, a strong move higher in the USD, a continued selloff in physical commodities in general and crude oil in particular, a pullback by the European Central Bank from even greater monetary stimulus and another global equity selloff to start 2016.





These market developments scarcely have affected the implied real rates on individual TIPS issues. Some of the shorter-dated implied real rates remain negative as generic two-year TIPS breakevens have increased over this period. However, longer-dated implied real rates and generic breakevens have remained within narrow trading ranges for more than four months. An environment that should be conducive to declining TIPS breakevens and rising implied real rates has failed to produce either outcome.

My principal criticism of central planning by central bankers has been the lack of deterministic outcomes. Their alleged favorite measure of inflation, the core personal consumption expenditure index, has been in a long-term downtrend since the mid-1980s. Much has changed over the past three decades, except for this. Now we are on to monetary policy, alleged to operate with long and variable lags, being based on backward-looking measures of employment regardless of whether the world is wrestling with deflationary pressures. Will those who need critical staff be deterred from hiring by a 25 basis point hike in the overnight federal funds rate? Let's hope we collectively have better business sense than that.

Maybe we should start the equivalent of Yelp or Angie's List reviews for central banks. Would you hire a handyman who could not indicate the consequences of his actions? Of course not. Then why should we accept anything less for matters of much greater importance?