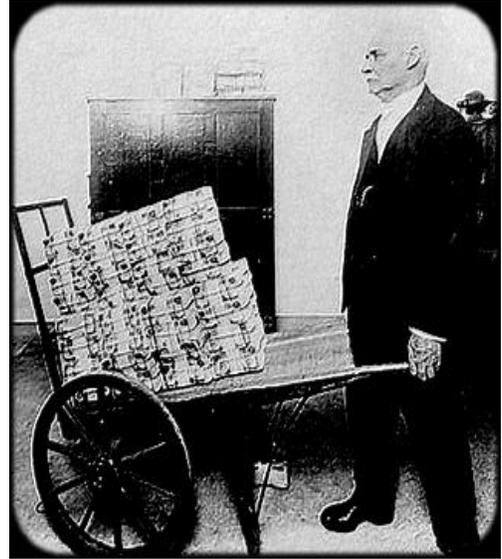


Mitchell's Musings 12-10-12: Crowd Wisdom?

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Poke around the Internet and you won't have to look far to find dire warnings of economic catastrophe in the no-so-distant future, usually tied to current economic policy. A favorite disaster is a tsunami of inflation, because of the aggressive policies of the Federal Reserve in dealing with the downturn and financial collapse of 2008 and its aftermath. At the wackiest level, there are fears of a hyperinflation because of all the liquidity provided by the Fed, the kind of inflation seen in Germany in the 1920s when wheelbarrows of currency were needed to make purchases.



Now it *can* be said that under Fed Chair Bernanke, the Fed has been the most active player in Washington, first in halting the downturn and then in trying to foster recovery. And you can be critical of this or that aspect of the Fed's approach. Indeed, you might even argue that the Fed should have been *more* aggressive than it was, although there are some legal constraints on what the actual Fed can do as opposed to what an abstract central bank might do. But what about fears of inflation? Could we have locked in future inflation – not at hyperinflation rates – but at more than we would like once the economy gets back to something like a full employment level?

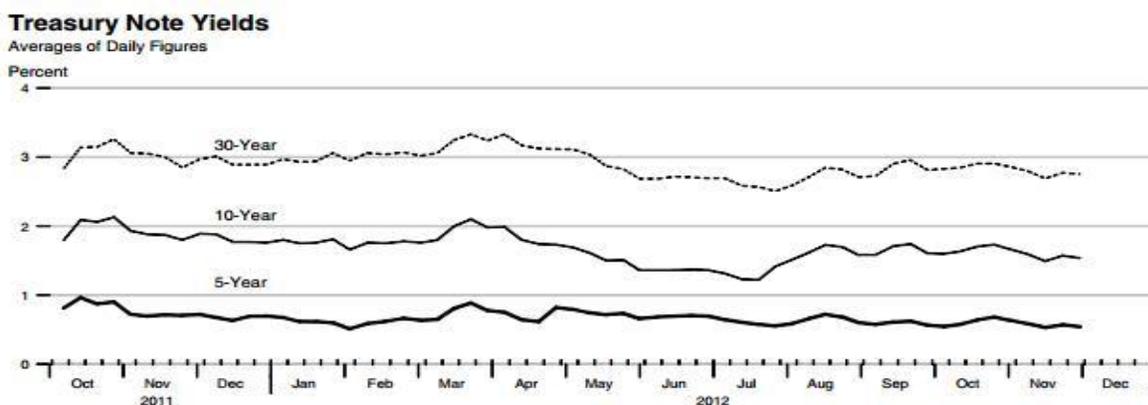
Traditional monetarists are nervous about such inflation. But what do financial markets think? Now that we are in the post-presidential election season, financial markets know something about the configuration of American political institutions for the next few years. So what is their inflation forecast, given the new information?

As pointed out in past musings, we can get a reading on financial market inflation expectations by looking at longer-term Treasury bond yields. It is sometimes said that bond investors will "demand" yields high enough to offset expected inflation (which would otherwise reduce the maturity purchasing power of their securities). The story is more complex but the basic idea allows us to compare – conveniently, thanks to the weekly releases of the Federal Reserve Bank of St. Louis – yields on conventional longer-term Treasuries vs. yields on inflation-adjusted

Treasuries.¹ The difference should give an indication of what the market consensus expectation of likely inflation rates over various maturity periods.

Of course, such expectations could be wrong, although the error might be in either direction. Financial markets are the classic example of the so-called “wisdom of crowds.” Sometimes, crowds are more accurate than any one forecaster. But crowds can become mobs. In financial markets, crowds become mob-like when they produce bubble-type behavior with everyone following the leader blindly.

Still, if you are a dedicated monetarist, you are likely to have faith in – or at least to have interest in – what financial markets are saying. So let’s look at conventional Treasury yields. Even conventional 30-year Treasuries, at the chart below shows, have floated around nominal yields of 3%/annum. So if inflation were to exceed 3%/annum over the next three decades, Treasury bond holders would be losing purchasing power by holding these securities. If that was all we knew, we might put 3% as a maximum financial market estimate of future inflation.



But because the Treasury issues inflation-adjusted bonds, we can compare the spread (gap) between their nominal yields and those of the conventional bonds. As noted earlier, the spread can be viewed as the market expectation of inflation. At the 30-year maturity, the spread is below 2.5%/annum and has fallen since the election, as shown on the next page.²

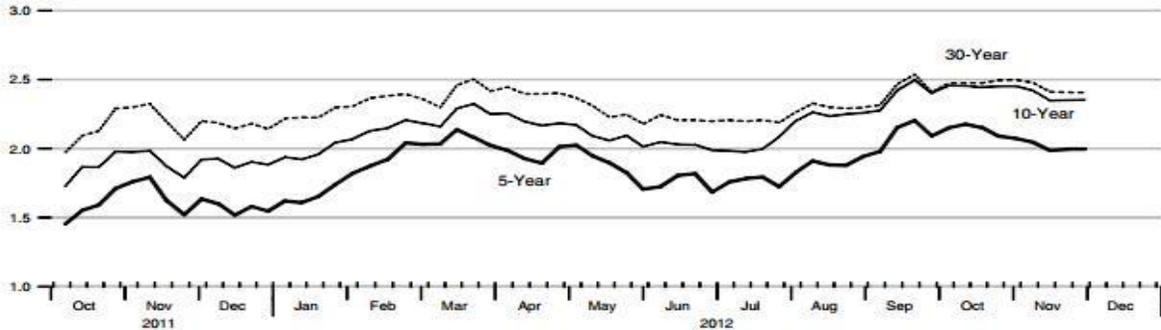
¹ Conventional Treasury bonds pay a fixed nominal interest rate and then pay off at the face value on maturity. Inflation-adjusted Treasury bonds also have a fixed nominal interest rate but the face value is adjusted by the Consumer Price Index (CPI) so that their real purchasing power is preserved. If inflation over the maturity period raises the CPI by, say, 25%, the maturity payoff of a \$1,000 bond will be \$1,250.

² The nominal yields on inflation-adjusted 5 and 10 year Treasuries have been negative over the past year because of a market belief that the maturity adjustment for inflation will be sufficient to make such bonds equivalent in some sense to their conventional counterparts.

Inflation-Indexed Treasury Yield Spreads

Averages of Daily Figures

Percent



To be sure, you can question the crowd wisdom expressed in the spreads. Note that there have been gyrations in the spreads during the period shown on the chart above. Was there really some insight from contemporary information that could change the prediction of inflation averaged over the next 30 years? The gap in the spreads between the maturities presumably reflects some market perception of risk. The risk premium – if that is what it is – between the 10-year bonds and the 30-year bonds seems to have converged of late. Any reason for that? Not one that is obvious.

In short, we can surely say that financial markets are not expecting hyperinflation. And they are not even expecting inflation that would be out of line with long-term trends. They may be wrong, but –again – the error could be in either direction. Nonetheless, the markets represent a broad consensus of those who are literally willing to bet their money on their expectations of future inflation rates. If you think they are wrong, what do you know that they don't? For that matter, what do you know that Ben Bernanke doesn't?