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Perspectives

When Markets Disagree

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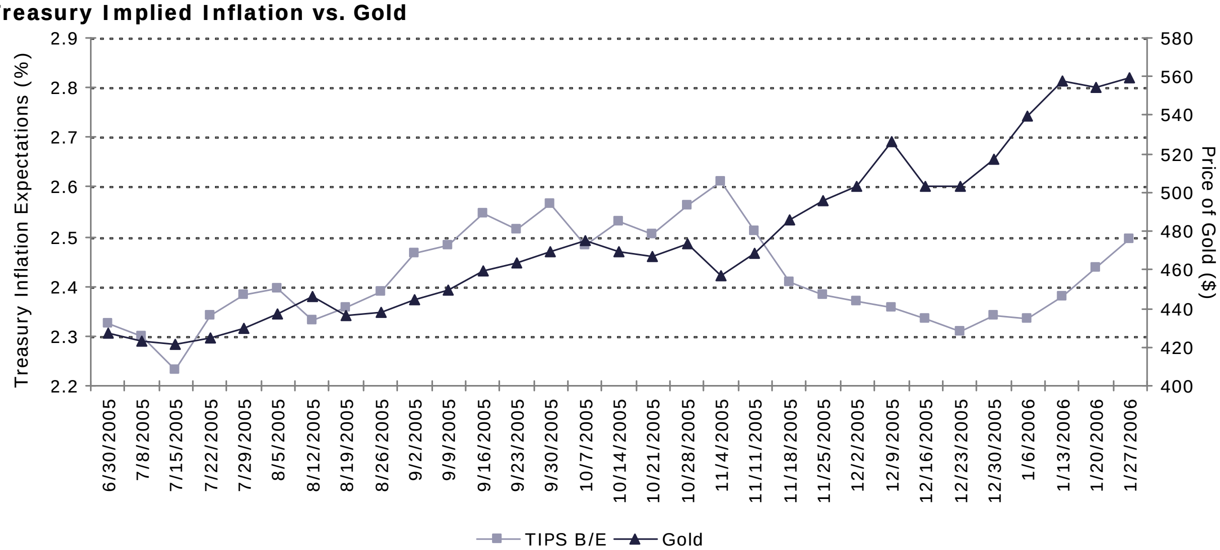
If markets are efficient, can well developed and liquid markets reach opposite conclusions about the future direction of inflation?

The chart below compares the price of gold to Treasury market expectations for inflation for the period June 30, 2005 through January 27, 2006. Gold has long been viewed as a barometer of inflation expectations. In this historic context, owning gold was the original real return strategy. For most of this period, gold and Treasury inflation expectations appear closely linked. Then, beginning in early November, the two data series moved in different directions. Commodity investors remained concerned about inflation, driving the price of gold higher. Treasury investors became less concerned about inflation and Treasury market expectations for inflation fell for several weeks before rising again more recently. For the period, gold prices have risen 31%. Treasury market expectations for inflation remain in a tight range of 2.3% to 2.6%.

Treasury Implied Inflation vs. Gold



When we consider that the period captured by our chart is also a time when the Federal Reserve had been hiking interest rates to achieve price stability, it is tempting to conclude that bond investors have more confidence in the Fed than do gold investors. Which market is the better inflation forecaster – the Treasury market or gold?

Before we answer that question, let us better define the exact meaning of the phrase - "Treasury market expectations for inflation." Traditional Treasury bonds pay investors a fixed coupon and a fixed principal amount at maturity. When inflation or inflation expectations increase, bond yields often rise and bond prices fall to compensate investors for the loss of purchasing power that results from greater inflation.

TIPS (Treasury Inflation Protected Securities) respond somewhat differently to inflation. Like traditional Treasuries, TIPS have a coupon, but the coupon and its yield are usually lower than a traditional Treasury because TIPS have a special feature. When inflation increases, so does the principal value of the bond and its coupon payment. As a result, the TIPS yield is called a real yield since the coupon and principal of the bond are inflation protected. We derive the Treasury market's expectation for inflation, or the breakeven inflation rate, by subtracting the TIPS yield from that of a traditional Treasury note of comparable maturity.

Now we can return to our original question: Which market is the better inflation forecaster? When we consider that breakeven inflation rate between TIPS and traditional Treasuries has remained rather steady and low, while actual CPI-U on a year over year basis has accelerated from a 2.5% rate to a 3.4% rate over this period, it is tempting to conclude that gold has indeed been the better inflation indicator.

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Gold is just one commodity, and a volatile one. To further evaluate this question, we have analyzed the statistical relationship between actual inflation and various commodity benchmarks such as the Goldman Sachs Commodity Index (GSCI), as well as the relationship between actual inflation and Treasury market expectations for inflation since the advent of TIPS in 1997. We find the correlation between actual CPI and broad commodity benchmarks is higher than the correlation between actual CPI and TIPS. Furthermore, the correlation between broad commodity benchmarks and CPI is more significant than the relationship between Gold and CPI.

As the table below shows, the GSCI (a broad basket of commodities) and gold have risen sharply over the past several months. Though the rise in the GSCI has not been as dramatic as gold, the increase noted below is consistent with a higher level of inflation. If commodity market benchmarks maintain their current levels, Treasury market expectations for inflation will likely increase and TIPS will probably outperform their nominal Treasury counterparts. *In fact, over the past couple of weeks, TIPS breakevens have begun to rise again. If the commodity markets are correct, this could be just the beginning.*

Dates	Treasury Inflation Expectations	Actual CPI YOY*	Gold	Goldman Sachs Commodity Index
7/1/2005	2.33	2.5	$427	391
1/27/2006	2.50	3.4	$560	449
Change	0.17	0.9	$132	58
% Change	7%	36%	31%	15%

Note: Actual CPI For June and December 2005

Now we enter the realm where numbers end and qualitative judgments begin: Why do Treasury investors appear to ignore the warning signals that commodities seem to be sending? Some of the explanations seem clear: Since 9/11 and the stock market collapse, investors have been more concerned about safety. Their fear, transmitted to the bond market through a more conservative asset allocation strategy, has no doubt supported the bond market immensely – particularly traditional Treasuries. Foreign central banks, awash in dollars, have put their significant dollar holdings to work in U.S. Treasuries as well. Large purchases of nominal Treasuries squeeze the spread between traditional Treasury bonds and TIPS – keeping the breakeven inflation rate lower than might otherwise be expected. *In this context, we must accept the possibility that Treasury market inflation expectations have been distorted by factors unrelated to a view on inflation. For investors who believe inflation is likely to rise in the future, the TIPS market remains a reasonably priced source of inflation protection.*

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