Brain worms

The world hasn't ended yet in an inflationary heat bath — why not? Will higher rates be the trigger?

This is almost as good as the FT's "Death of Gold" piece back in 1999. "Austrian Economics, 9/11 Truthers and Brain Worms," written by Bloomberg's Noah Smith, suggests that those dubious of the Fed's Grand Experiment are a) wrong and b) batshit insane. As equity indices crest new highs, one could be forgiven for thinking that this-time-its-different triumphalism has returned. After the most recent jobs report a few weeks back, another prominent financial commentator characterized the American recovery as being "eight inches dilated" and quipped that things haven't been so good since the late 1990's, an interesting choice of dates. We scrolled down to the comments to see if Abbey Joseph Cohen had chimed in.

We may or may not be "truthers", we may or may not have sympathies with the Austrian school and we have no idea if our brains are riddled with "brain worms" or not. But we certainly are on record as being cynical in regards to the Fed and here Mr. Smith does have a point: notwithstanding the wholesale money printing – unprecedented in history, and by a long shot at that – runaway inflation has not materialized. Skeptics have some 'splaining to do. Here is our best shot at this.

First of all, even as it seems like punting on first down, we point out that there is no one measure of inflation. There is a cross rate between everything and everything. There is sugar as measured in USD, sugar in Yen, sugar in Pesos, crude in Pesos, crude in sugar, Dow in dollars, art in Euros, bonds in Roubles, etc., etc., etc. Inflation is about how far a unit of money will stretch and since QE began it is clear that when it comes to most things that unit of money doesn't stretch nearly as far as it used to.

The New York Times recently put it this way:

> *In Spain, where there was a debt crisis just two years ago, investors are so eager to buy the government's bonds that they recently accepted the lowest interest rates since 1789.*
>
> *In New York, the art deco office tower at One Wall Street sold in May for US$585 million, only three months after the going wisdom in the real estate industry was that it would sell for more like US$466 million, the estimate in one industry tip sheet.*
>
> *In France, a cable-television company called Numericable was recently able to borrow nearly US$11 billion, the largest junk bond deal on*

WORLD ECONOMY

Welcome to the Everything Boom, or maybe the Everything Bubble

Neil Irwin
9 Hours Ago
The New York Times

Spencer Platt | Getty Images

A board of stock indicators shows upward momentum on the floor of the New York Stock Exchange.

> *record – and despite the risk usually associated with junk bonds, the interest rate was a low 4.875%.*
>
> *Welcome to the Everything Boom – and, quite possibly, the Everything Bubble.*

Not everyone sees this as inflation, however. Certainly, Mr. Smith does not likely see this as inflation. Rather, inflation is all about the CPI and the CPI throughout all this has been somnolent. What gives here?

We can argue about methodology, as many have. There is no doubt that the BLS (Bureau of Labor Statistics) keeps changing the way it measures inflation and that most of these changes act to soften the impact of rising prices. For example, if the price of chicken rises enough, the Bureau figures folks will eat less chicken. So it lowers the weight of chicken in the index, arguing along the way that their mandate is to produce numbers that reflect the individual's cost of day-to-day living. Some of this makes sense.

What about the price of money, then? Surely, this looms large when it comes to the real cost of "day-to-day living." In an extreme case, consider an interest-only mortgage – here, the price of shelter *is* the price of money and only the price of money. More generally, in a massively indebted economy, the price of money would surely factor as the most significant cost center.

We called the BLS up to inquire further. There is a num-

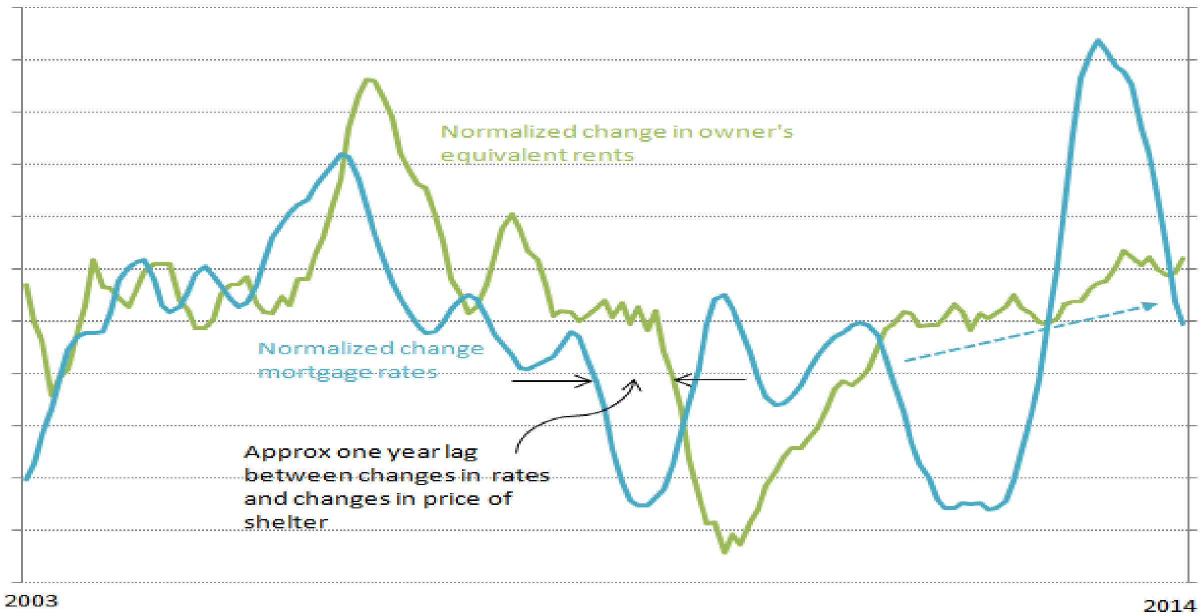

Figure 1: *We plot the rate of change of National Average Contract Rate (from Mortgage-x.com, in blue) against the rate of change of owner equivalent rent component of the CPI (from the BLS, in green). Each data series was normalized to have zero mean and a standard deviation of 1. The Y-axis should be seen as unitless. The correlation between the cost of shelter and rates is both intuitive and striking.*

ber on their website and if you call it a man will answer on the first or second hop and answer all your questions, with a fair amount of insight at that. "No, we don't consider the price of money," he told us, "but you do make a fair point."

Maybe there was relationship embedded somewhere in the data. We started with the housing component of the CPI, for this was surely the most rate-sensitive input to the general cost index. This is a large component – almost 30% of the CPI is shelter – and they measure this not by tracking house prices but rather by asking owners what they feel they could rent their house out for. "Owner's equivalent rent", they call it.

We plotted owners' equivalent rent and compared it to mortgage rates over the last decade. This can be seen in figure 1, (along with some of the details of the data processing.) Do you see what we see? Between 2003 and 2010 there is a high degree of correlation between changes in mortgage rates and changes in the owner equivalent rents, with the latter lagging the former by about a year. In the years following Lehman, from 2010 on, when rates went to zero and small nominal changes resulted in much larger percentage swings, the tight relationship breaks down, at least over the shorter time frame. But more generally it has held here as well.

This makes complete sense. Rates go up, costs go up, rents go up. Rates go down, costs go down, rents to down. And this phenomenon would hardly be restricted to rents/shelter, so pervasive is debt in Western economies. But this cost, unlike chicken, has been going down for the last 35 years. Surely this has contributed a disinflationary offset to standard cost indices.

Now, of course, rates have nowhere to go but sideways or up. If they go up, monthly household outflows will rise sharply and cost-push will follow. Governments and their deficits will be no less immune. If rates go sideways, the Fed and its brethren will be (rightly) seen as being ineffectual and the basic underpinnings of *credit* (from the Latin Credere—to believe) will be undermined, the man behind the curtain exposed as just that.

The monster bull market in bonds and the dead-end it now finds itself in deserves more attention. This climate is all most investment professionals know. Anything else would be like landing on Mars.

And on Mars, everyone has brain worms. The radio signals told us so.

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