Bond investor alert: Inflation beast lurks in the shadows

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Today's markets remind me of the 1970s when bond investors were badly burned for underestimating the threat and presence of inflation.

Inflation today doesn't seem to be just 2 per cent in Canada and 4 per cent in the U.S. It feels much higher. And think about this: The markets for real assets – gold, food, energy and commodities – continue to rise, which suggests inflation.

It seems to me that over the next few years bond investors will wake up, lick their wounds and bang their heads against the wall for being so gullible to believe the reported inflation statistics.

Even if inflation really is in the reported 2-per-cent to 4-per-cent range, it's not going to be that low for much longer. Buying a basket of goods will cost much more in the future.

Already, recently reported U.S. inflation statistics show that almost everything consumers purchased in January was more expensive, including clothing, medical care, recreation, education and communications. At the producer level, prices rose year-over-year by 7.4 per cent, the largest increase in more than 26 years.

Inflation is primarily a monetary phenomenon. An increase in money supply results in an increase in inflation. The U.S. money supply (M2) went up by an average rate of 7.7 per cent per annum between 1965 and 1974. This led to an average annual inflation rate of 9.2 per cent between 1973 and 1981.

The story has been similar in the 2000s. The U.S. Federal Reserve pumped a lot of money into the economy in 2000 in preparation for Y2K – which never happened. This year, the Fed has again been pushing a lot of money into the system and this, along with some other structural changes in the global economies, is bound to have an increasing effect on inflation, triggering quite possibly a wage price spiral in the near future.

Food inflation in particular is quite worrisome, as it affects a wider spectrum of people than energy prices. Food inflation is expected to increase to over 7.5 per cent over the next few years from an average of 2.3 per cent over the last 10 years. This is quite similar to the U.S. experience in the 1970s when commodities doubled, eventually leading to average annual food inflation of 8.2 per cent between 1973 and 1981. Eventually, consumers will have to shoulder these increased costs. And workers around the globe will soon start demanding higher salaries as in earlier inflationary periods.

The latest available figures show that the U.S. money supply has increased by 7 per cent during the last 12 months. We have almost reached the inflation-causing levels achieved between 1965 and 1974, when the M2 growth rate averaged 7.7 per cent a year.

Moreover, China is rapidly moving from mainly a producer country to mainly a consuming country as more Chinese citizens enter the middle class. They will be spending more on food, entertainment and travel. As opposed to the dampening effect on global inflation that China has had over the last decade, in the future, China will contribute to global inflation.

One only has to look at what has been happening to Australia. Core inflation in that country has been hitting 16-year highs in recent months and is expected to hit 4 per cent year-over-year in the first quarter, well above the 2-per-cent to 3-per-cent target rate of the central bank. The rise is partly due to Australia's proximity to the booming Asian markets and spending sprees by Chinese and other Asian tourists.

The latest cut in U.S. interest rates has moved the real interest rate into negative territory, for the first time since 2001. When Ben Bernanke, chairman of the U.S. Federal Reserve, got the job, he indicated that controlling inflation would be his priority and that he would not budge when it came to inflation.

Recent events, however, show that he is at the mercy of financial markets to a greater extent than his predecessors. This definitely is not doing any good to his reputation and the credibility of the Fed, and once the Fed's credibility has been lost, then it is a free for all.

As I said, the markets for real assets, normally a good hedge against inflation, agree with me. Gold prices are up to levels not seen since the last big run up in inflation in the late 1970s and early 1980s; commodities are up; energy prices are up; food prices are up – and all at record levels.

On the other hand, the markets for financial assets, like bonds, seem to trust the officially reported inflation numbers and show little concern for the likelihood of higher and accelerating inflation in the future.

Bond prices are up and interest rates on long-term bonds are way down to a level indicating that bond market participants believe the official inflation numbers. Well, both markets cannot be right. Something has to give and either bond prices will collapse or commodities will do so.

If I am going to bet on who is right I will be on the side of the markets for real assets.