Hold Your Horses!

Galloping Inflation and Interest Rates are on the Way!

By Richard Benson
(www.sfgroup.org)

For those readers who have not spent time around "Lake Lag" on the Stamford Campus (https://125.stanford.edu/then-and-now/990/), the name John Taylor, the economic genius, may not be known to them but he is well-known by central bankers who are starting to rue the many days they have been running Quantitate Easing and blissfully ignoring Mr. Taylor's simple rule, which is:

$$\mathbf{R = P + 0.5Y + 0.5(P-2) + 2}$$

(See: https://www.investopedia.com/terms/t/taylorsrule.asp)

Where R = Nominal Fed Funds Rate, P = The Rate of Inflation, and Y = The percent deviation between current Real GDP and the long-term linear trend in GDP.

The Fed is holding R = 0 by force and QE. **P** the inflation rate CPI just clocked in year-over-year at 5.4%. The simplest calculation of all, the Real Rate of interest, R - P = **a Negative 5.4% Something looks horribly wrong!** Investors understand you make money if you buy stuff with debt and pay zero on the debt while the price of the stuff is going up! Just lever and buy, lever and buy! Free wealth! Free wealth in stuff, stocks & bonds!

Worse yet, P by the BLS is the inflation rate that uses every trick in the book with Hedonic adjustments and leaves housing prices out of the calculation. John Williams at Shadow Stats (http://www.shadowstats.com/alternate_data/inflation-charts) looks at inflation based on 1990 and 1980 CPI calculations but the real inflation rate is way higher. ***Buckle your seat belt before clicking on the Shadow Stats Link.*** For the people who do not work at the Federal Reserve or US Treasury, and have to go out and buy food and fill up the car, they know the Shadow Stats numbers are the ones they actually live with. *The CPI at 5.4% is a nice fairy tale to tell children.*

For participants in the credit markets, the sad facts of the formula above are: 1) solving for **R** is the Fed funds rate you need to get up to for inflation to be holding steady. **R** less than that is encouraging inflation to pick up speed; 2) Way before **R** gets to the neutral number bonds crash, and leveraged carry trades expose lots of Long Term Capitals, Bear Stearns, Lehman Brothers etc.; in other words, over-levered and ready to blow**!** While we are waiting for the play to start, with many acts and intermissions between panic attacks over the next ten years, normalizing interest rates will *not* be a normal experience.

For those of you who exit the financial casino now and sell *before* the fire as someone yells "smoke in the room" and are fortunate enough to lock in low long-term costs of borrowing, and get the *longest interest rate caps the casino will sell to them*, history will look on as being prescient.