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Special Report

February 2010

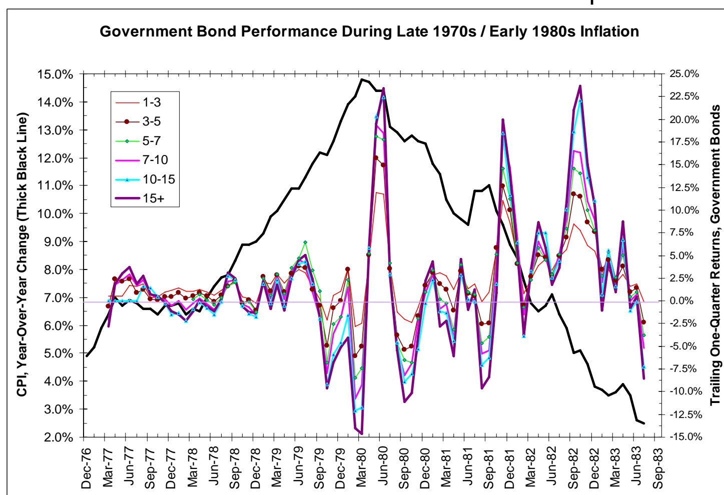
Bond Returns In The Last High-Inflation Era

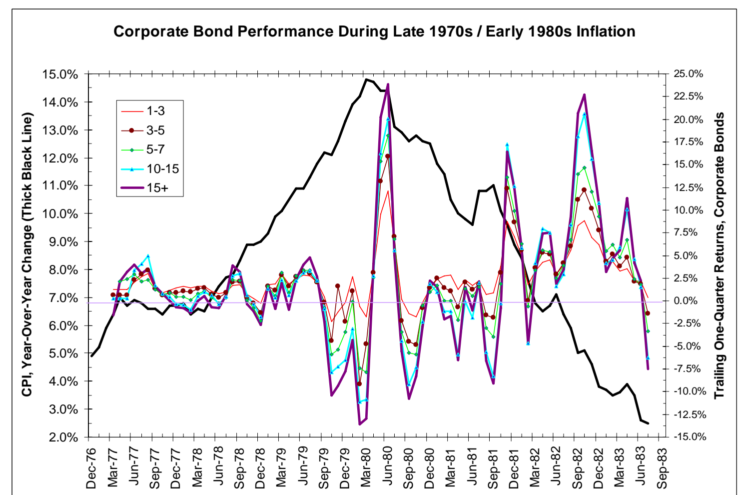
By Howard L. Simons

A journalist asked what bond returns were during the last period when inflation (black line, both charts) was at double-digit rates. **This question is in anticipation of a day when inflation will reach such levels again.**

While the double-digit inflation period could be limited fairly to March 1979 – October 1981, it is more interesting to extend the analysis backwards and forwards in time to the takeoff point in December 1976 and the low of the first disinflation cycle in July 1983.

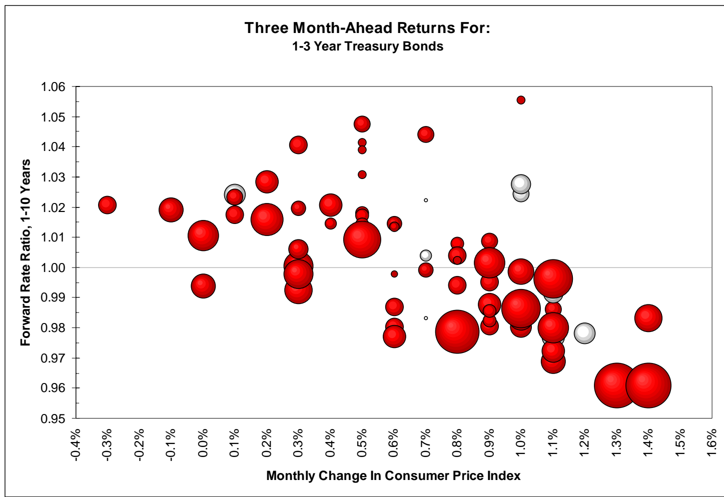
We can overlay the trailing one-quarter returns for both Treasuries and corporate bond indices (left- and right-hand charts, respectively) over a range of maturity segments.

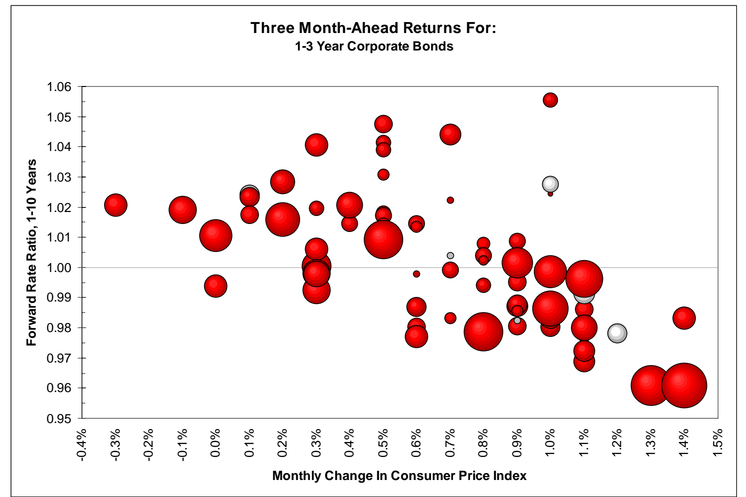


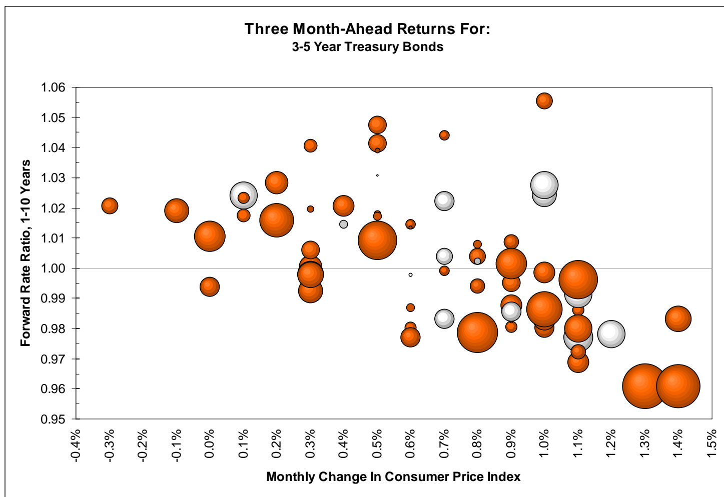


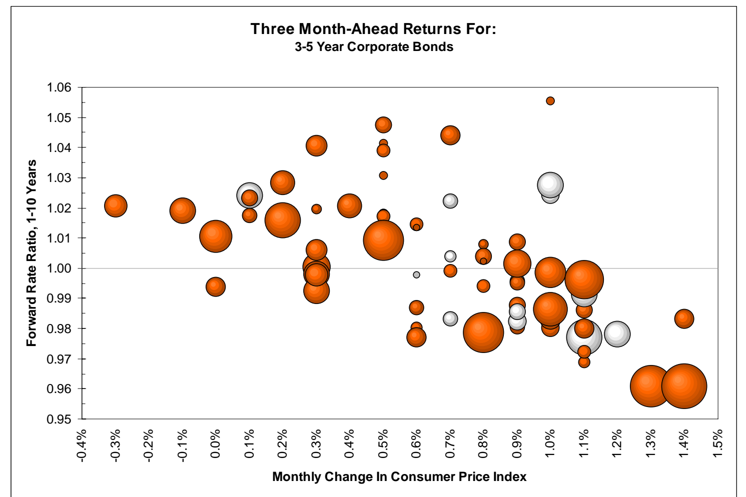
Prospective Returns

As the high-inflation era was characterized by large swings in both the ordinal level of interest rates and in the yield curve as measured by the forward rate ratio between two and ten years, we should map three month-ahead returns along the dimensions of the $FRR_{2,10}$ and monthly changes in the Consumer Price index. The chart pairs below have the Treasury returns on the left and the corporate returns on the right. Positive returns are depicted in color; negative in white. The diameter of the bubbles corresponds to the absolute magnitude of the return. Finally, data consideration mandated 5-10 year corporates be matched to the 7-10 year Treasuries.


Three Month-Ahead Returns For:
1-3 Year Treasury Bonds
Forward Rate Ratio, 1-10 Years
Monthly Change In Consumer Price Index


Three Month-Ahead Returns For:
1-3 Year Corporate Bonds
Forward Rate Ratio, 1-10 Years
Monthly Change In Consumer Price Index


Three Month-Ahead Returns For:
3-5 Year Treasury Bonds
Forward Rate Ratio, 1-10 Years
Monthly Change In Consumer Price Index


Three Month-Ahead Returns For:
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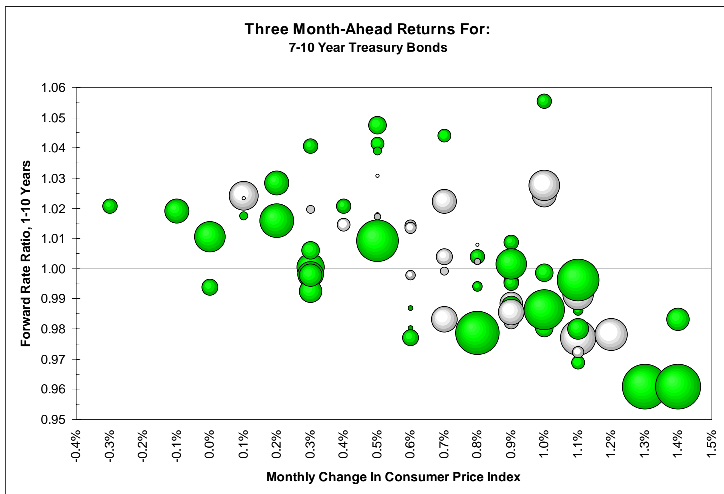
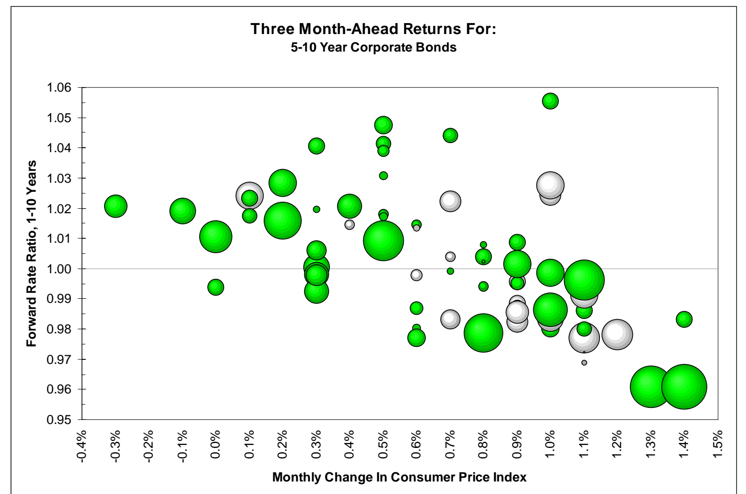
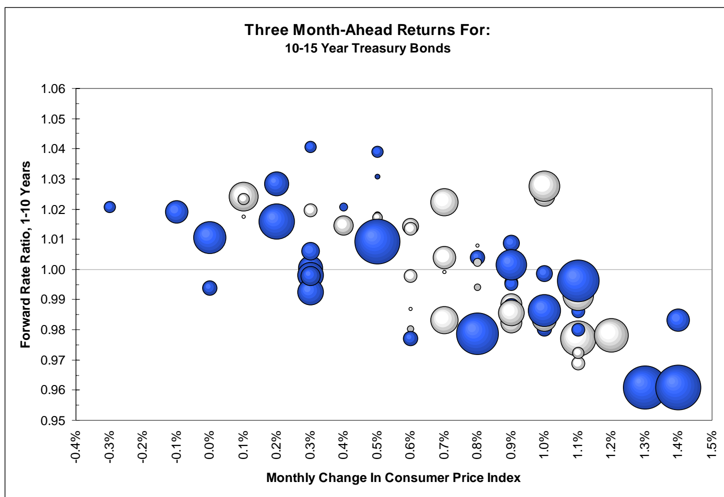
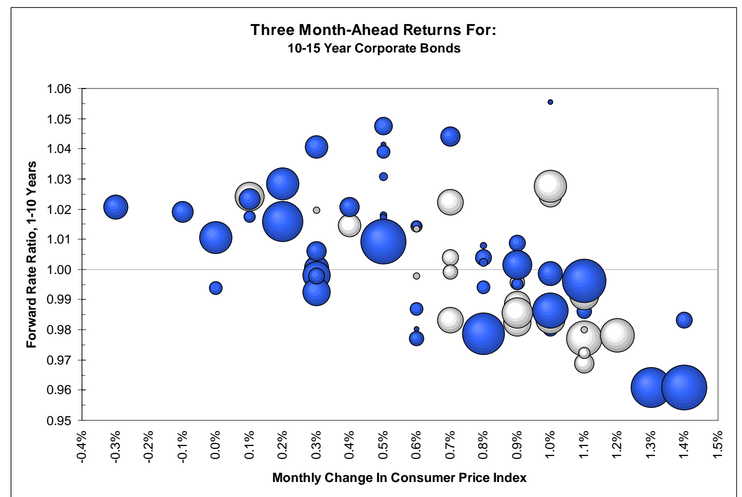
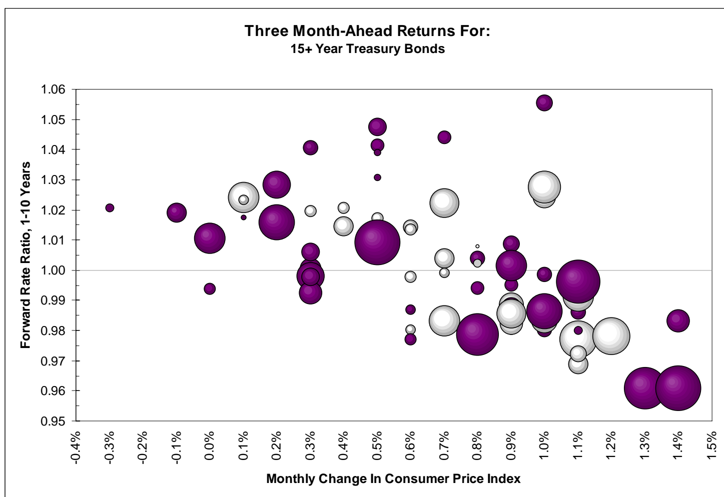
Forward Rate Ratio, 1-10 Years
Monthly Change In Consumer Price Index

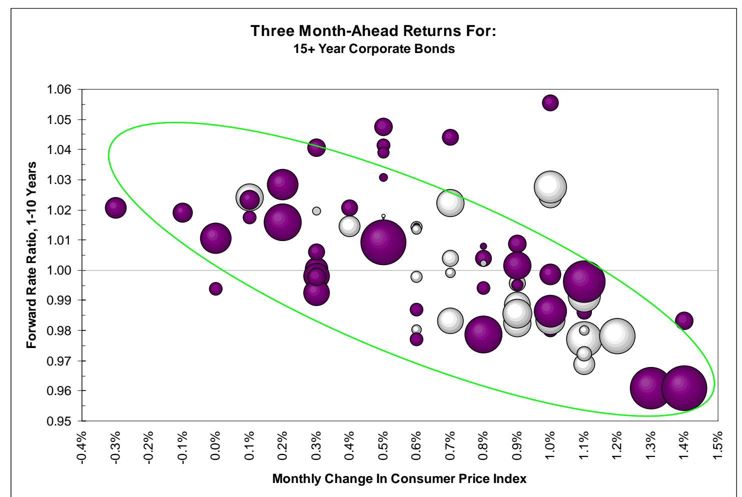

Three Month-Ahead Returns For:
7-10 Year Treasury Bonds
Forward Rate Ratio, 1-10 Years
Monthly Change In Consumer Price Index


Three Month-Ahead Returns For:
5-10 Year Corporate Bonds
Forward Rate Ratio, 1-10 Years
Monthly Change In Consumer Price Index









Conclusion

Several conclusions are readily observable. First, the higher-yielding corporate bonds had consistently higher returns throughout this era than did the Treasuries. Second, the high short-term interest rates and inverted $FRR_{2,10}$ common in that era made the shorter maturity bonds a better investment. **The high-inflation era simply was a bad time to be long duration from either a lower yield or a longer maturity standpoint.**

Third, the near-mechanical policy of that era was to flatten/invert the $FRR_{2,10}$ in response to high inflation readings; this led to a clustering effect from northwest to southeast on the map highlighted by the green oval superimposed on the 15+ year corporates. **If the yield curve was steeper than expected given this trend, prospective returns suffered.** This was, after all, the era of the "bond vigilantes," Real Men who stared fearlessly at their non-graphical Bunker Ramo or Quotron screens and made actual telephone calls during the day as neither the *Bloomberg* nor computerized trading had been invented yet.

Finally, the principle of buying when other people are selling was honored then as now: The best returns, especially for the shorter-maturity bonds, emerged from those periods when the yield curve was most inverted and inflation readings were the highest.

Despite our journalist friend's foresight, we probably have a ways to go before reaching double-digit inflation again; the 1970s inflation was born in the late 1960s and accelerated through the collapse of the Bretton Woods fixed exchange-rate system and the creation of bogus money in the form of IMF Special Drawing Rights. Richard Nixon imposed wage and price controls, broke the gold-dollar link and devalued the dollar in August 1971. It took another seven and one-half years to get to the double-digit inflation readings noted above. But as the inevitable result of wanton monetary creation throughout history has been high inflation, it does not matter so much when you prepare as long as you do prepare.

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