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MANAGER INSIGHT

Demystifying TIPS

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KEY TAKEAWAYS

- TIPS provide a hedge against inflation for a broader fixed income portfolio, but they are more complex and nuanced than investors may initially think.
- Total returns for TIPS and nominal Treasurys are linked to real economic growth in the long run.
- In an environment of rising inflation and low growth, we would expect real yields to fall and TIPS to have a positive return, while the return for nominal Treasurys may be flat or even negative.

With oil prices beginning to rise and ongoing financial market uncertainty, a low-risk asset with some built-in inflation protection appeals to many investors. But Treasury inflation-protected securities, or TIPS, are more complex than this definition implies.

TIPS have a history of cycling in and out of investors' minds as a du jour investment idea. At their core, TIPS provide a hedge against inflation for a broader fixed income portfolio, but they also have many unique, often misunderstood, features. Below, we examine TIPS and debunk several misconceptions.

What Are TIPS?

First issued by the US government in 1997, TIPS were designed to provide investors with inflation protection. The TIPS market has grown to about $1.2 trillion, representing roughly 9% of total Treasury issuance.[i] Like any asset class, supply and demand can impact valuations. If the Treasury issues fewer TIPS, investors could bid up TIPS prices. This year, net issuance is expected to be about $48 billion, down from $87 billion in 2015.[ii]

In practice, the principal value of TIPS increases with inflation and decreases with deflation. Multiplying the adjusted principal by the fixed coupon rate calculates the semiannual coupon payments, so coupons also float relative to the inflation environment. When TIPS mature, the Treasury repays the adjusted or original principal, whichever is greater, creating a deflation floor. Older-issue TIPS are more sensitive to deflation since it erodes accrued inflation. Additionally, coupon payments do not enjoy similar deflation protection because coupon payments may be calculated on an adjusted principal less than par. As a result, there is some deflation risk.

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TIPS principal adjustments are calculated monthly with a three-month lag based on changes in the Consumer Price Index for Urban Consumers non-seasonally adjusted (CPI-U). The CPI-U measures changes in the price paid by urban consumers for a basket of consumer goods and services. Shelter, food, transport, energy and medical care prices make up almost 75% of the index. Over the past year, the energy component has been a significant drag, while shelter costs have steadily risen since 2010.

What Are Breakeven Inflation Rates?

A breakeven inflation rate is the annualized rate of CPI-U inflation that makes the total return of a TIPS equal the total return of a similar-tenor Treasury. Breakeven rates are calculated as the yield difference between Treasury bonds and TIPS of the same duration.

Breakeven rates are a proxy for the market's inflation expectations. The smaller the rate, the lower expectations are for inflation. Higher rates indicate increasing inflation expectations. A change in market expectations or uncertainty about inflation can change TIPS prices even if realized inflation remains constant.

If Inflation Expectations Increase, What Can I Expect?

Ten-year breakeven inflation (expected inflation for the next ten years) is currently around 1.6%,[iii] but the five-year average for ten-year breakevens is 2.1%. If the current ten-year breakeven rate moved toward longer-term historical averages, we would expect TIPS to outperform nominal Treasurys.

TEN-YEAR BREAKEVEN INFLATION

Source: Bloomberg, data as of 3/31/2016.

Ten-year Breakeven Inflation

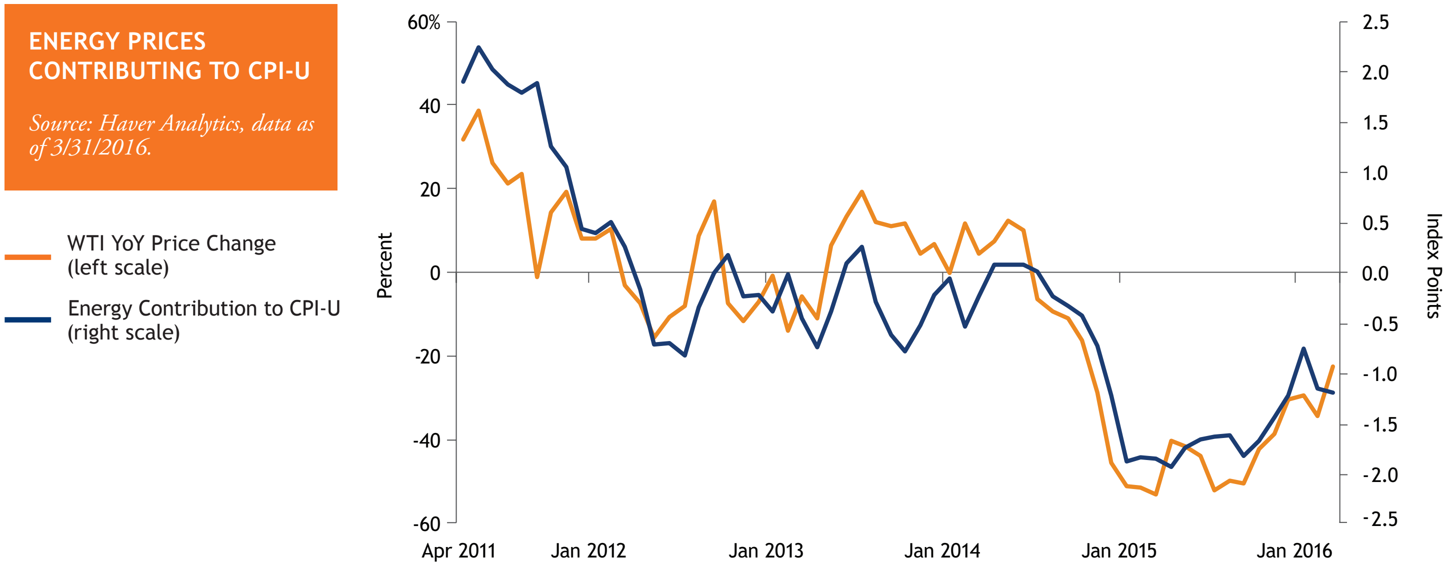
Five-year Average of Ten-year Breakeven Inflation

If Energy Prices Rise, What Can I Expect?

If energy prices continue to increase, CPI-U will rise, and in turn, TIPS will benefit from principal accretion and higher coupon payments. If the energy component in CPI-U were to increase 5% year over year, we would expect a 0.4% to 0.6% contribution to CPI-U based on the historical weighting of the energy component. If oil has bottomed, TIPS could stand to benefit.

ENERGY PRICES CONTRIBUTING TO CPI-U

Source: Haver Analytics, data as of 3/31/2016.



When Do TIPS Outperform Treasurys?

Nominal Treasurys can lose real value when realized inflation exceeds inflation expectations at the time of a bond's purchase. In such an environment, TIPS outperform nominal Treasurys. When realized inflation is lower than breakeven inflation, nominal Treasurys outperform TIPS.

However, there are some important nuances to the nominal Treasury/TIPS dynamic, mostly depending on whether changes in real or nominal rates are driving inflation expectations. Total returns for TIPS and nominal Treasurys are linked to real economic growth in the long run. In an environment of rising inflation and low growth, we would expect real yields to fall and TIPS to have a positive return, while nominal Treasury bonds may have a flat or even negative return. In an environment of rising inflation and higher growth, TIPS will still outperform nominal Treasurys but could lose value as real interest rates rise along with breakeven inflation.

About Risk

The value of inflation-protected debt securities tends to change less due to changes in inflation than other types of bonds but may decrease with decreases in inflation or, as with other debt securities, with increases in interest rates.

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Endnotes

[i] *Monthly Statement of the Public Debt of the United States compiled by the Bureau of the Fiscal Service, as of 3/31/2016.*

[ii] *"Where's the progress?" Barclays Interest Rates Research, 2/5/2016.*

[iii] *Bloomberg, as of 3/31/2016.*

[iv] *Barclays Live, as of 3/31/2016.*

Disclosure

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