Maybe Treasury Inflation Protected Securities are the Place to be Again

By Vineer Bhansali| July 18, 2022

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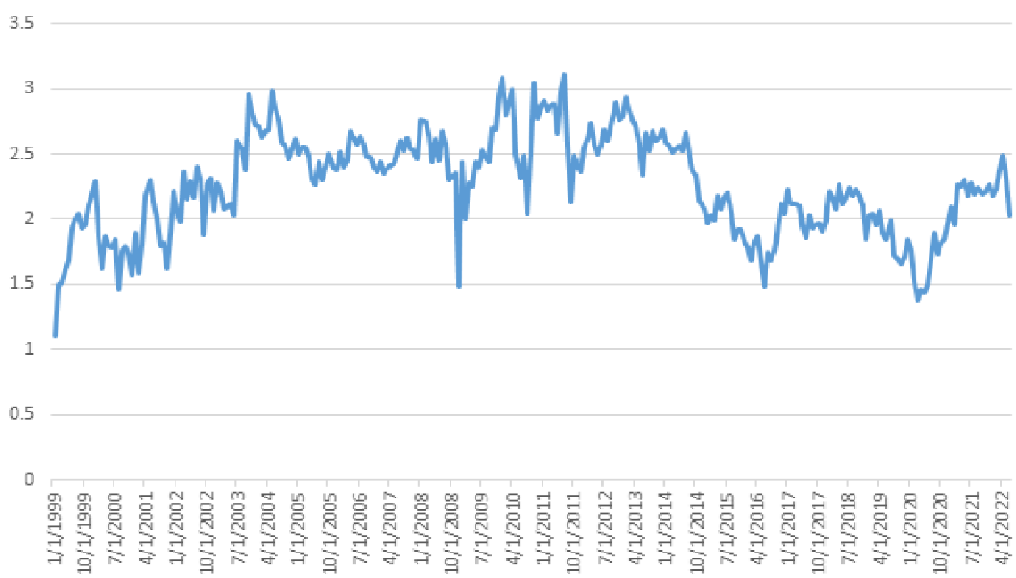
As far as managing longish-term, market-implied expectations go, the Fed could declare victory now. The 5-year forward 5-year breakeven inflation rate computed using Treasury Inflation Protected Securities (TIPS) and Nominal bonds, has dropped (again) right to the 2% level (of course since the Fed is majority owner of both nominal bonds and TIPS, they can make this number whatever they wish it to be by buying or selling nominal and inflation linked bonds, so this indicator should be taken with a HUGE grain of skepticism).



Source: Bloomberg

The recent low of the 5y forward 5y breakeven was about 1.4% at the height of COVID, and the high was 2.4% in early 2022, before the Fed pivoted aggressively to squash inflation and inflation expectations. Recall that during the financial crisis of 2008 TIPS were sold aggressively as both illiquidity and fears of deflation surfaced and drove the forward breakeven down to about 1.5%. TIPS don't act like Treasuries should when there is a race for the exits.

The pyrrhic victory over the breakeven inflation rate has come at significant cost. In the US, rich asset owners have of course been socked. Those who cannot afford high-priced food stuffs and gas are losing purchasing power, too. And those in the middle, who loyally contribute to their retirement plans, are finding that their nest eggs are about 20% to 30% less valuable than at the beginning of the year. Everyone is beginning to hurt. Internationally, rising US short-term rates are resulting in sharp dollar strength, which is making nations like Sri Lanka go through what is effectively a revolution. The damage is just starting to show globally.

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Though interest rates are most likely going to be raised again at the next Fed meeting by at least 75 basis points, the severe yield curve inversion, where short-term yields are now higher than almost all longer maturities, suggests the market is pricing in lots of things, including the global economy breaking in the next few months. An actual crisis could require the Fed to pivot and go neutral at a minimum and perhaps even talk about easing if things get much worse. For those who insist that the Fed will cure inflation even if it means throttling the economy do not understand the fact that "monetary policy is the handmaiden of fiscal policy", to use words of Paul McCulley. In other words, a political entity that will give under the weight of political pressure when Washington complains about a deflating economy. The Fed is faced with two future constraints: high inflation and cratering markets.

So what will precipitate the pivot that I have been talking about? Quite simply an excuse that financial market stability has become more of a threat than the economy can live with. As with earthquakes, there are already signs of these precursory phenomena of illiquidity rising. The rapid disappearance of liquidity across many different markets suggests we are on the precipice of a financial market disaster if more financial stress is put on the economy.

The Fed knows this. If they really wanted to slow the economy down, there is a way to do it beyond just raising rates. This would include outright sales of assets. The trillions of longer-term Treasuries and mortgage pass-throughs that they bought in the frenzied stimulation of the economy over the last few years could be sold to suck out more long-term liquidity than just raising rates can. But selling assets in a bottomless pit of illiquidity can also destroy confidence. So I don't think that massive scale asset sales are likely to happen anytime soon.

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Back to TIPS.

What is more likely to happen is a compromise. The compromise could look something like this: reported inflation will be FORCED down. Maybe inflation settles down to between 5 and 6 percent. And because bringing realized inflation down from the recent 9.1% to 2% in any short period can only occur with a deep recession, which no one wants, the Fed slowly begins to telegraph that while 2% is the long-term inflation target, the short-term target is something like 4%. My guess is that policymakers won't want to define "long-term" or "short-term" too precisely to keep maximum flexibility.

Let us assume for discussion that long-term means 10 years and short term means 2 to 3 years. If this is the possible path of inflation, what is best way for investors to position their portfolios?

A little over a year ago I wrote in this forum why we should not look for TIPS to protect against inflation (here). But I am increasingly of the view now that TIPS, which had previously been bid up to insane price levels by the Fed and retail ETFs, might be beginning to provide some asymmetric protection and the potential for total return as well. That's primarily because they have lost so much value recently.

TIPS theoretically are insurance against inflation. But insurance is only potent when the price of that insurance is relatively cheap. When TIPS were trading at deeply negative real yields due to frenzied buying by the Fed and retail investors, they were "negative insurance" against inflation. Which is why as inflation has risen sharply, TIPS and TIPS funds have fallen in price, rather than rising in price. The pure duration effect of rising real yields, which had boosted the price of TIPS killed the benefit from the purported inflation protection. But are we at a stage where TIPS are attractive again?

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Let us take a couple of examples.

First, just a simple 2year maturity TIPS. Currently this TIPS has a 0.10% real yield. But the actual yield earned by an investor is the sum of the real yield and the inflation rate (lots of details on this at the website of the Treasury Direct). Both the principal and coupon are adjusted for inflation. So as inflation grows, so does the principal, and the coupon is paid on the increased principal. If we add the 9% inflation, then yes, this bond is yielding, instantaneously, in annualized terms, about 9.10% (Source: Bloomberg). Pretty good. How about a year out? If we look out a year and attach some probabilities to the various outcomes for real yields (the way I did is to use the probability distribution of nominal yields as implied by the market), we can compute scenario prices based on the hypothetical yield changes and the coupon income. Then we can weight the outcomes with the probabilities to get the expected return.

If inflation averages 9%, the “expected value” of the annual return from the coupon and the possible change in yields is about 9.81%. What if inflation averages 5%? The expected return drops to about 6.5% over the next year. And if inflation actually, miraculously drops to 2% this bond will still have an expected total return of 3.8%. For a 0% inflation rate the total return is about 2%, and you have to have an outright deflation of -2% for this TIPS to have a zero return. There is no magic here, just bond math, and incorporation of total return principles of roll-down and carry and pull-to-par.

Running the same numbers for a 10-year maturity TIPS, we find that at 9% inflation the expected annualized return for a one-year horizon is 10.5%, at 5% inflation averaged over the period the total expected return is 7.1%, at 2% inflation 4.5%, at 0% inflation 2.75%, and at -3% inflation (deflation) the expected return is 0 over the horizon. Again, no magic, just bond math and averaging over market implied probabilities.

So in summary, buying inflation insurance via TIPS was extremely unattractive just a few months ago when the Fed had crowded the TIPS market and retail investors followed them like the piper and dealers front-ran the Fed and got stuck with the TIPS; today the fact that TIPS have lost so much value from an unwind of the excess, while inflation is rising, makes them attractive again as a fixed income instrument. This is because the market has punished the high-priced TIPS owners by forcing real yields high and prices low. Right when inflation is spreading and peaking, voila, the price of the insurance again is getting cheap.

If a fumbling, panicking Fed raises rates too quickly and aggressively, I suspect the economy will tank, and real yields will fall sharply. TIPS ought to do well from their current starting point, since they are bonds after all and bonds rally when yields fall. On the other hand, if the Fed stays behind the inflation curve and lets inflation go higher, TIPS will compensate for the higher inflation in terms of higher coupon and principal. That’s why they are called TIPS after all.

Important Disclosures

Vineer Bhansali, Ph.D. is the Founder and Chief Investment Officer of LongTail Alpha, LLC, an SEC-registered investment adviser and a CFTC-registered CTA and CPO. Any opinions or views expressed by Dr. Bhansali are solely those of Dr. Bhansali and do not necessarily reflect the opinions or views of LongTail Alpha, LLC or any of its affiliates (collectively, “LongTail Alpha”), or any other associated persons of LongTail Alpha. You should not treat any opinion expressed by Dr. Bhansali as investment advice or as a recommendation to make an investment in any particular investment strategy or investment product. Dr. Bhansali’s opinions and commentaries are based upon information he considers credible, but which may not constitute research by LongTail Alpha. Dr. Bhansali does not warrant the completeness or accuracy of the information upon which his opinions or commentaries are based.

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