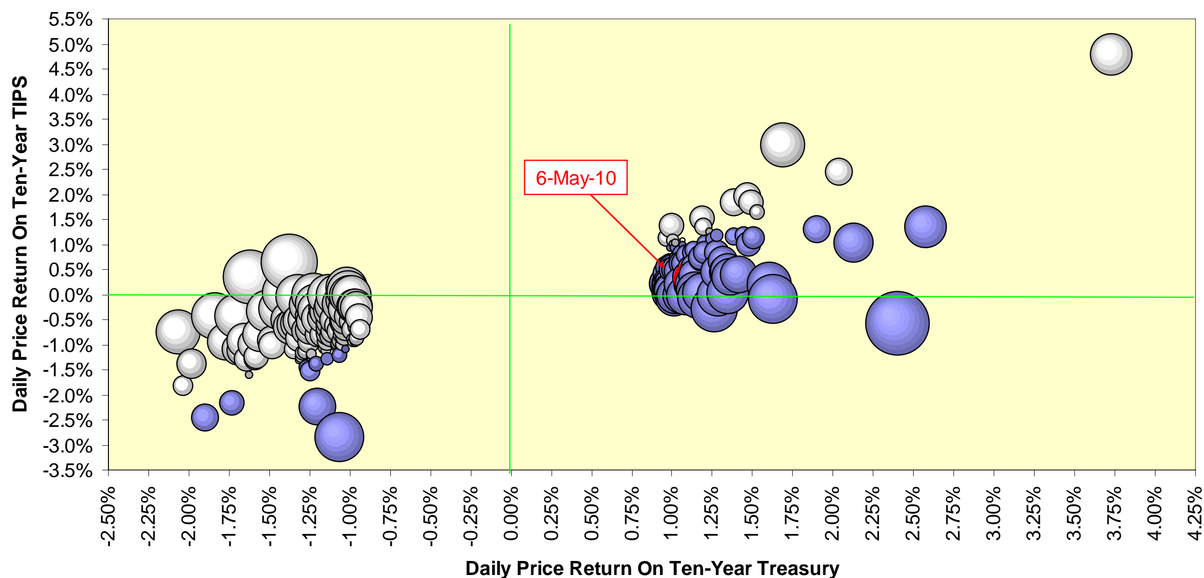
TIPS Distortions During A Panic

If you are going to hang around traders and get a whiff of anything, it might as well be panic. Last Thursday's trapdoor opening under the market produced the very common buying spree in long-dated Treasuries known as a "flight-to-quality," as if the debt of an issuer surely headed down the path of Japan if not Greece should be confused with quality and not things you whiff.

As the market for Treasury Inflation-Protected Securities is much smaller than that of conventional Treasuries and as many TIPS are held as part of mutual funds or ETFs and thus are not part of the liquidity pool on most days, we should expect Treasury yields to fall much faster than TIPS yields on these panic days and, conversely, for conventional Treasury yields to rise much faster than TIPS yields on those occasional bad-hair days in the bond market.

We can illustrate this phenomenon by isolating all ten-year Treasury moves outside of an in-sample 95% confidence interval going back to the January 1997 introduction of TIPS. If we map the price return for ten-year TIPS against these large Treasury moves and display their yield differentials in bubble form where blue bubbles represent Treasury outperformance and white bubbles TIPS outperformance with the diameter of the bubble corresponding to the magnitude of the differential, we how most big "up" days in the bond market involve Treasury outperformance.

Flight Into Treasuries Depressed Ten-Year TIPS Return
95% Confidence Interval Since January 31, 1997

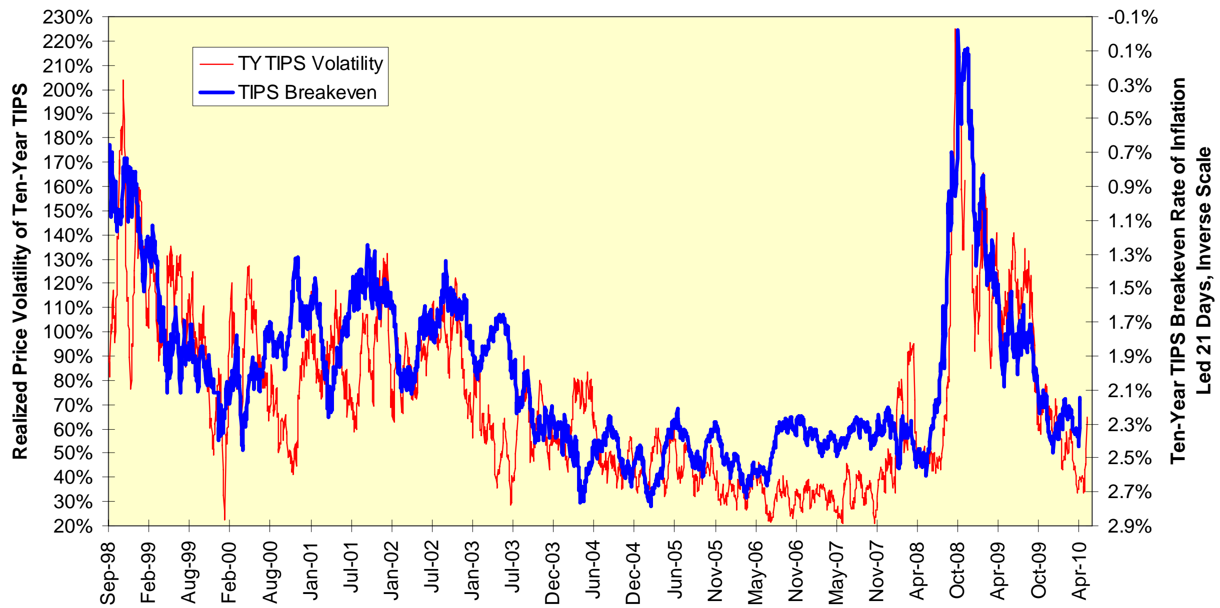


The policy implication of this is significant; as we saw in 2008, when TIPS breakevens went negative at many maturities, a flight into conventional Treasuries can be confused with declining inflation expectations. That gives the Federal Reserve and other serial bubble-blowers additional ammunition to keep interest rates too low in their courageous fight against the scourge of deflation (Memo to file: How is it the dollar has lost 87.7% of its purchasing power in my lifetime on a CPI basis and worse on a global, currency-adjusted basis, and yet my government keeps telling me the real danger is deflation? Hmmm).

Note On TIPS Volatility

While stock volatility rises as the market falls – there is no shortage of those who tell you how to make money by trading volatility as a substitute for price even though the market for price is deeper and more liquid – bond volatility rises as yields fall and prices rise. After all, there is good resistance at 0% in bonds, and the further down yields go, the greater the price response of each basis point change in yield will be. TIPS are no exception to this principle. The realized 21-day price volatility of TIPS moves inversely to their breakeven rate of inflation and even leads the breakeven rate by a 21-day trading month at most as an artifact of volatility calculations.

Ten-Year TIPS Inflation Volatility Moves Inversely To Breakevens



Note how realized TIPS volatility jumped last week as breakevens fell…and remember the breakeven rate itself was depressed artificially by the flight-to-quality (snicker) response noted above. As higher volatility degrades the probability any single price represents true economic value for an asset, the resulting TIPS breakeven rate used to justify the deflationary scare actually has a wider error band associated with it. I will wait for the first Federal Reserve official to discuss this with the likes of Barney Frank and Chris Dodd. It would be a YouTube sensation.