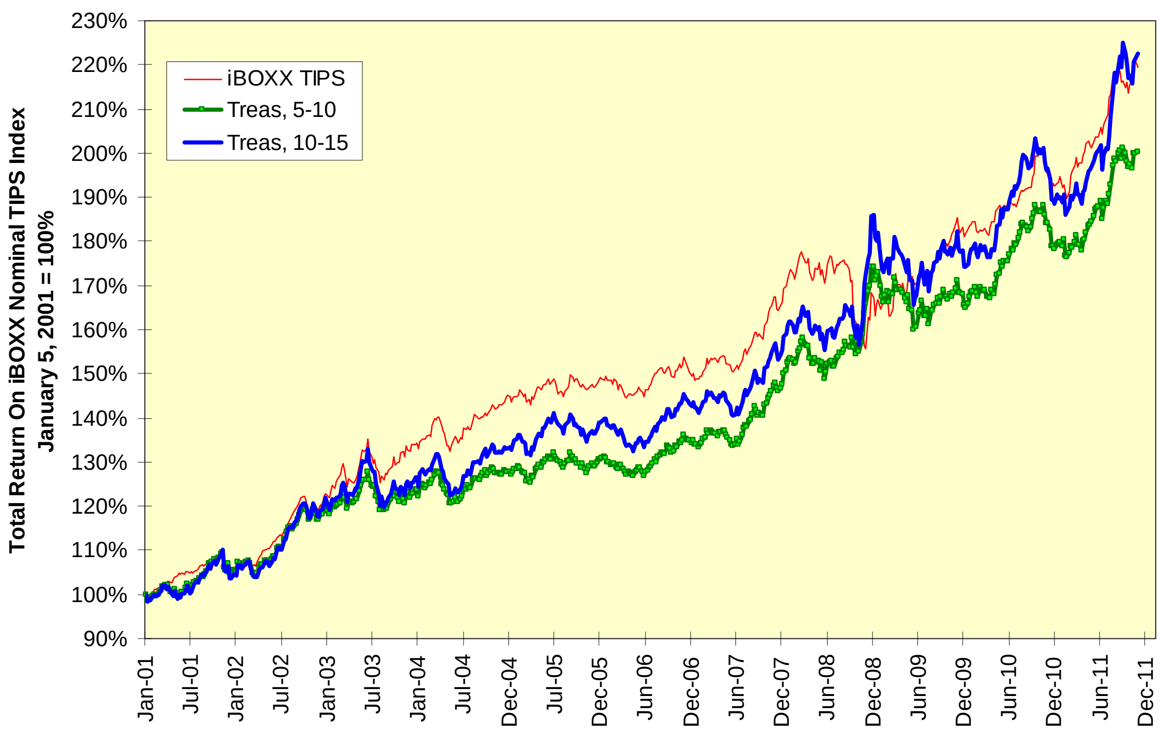
TIPS Should Outperform Nominal Treasuries For Next Three Months

The Excess Of Reported Over Expected Inflation Is Responsible

I have never been one to drink TIPS-flavored Kool-Aid, a ringing non-endorsement of both the Treasury and of Kraft Foods' flagship insult to bad instant drinks (and yes, I know the cyanide was mixed into Flavor Aid at Jonestown). As I noted in March 2010's [Free Inflation Insurance. Inquire Within](), the entire premise of TIPS is based on someone selling you underpriced insurance against inflation. We do not expect Allstate or Geico to sell us underpriced automobile insurance; why do we think we are capable of outfoxing the future course of inflation (see [Assessing The TIPS Market's Ability to Forecast Inflation]() in this regard)?

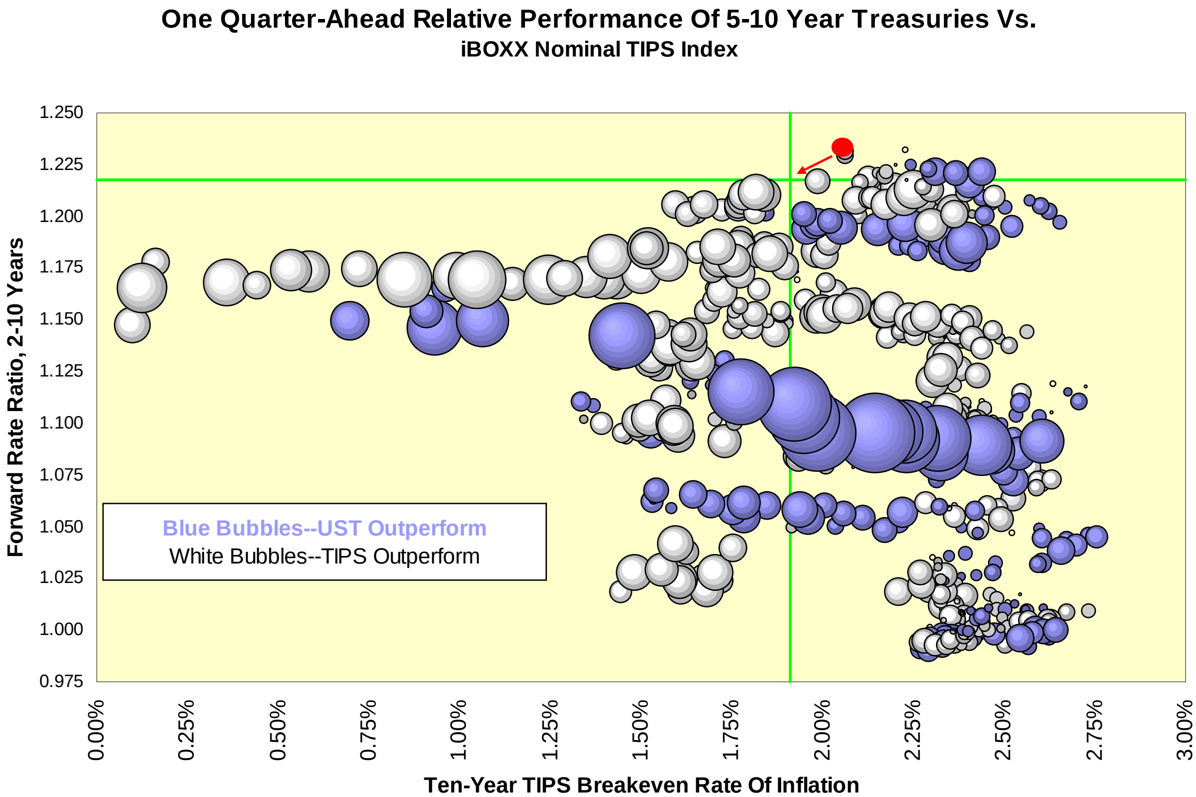
How, then, can any sort of forecast of TIPS outperformance over the next three months be made? The answer, quite simply, lies in how TIPS pay off in relation to inflation. Their accrual index is based on a backward-looking average of the CPI-U. As a TIPS holder pays for inflation insurance based on the market's prospective assessment of the CPI-U and gets paid based on the realized CPI-U, the whole affair is misaligned in time. It has been working in favor of the TIPS holders for a while, relative to 5-10 year Treasuries, as seen below. The total returns of 10-15 year Treasuries have outpaced TIPS in recent months as Operation Twist and the compression of the yield curve have made long-term Treasuries tough to beat.

Relative TIPS Performance Over Time



Two Dimensions

Let's take a look at three month-ahead relative returns for TIPS and 5-10 year Treasuries along the dimensions of ten-year TIPS breakeven rates and the yield curve as measured by the forward rate ratio between two and ten years ($FRR_{2,10}$). The latter is the rate at which we can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself; the more the ratio exceeds 1.00, the steeper the yield curve is.



Current values for ten-year breakevens and for the $FRR_{2,10}$ are highlighted with a green bombsight; the datum from three months ago is highlighted in red along with an arrow to the present. Please note how we have been and continue to be in a region of white bubbles; these denote observances of TIPS outperforming nominal Treasuries. A combination of sub-2% inflation expectations means you can buy TIPS at a rate likely to be exceeded by reported inflation; a steep yield curve tends to keep a bid under reported inflation itself. The net of it all is this is a good time to devote whatever you were tending to allocate to Treasuries to TIPS instead.

One caution from December 2010's Remember, Fixed-Income Investors: TIPS Are Still Bonds remains: Despite the alternatives being poor right now, the risk/reward for longer-dated Treasuries may be poorer still. I have questioned whether Treasuries Approaching Zero-Coupon Status should even be considered suitable investments for individuals. We have seen how sovereign bonds in Europe have been dicey investments, and never forget it can happen here, too.