Central Banks And The Mirror, Mirror On The Wall

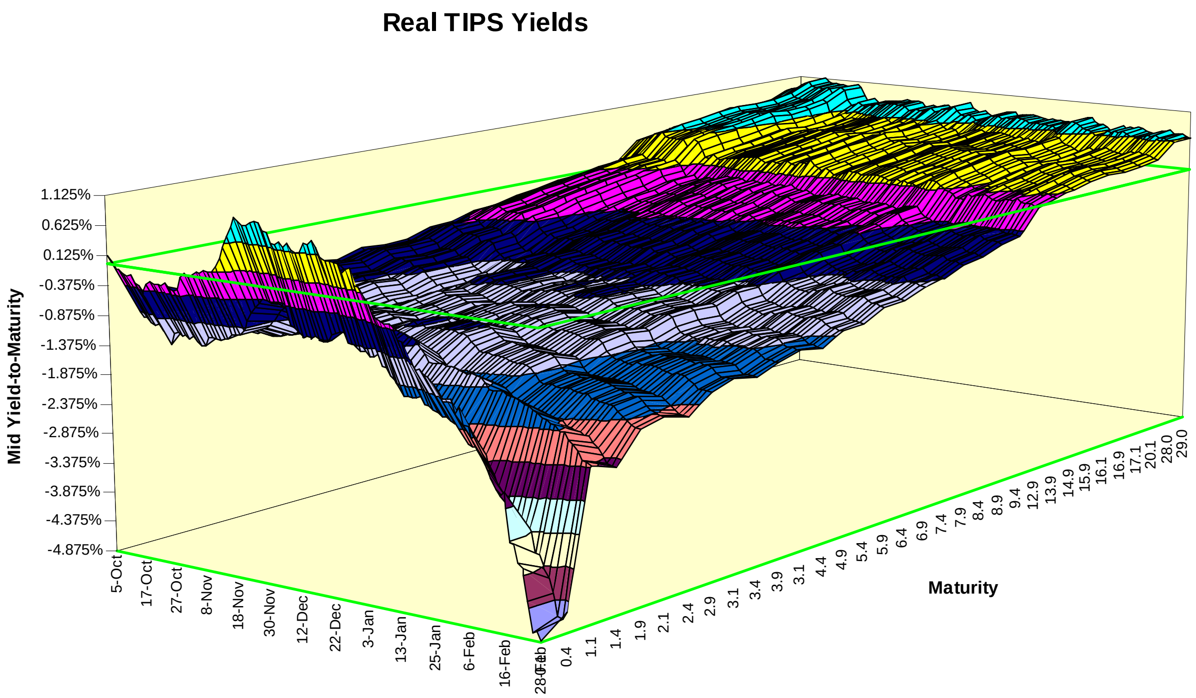
Financial Repression Distorting Inflation Breakeven Signals

Long before the days of Websites such as Angie's List and the obsessive-compulsive worries about how many "likes" or "friends" you or your creations have, habitués of bazaars understood something very simple about customer relations: You can scalp anybody once, but if you have any hope of repeat business, you had best lean toward honesty and keep your thumb off the scale. Even more basic is a streetwise prohibition against believing your own publicity, with "publicity" being a euphemism.

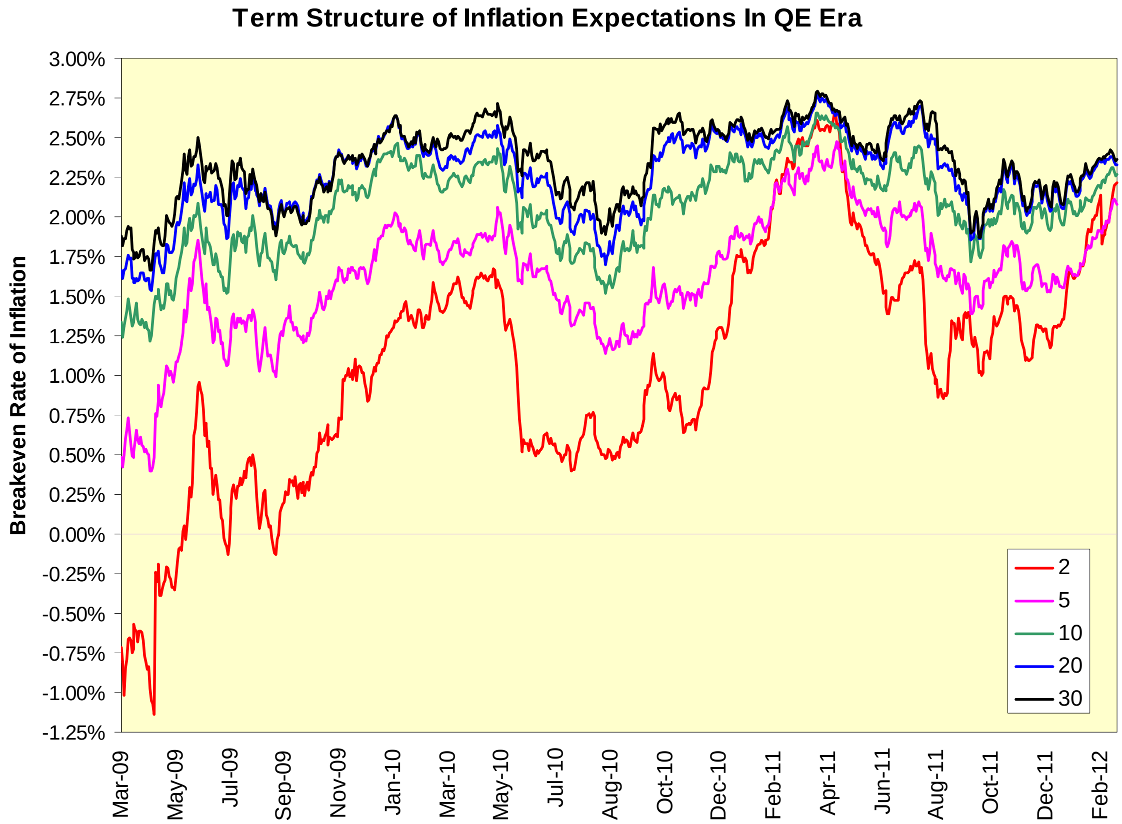
Both the Federal Reserve and the European Central Bank are in the midst of violating this last admonition. As I noted in How the Fed Has Distorted the Nature of the TIPS Market, all of their suppression of short-term interest rates and twisting of long-term rates have altered the TIPS breakeven rates beyond utility.

Negative Real Yields

TIPS breakevens are the difference between nominal Treasury yields are the real yield on the inflation-linked bond itself. If you drive the real yield lower by flooding the market with cash, you are subtracting a negative number from the Treasury yield. On an issue-by-issue basis, real yields are now negative out to 12.9 years. Moreover, the shorter-dated real yields have been increasingly negative since last October's market low.



While these real yields have declined, the nominal Treasury yield curve has flattened bullishly under Operation Twist. That has forced longer-dated breakevens lower than where they would be otherwise while the effects of negative short-term yields are pulling short-dated breakevens higher. The net result of this little mouthful has been a growing inversion in the term structure of TIPS breakevens.



Please note how the two-year breakeven now is higher than the five-year breakeven; a similar situation prevailed at the end of QE2 between March and May 2011. Given the Federal Reserve's high self-opinion, the danger here is they might interpret this as the market saying, "Yes, we have to worry about rising inflation in the short-term but this will not be a problem five years from now."

We have no idea where the ten-year and higher breakevens would be in the absence of Operation Twist. However, if we lower the nominal Treasury rate artificially, we should expect that we have lowered the breakeven rate as well.

Caution On TIPS

I entitled a December 2010 column, Remember, Fixed Income Investors: TIPS Are Still Bonds. The message here was and is quite simple: No matter what the breakevens do, if interest rates rise, the value of your TIPS will decline. The real danger for you as an individual investor (or as a group of investors if you happen to be hosting a group of "friends" reading this together) is you will buy TIPS when the breakevens are apparently low only to discover subsequently that higher long-term interest rates will wipe out the gains from a gain in breakevens. In addition, much of the payout on TIPS is linked to the inflation accrual index. That number is calculated from the realized All-Urban CPI, which is a backward-looking number unrelated to the forward-looking breakevens. That means you could get paid very little to take on a lot of interest rate risk.