TIPS Are Still Bonds. Still

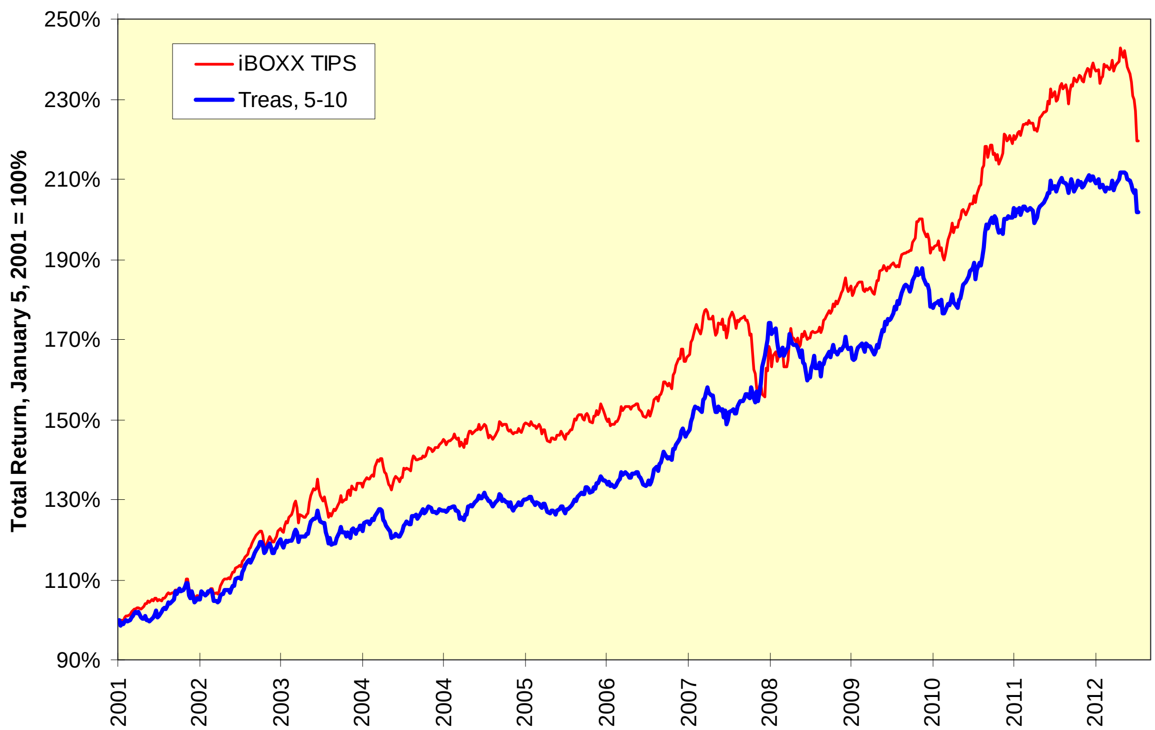
In December 2010, when QE2 was just one month old and neither QE3 nor QE4 were even in glimmer in Ben Bernanke's eye and everyone knew when Jackson Hole was even if they did not know where it was, I entitled a column, "Remember, Fixed-Income Investors: TIPS Are Still Bonds." This admonition was for the many investors who remain so fixated on an inflation risk they cannot forecast correctly they forget all about the interest rate risk they cannot forecast correctly. As a certain national business newspaper reminds its readers regularly, when interest rates rise, bond prices fall.

The Expected Inflation Reaction

The confusing chatter emanating from the Federal Reserve about the ultimate fate of QE has combined with slow growth, a decline in monetary velocity and a belated recognition by many that cash sitting on bank balance sheets and not being lent to others is deflationary has led to a 0.60% decline in inflation expectations as measured by the ten-year TIPS breakeven rate of inflation since mid-March. The confusing aspect of all this has been more than four years of money-printing in the U.S. and more than 14 years of the same in Japan have not ignited higher expected or reported inflation. This is another topic for another day.

If TIPS breakevens represent insurance against higher future inflation, the shift in sentiment toward lower future inflation and those very same higher interest rates should hurt TIPS badly, and they did. Between May 3 and June 27, 2013 the iBOXX nominal TIPS total return index fell 8.62%. A widely held TIPS mutual fund, the Vanguard Inflation-Protected Securities Fund (VIPSX) declined 8.18%. For purposes of comparison, the total returns on indices of 5-10 year and 10-year+ Treasuries (not shown on the chart below) over the same period were -4.49% and 9.19%, respectively.

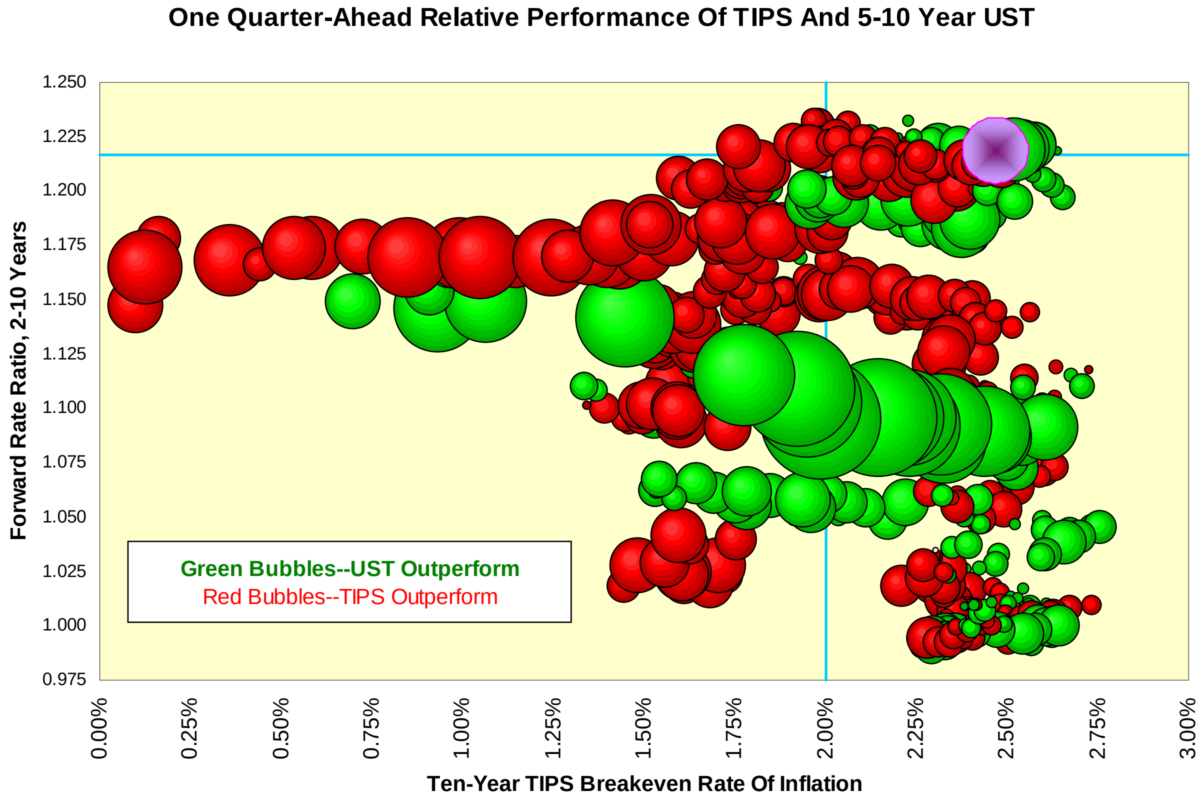
Comparative TIPS / Intermediate Treasury Performance



Buy Low, Sell High

The time to buy is when there is blood in the streets; the trick is to make sure none of the red stuff is yours. As TIPS investors are rewarded when future realized inflation exceeds the breakeven rate at the time of investment, the drop in breakevens and the rise in rates creates an opportunity. Moreover, the still-steep yield curve suggests monetary policy remains very accommodative, all of the confusion notwithstanding. This yield curve is measured by the forward rate ratio between two and ten years; this 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 higher the number, the steeper the yield curve.

If we map prospective relative returns between TIPS and 5-10 year Treasuries as a function of breakevens and the yield curve, we can see we are in a zone where TIPS should outperform nominal Treasuries. In the chart below, these times are marked with red bubbles; prospective nominal Treasury performance in marked in green. The size of the bubbles denotes the absolute magnitude of the outperformance. The current environment is marked with a bombsight and the datum from three months ago, one predicting strong UST outperformance, is highlighted.



Please remember this is a relative and not an absolute forecast; TIPS outperformance will mean very little to you if interest rates jump over the next three months as they have over the last six weeks.