TIPS And The Performance Toss-Up

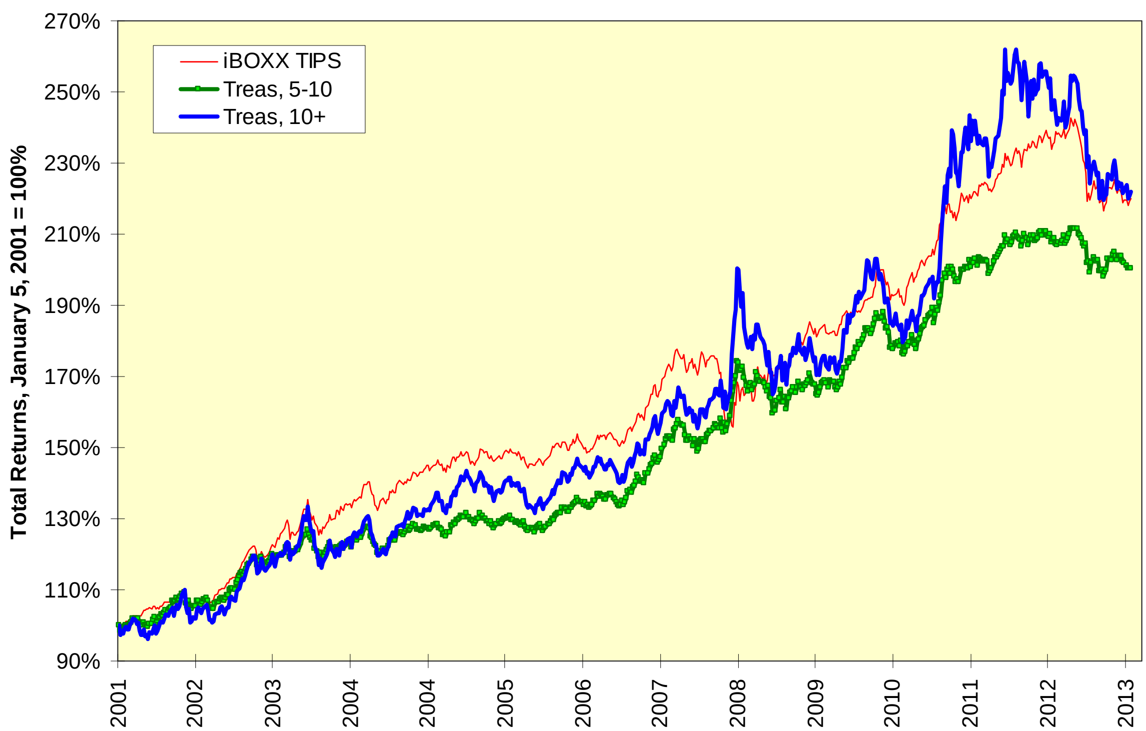
What would you do if I forecast out of tune, would you stand up and walk out on me? You very well might have if thirteen years ago this month I told you the total returns on the iBOXX nominal TIPS index and ten+ year Treasury bonds would be essentially equivalent come January 2014. After all, TIPS have been sold as protection against the ravages of inflation surely to arrive soon as punishment for our wicked, wicked ways while ownership of long-term Treasuries is just supposed to asking for it, whatever 'it' is, when inflation arrives.

Well lend me your eyes while I write a surprise and I'll try to hit the right keys.

Comparative Return Paths

Let's map the total returns for the iBOXX nominal TIPS index along with total returns for indices of 5-10 and 10+ year Treasuries reindexed to the January 2001 start-date of the TIPS index. TIPS have outperformed 5-10 year UST throughout the post-March 2009 launch of quantitative easing as inflation expectations remained relatively high and as the reinvestment rate on the 5-10 year notes' coupons fell toward zero. TIPS have underperformed 10+ year UST since the August 2011 launch of Operation Twist gave the long end of the yield curve an artificial boost. Both TIPS and long-term Treasuries lost money in 2013 regardless of inflation's course as I pointed out in July 2013's TIPS Are Still Bonds.

Relative TIPS Performance Over Time



No Free Insurance

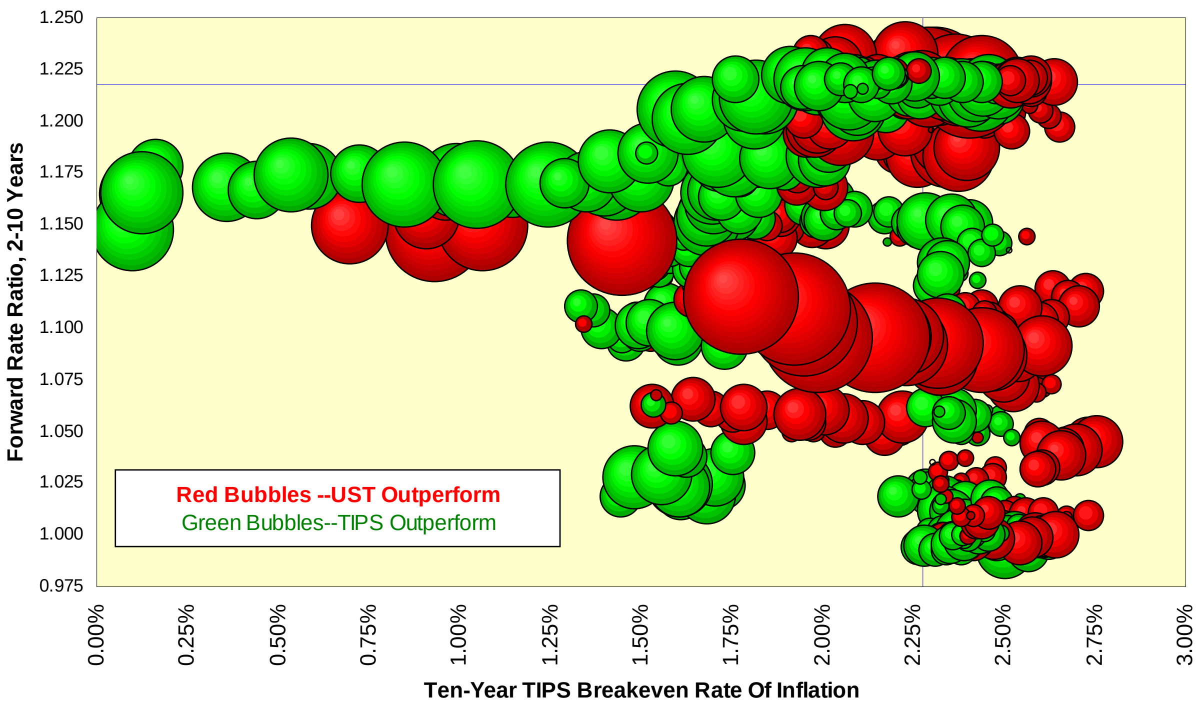
Perhaps some Himalayan hermit schooled in life's mysteries can explain why investors believe issuers no less sophisticated than they are will sell them underpriced inflation insurance, but I doubt it. The tradeoff in TIPS is you accept a lower coupon rate in return for a higher principal at maturity if realized consumer inflation exceeds the level expected at purchase. Oh, and did I mention you have to rely on Uncle Sam's calculation of the CPI-U and the ongoing tax rate on the CPI accrual factor?

Investors are Charlie Brown to the Bureau of Labor Statistics' Lucy; in 2013, ten-year TIPS breakevens averaged 2.278% while the CPI-U averaged closer to 1.5% through November. This high bias resulted in systemic overpricing of TIPS.

Where do we go from here? Let's take a look at three month-ahead relative returns for TIPS and 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 blue bombsight. We are in a region of a very steep yield curve combined with breakeven levels near 2013's average level. This is a region of indeterminate prospective relative performance.

One Quarter-Ahead Relative Performance Of 10+ Year Treasuries Vs.
iBOXX Nominal TIPS Index



What should you do, then? My suggestion is simple for the fixed-income portion of your portfolio: Do not pretend you can outguess the relative course of future realized inflation vis-à-vis today. History says it is a loser's game. You might get by with a little help from your friends, but you will not get by with any help from the TIPS market.