Yes, Virginia, There Is TIPS Protection

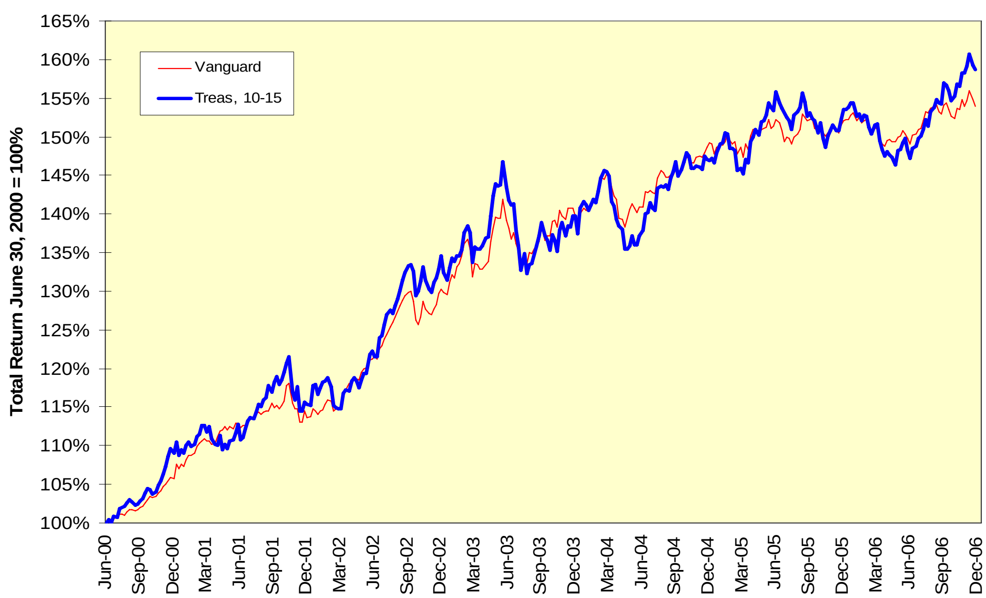
For those still enamored of the Tooth Fairy, Santa Claus and Social Security, may we suggest a healthy dollop of TIPS to round out your portfolio this holiday season? Treasury Inflation-Protected Securities have had something of a rough year vis-à-vis conventional Treasury bonds. TIPS' payoff is linked to the All-Urban Consumer Price Index and despite a gallop higher in early 2006, the year-over-year changes in the CPI-U have declined noticeably over the past three months. If last week's discussion on macroeconomic indicators pointing toward lower inflation is at all correct, TIPS should be pricing in lower inflation for a while.

Think of TIPS as insurance against inflation. In return for a payment, in this case a lower yield than available on conventional Treasuries, you get paid a reward if the adverse event occurs, in this case higher than expected inflation. This insurance mechanism is subject to several embedded options, including a short call option on both tax rates and government honesty in reporting inflation. These were discussed in October 2003, but let's keep the case as simple as we can for right now.

How often do you buy insurance for free? The lower yield on TIPS reflects the market's best estimate not only of the future CPI-U but of the effects of all those embedded options. If the market's estimate is correct, the total return on TIPS and comparable Treasury bonds should be equal subject to unexpected changes in the reinvestment return on coupons received. That's a mighty bold conjecture; can we demonstrate it in fact? (Really, would I ask this question if the answer were "no?")

Let's compare the total return on the Vanguard Inflation-Protected Securities Fund, which has an average maturity between 7-20 years against the total return on a Merrill Lynch index of 10-15 year Treasury bonds. Both total return streams will be indexed to June 30, 2000 = 100%.

TIPS Market Offers Illusion of Protection



After 6½ years, the total return index on the Vanguard TIPS fund stands at 154.0%, while the total return of the Merrill Lynch Treasury index stands at 158.8%. The two measures have leapfrogged each other over time; until September 2006, the TIPS fund had a higher return.

This is evidence of an efficient market in action: TIPS sellers charge a higher price/lower yield for inflation insurance when inflation fears are rampant upon the land and less when they are not. The lower yield lowers the prospective return and brings TIPS and Treasuries into equilibrium. Moreover, to the extent greater inflation fears induce higher short-term interest rates, the higher coupons paid by conventional Treasuries will earn more income if reinvested in cash.

The only time TIPS can achieve higher total returns is when future inflation exceeds current expectations therefor. Why anyone would think otherwise, that insurance buyers could achieve greater rewards by accepting less risk, is unclear. The meek may inherit the Earth someday, but not by doing this trade.

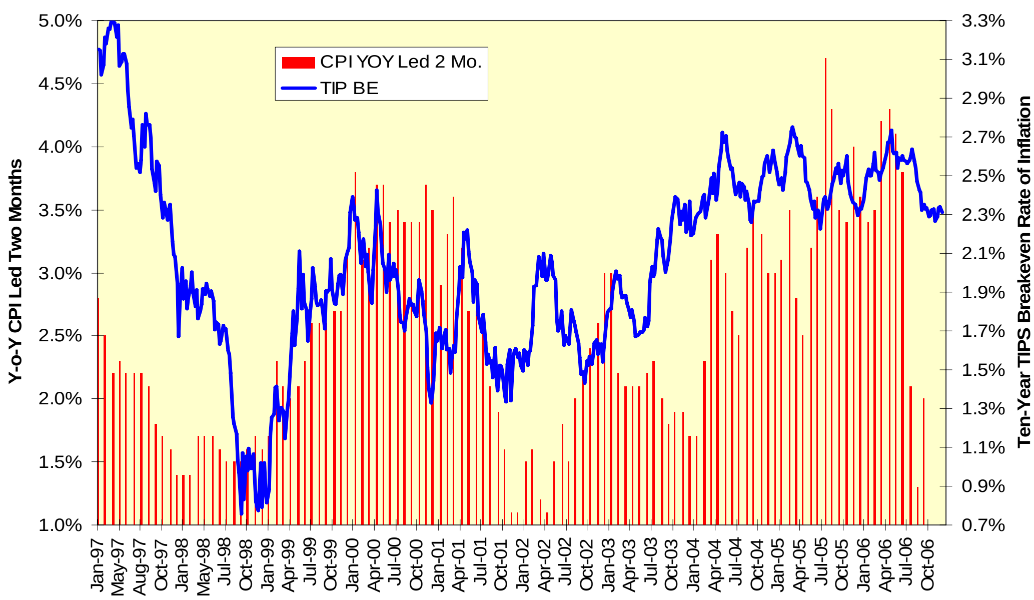
TIPS' Forecasting Ability

As most Americans have little direct experience with agricultural structures, the phrase "broadside of a barn" might not be as evocative as it once was. Still, the TIPS market has demonstrated no ability to hit it with assessments of future inflation.

Statistically, TIPS' breakeven rate of inflation leads year-over-year changes in the CPI-U by two months; this is nothing to crow over considering many TIPS have maturities in excess of ten years. And while the market sort of gets the directional changes in the CPI-U more or less correct, it gets the magnitude all wrong. At last reading, the ten-year breakeven rate of inflation was 2.31%; the year-over-year change in CPI-U was 1.97%. The chart below shows just how meek the meek have been; they persist in overpaying for inflation protection and have yet to follow the CPI-U lower.

Oh, almost forgot: If you believe the CPI-U is bogus, remember this is the accrual index for TIPS' principal adjustment. Remember, you are short a call on government honesty, and I like their side of the trade. Never play poker with a guy named Doc.

TIPS Still Overstating Realized Inflation

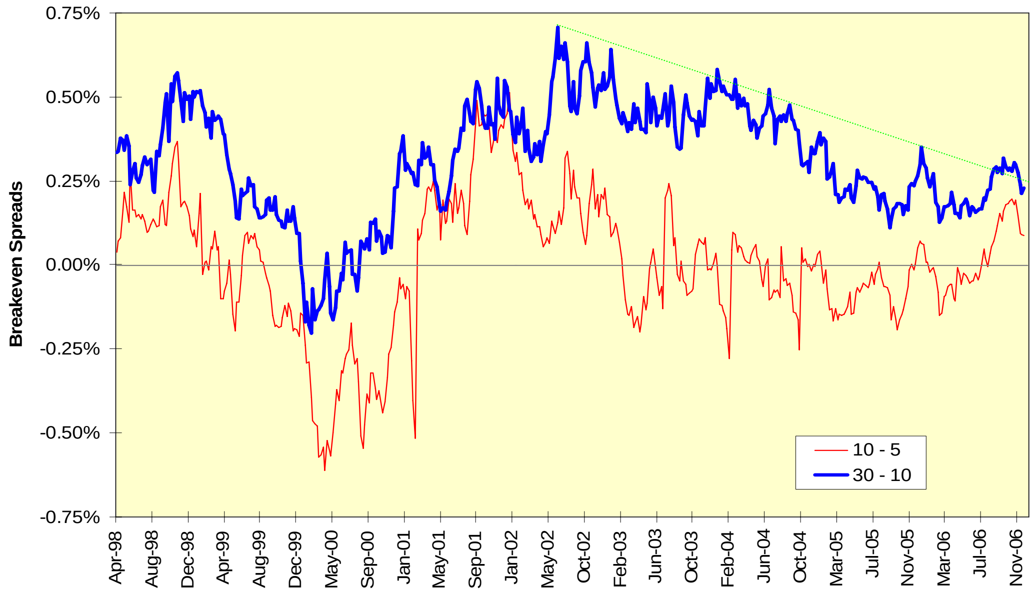


Changing Term Structure

There's something about the Federal Reserve's credibility people do not admit in public but somehow the market admits in action. Not only can we construct breakeven rates of inflation at the ten-year maturity, we can do it for both five- and thirty-year bonds as well. The five-year data are very noisy by virtue of shifts in which note is considered the on-the-run issue.

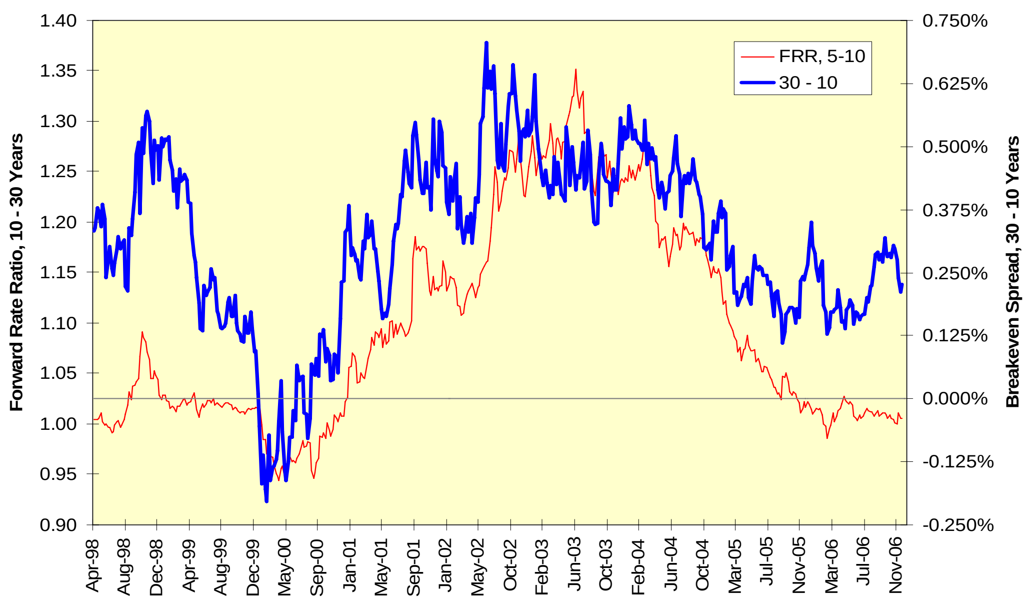
The spread between the ten- and five-year breakeven rates has been negative for much of the time since February 2003. It turned positive in August 2006, peaked in November and is now headed lower. The spread between thirty- and ten-year breakeven rates had been in a downward channel since June 2002; it broke higher in August as well but has since resumed its downtrend. The overwhelming and irrefutable message of these spreads is the market believes any upturn in inflation, such as that seen in early 2006, is short-lived and will provoke a monetary policy response.

The Term Structure Of Inflation Expectations



That message is coincident with the flattening of yield curves across the maturity spectrum. The forward rate ratio between five and thirty years, the rate at which we can lock in borrowing for 25 years starting five years from now divided by the thirty-year rate itself, has been in a downtrend since mid-2003. The bond market is not pricing in accelerating inflation at the long end of the yield curve.

The Yield Curve And The Inflation Spread



What does this all mean for those who are holding TIPS? Current holders should recognize their total return package will be nearly equivalent to conventional Treasuries. Prospective buyers should recognize their investment will pay off only if their forecast for higher inflation than expected by the market is realized and reported as such by the government. Overall, TIPS are not something to flee from, but neither are they the gift people thought they were buying.