Real Rates And Inflation Expectations Misaligned In Time

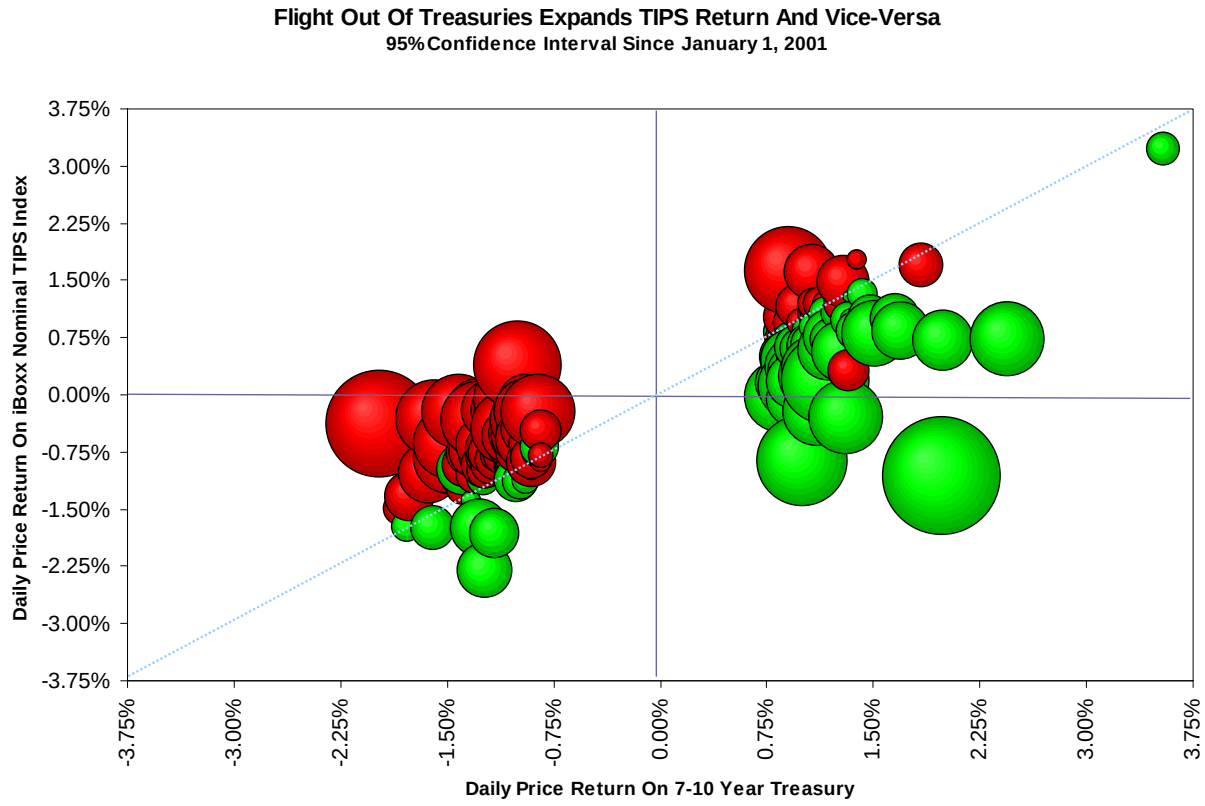
I never have been a big fan of TIPS and probably never will be. Their essential promise of providing insurance against inflation relies on someone being willing to sell you that insurance for less than it is worth. You would not expect Allstate or Geico to be so generous in the realm of auto insurance, so why should you expect sophisticated issuers of and dealers in TIPS to be charitable in the realm of inflation insurance?

Of course, you might occasionally win your little bet if the future stream of realized inflation as calculated by our good friends at the Bureau of Labor Statistics is higher than market expectations at the time of your purchase. But the long-term return of TIPS has been less than that of 10-year+ U.S. Treasuries, leading to the bizarre reality long-term UST, the maturity segment most sensitive to inflation, have been a better hedge against inflation than TIPS as measured by the iBOXX nominal TIPS index. Go figure; I have.

The Distortion Of Large Treasury Moves

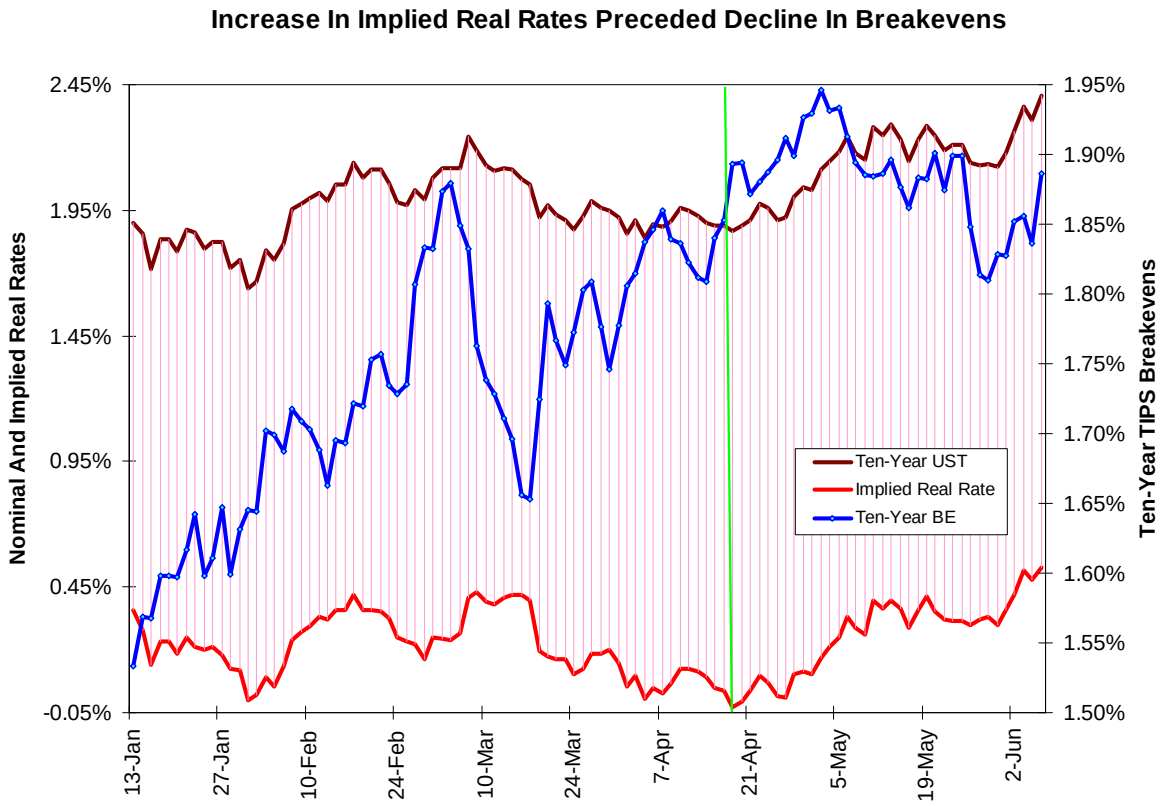
An often overlooked aspect of TIPS breakevens, the difference between the nominal Treasury yield and the TIPS' yield, is nominal Treasuries are far more liquid and are traded for all sorts of reasons, including spreads against corporate and municipal bonds and as a knee-jerk expression of sentiment on those days with economic reports or stock market marshmallow roasts. Treasury yields on those days rise and fall far more than do TIPS yields.

If we map the differences between 7-10 year UST returns and the iBOXX Nominal TIPS index since January 2001 as a function of 7-10 year UST returns outside of a ±95% confidence interval and the associated daily returns on the iBOXX index, a stark picture emerges: Large positive returns on 7-10 year UST exceeded TIPS returns on 69 out of 94 observations (green bubbles) and large negative returns on 7-10 year UST were lower than TIPS returns on 83 out of 109 observations (red bubbles).



What may look like an inflation expectations signal may be in fact be nothing more than the effects of exaggerated flows into and out of nominal Treasuries. A large selloff in nominal UST such as the one on May 11, 2015 (June 3, 2015 did not meet the exclusion parameter) produces an expansion of TIPS breakevens mechanically regardless of any actual change in inflation expectations. The process reverses mechanically as well, as it did on June 4, 2015.

A different interplay affects implied real rates. Ten-year TIPS breakevens hit a local minimum on January 13, 2015, but as nominal ten-year UST rates did not bottom until more than two weeks later, implied real rates continued to decline. The process can work in the other direction; implied real rates hit a local minimum on April 17, 2015 (green line) even though ten-year TIPS breakevens did not hit their local maximum until May 1, 2015.



One of the reasons TIPS are less liquid is many are held by long-term mutual funds and ETFs. If these investors move in response to their own longer-term psychographic needs or to the vagaries of external markets, their timing will be different from that of nominal UST investors.

Thus we can have anomalies such as the present month-long period of rising nominal rates, rising implied real rates and TIPS breakevens lower now than they were at the start of May. The combination of rising implied real rates and declining inflation expectations scarcely justifies talking about increases in short-term interest rates and yet we seem to talk about nothing else.