

TIPS Not Ready To Outperform

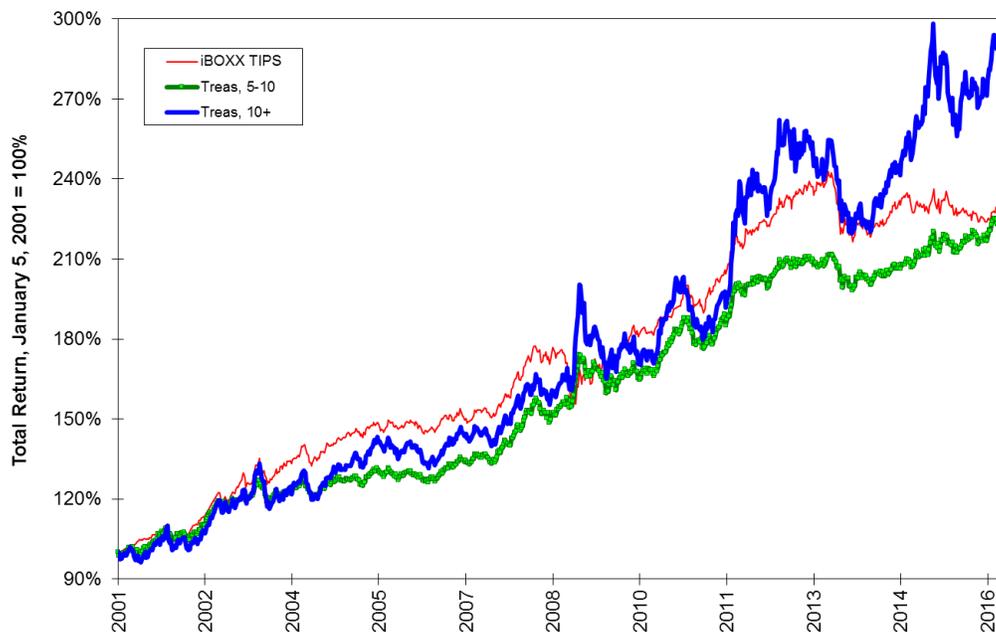
One of the more tedious aspects of a long political campaign season is hearing the same people say the same thing, often in complete disregard to the question posed. However, what if you actually are responding to a consistent question and your answer is based on simple, straightforward and (hopefully) irrefutable data?

Let's take the question of TIPS and whether they provide you, the investor, with a solution to a problem. The idea is simple enough; you lie there waiting in the weeds for a signal the rest of the world does not see, swoop in and buy TIPS at a low breakeven rate, wait for the actual rate of inflation as measured by the all-urban consumer price index not seasonally adjusted to rise and then smirk knowingly at all of those not quite as fast on the draw as you were. It is a great feeling, let me tell you.

Too bad it breaks down quickly. First, if TIPS are a form of insurance against inflation, why do you expect the sellers of that insurance to underprice it systematically? Second, if TIPS are a fixed-income instrument, why would you expect them to perform well on an absolute basis in a rising interest rate market even if they outperform conventional bonds on a relative basis? Third, how do you intend to account for all of those embedded options, such as you being long a call option on Uncle Sam's honesty in reporting inflation and short a call option on the tax rates you have to pay on the inflation accrual index? Finally, what do you do when various official Treasury bond-buying programs or haven bids compress TIPS breakevens via lower conventional bond yields?

The net result of all this is the iBOXX nominal TIPS return index has underperformed 10-year+ Treasuries by a significant margin since the January 2001 inception of the iBOXX index and it is only slightly ahead of an index of 5-10 year Treasuries.

Relative TIPS Performance Over Time



At this point I often insert a quip about long-term Treasuries being better inflation-protection than TIPS by definition, *plus* they give you the warm satisfaction of knowing you are financing the federal government and its well-designed and carefully executed spending programs. But that would be wrong.

Prospective Relative Returns

Where do we go from here, at least on a short-term basis? If we map the one quarter-ahead relative performance of 5-10 year Treasuries against the yield curve as measured by the forward rate ratio between two and ten years and the ten-year TIPS breakeven rate of inflation, we see distinct patterns of when nominal Treasuries outperform TIPS (blue bubbles, with the magnitude of outperformance represented by bubble size) and vice-versa (champagne bubbles). The current environment is marked with bombsights and the datum from December 11, 2015 is highlighted.

The present combination of a flattening yield curve and rising TIPS breakevens has pushed the environment slightly southeastward into a zone more favorable to conventional Treasuries than to TIPS.

