TIPS Attractive Amid Potential for Upside Inflation Surprise

Inflation-adjusted bonds are also useful to hedge credit risk.

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KEY INSIGHTS

- TIPS are attractive, in our view, because of the potential for inflation to exceed the widely anticipated increase in consumer prices later in 2021.
- Commodity price trends, a robust housing market, and fiscal and monetary policies designed to reduce income inequality contribute to our inflation outlook.
- We believe that TIPS can serve as both a useful hedge against the interest rate risk of nominal government bonds and against declines in risk assets.

Michael Sewell, CFA
Portfolio manager for US Inflation Protected Bond and US Short-Term Inflation Focused Bond Strategies

Treasury inflation protected securities (TIPS) are attractive, in our view, because of the potential for inflation to exceed the widely anticipated increase in consumer prices later in 2021. Several factors, including commodity price trends, a robust housing market, and fiscal and monetary policies designed to reduce income inequality, contribute to this outlook. Amid the potential for higher nominal[1] yields as COVID-19 vaccines become widely available and the economy recovers from the pandemic, we believe that TIPS can serve as both a useful hedge against the interest rate risk of nominal government bonds and against declines in risk assets.

TIPS Market Measures Investor Inflation Expectations

The principal of TIPS regularly adjusts according to fluctuations in the consumer price index (CPI), with the holder receiving the greater of the original principal or the inflation-adjusted principal at maturity (i.e., a 0% inflation floor). The difference in yield between a nominal Treasury bond and TIPS of the same maturity represents the market's current expectation for inflation over that time frame, referred to as the breakeven rate. If actual inflation is greater than the breakeven rate at the end of the period, holders of TIPS benefit more than holders of nominal Treasuries.

2020 Base Effects to Drive CPI Higher

Headline year-over-year changes in the CPI will move meaningfully higher beginning in March 2021 because the calculations start from the low base at the onset of the coronavirus pandemic in 2020, when consumer prices broadly fell. Prices of many commodities have recovered since then—for example, the price of Brent crude oil, the international

[1] Not adjusted for inflation.

> “...we believe that the risk of an upside inflation surprise is elevated in the current environment.

benchmark, averaged about USD 33 per barrel in the second quarter of 2020 amid expectations for cratering demand but has since recovered to above USD 55 in early 2021.

Shelter prices are also a large component of consumer price measures. Housing prices have been remarkably strong through the pandemic as people seek out more spacious houses outside major cities amid record-low levels of supply on the market. Extremely low mortgage rates have added fuel to the housing rally, and mortgage rates are likely to remain attractive even if they move modestly higher with Treasury yields in 2021.

From a broader point of view, we anticipate a strong rebound in economic growth after the first quarter of 2021 as vaccines become more widely distributed and available to the U.S. population. We also expect additional fiscal stimulus to fight the pandemic, potentially contributing to the growing savings of many consumers and the amount of pent-up demand that could drive consumer prices higher when the economy more fully reopens. Inventories of some products are also running low, which could help push prices higher when combined with vigorous demand.

Subtle Factors Also Contributing to Potential Inflation

There are also less obvious factors that could push inflation even higher than consensus expectations, in our opinion. Many of the recent measures implemented to battle income inequality are inherently inflationary—for example, the Federal Reserve's recent change in monetary policy framework incorporates a focus on reducing income inequality. In part, the Fed hopes to achieve this goal by keeping rates low to maximize employment rather than preemptively tightening policy to contain nascent inflation. On the fiscal side, the push for a USD 15 nationwide minimum wage as a tool to reduce income inequality could also contribute to inflationary pressure if implemented.

In addition, we expect the 2020 trend toward a weaker U.S. dollar to continue, creating the potential for higher import prices. Some measures of supply-side price pressure, including the Institute for Supply Management's prices paid and supplier delivery time indexes, are also rising. Producers could pass their higher costs along to consumers.

Consumer Expectations of Inflation Moving Higher

Importantly, some measures of consumer expectations of inflation are trending higher. We closely monitor the University of Michigan's consumer survey of expected price changes, which reached a five-year high in 2020 before moderating somewhat. In our opinion, changes in consumer behavior and mindset are the main factors that can solidify higher inflation expectations over the longer term.

The difference between inflation expectations and actual consumer price movements is a key consideration in determining the TIPS positioning in the inflation protected portfolios. We think that a significant, sustained increase in consumer expectations for inflation is the one variable—not headline CPI or higher breakeven rates—that could potentially prompt the Fed to shift to more hawkish messaging or start to taper its asset purchases, which could have negative implications for TIPS breakeven spreads. Nevertheless, while TIPS would likely deliver negative total returns in this environment, they would probably still act as a partial hedge by holding up better than other areas of fixed income.

Favorable Environment for Upside Inflation Surprise

While we think it is unlikely that the Fed will slow its bond buying this year in response to a surge in inflation, we believe that the risk of an upside inflation surprise is elevated in the current environment. We feel it is prudent to hedge that risk, so we have positioned the inflation protected portfolios to benefit from inflation that outpaces current breakeven rates, primarily through exposure to TIPS. These positions focus on the 10-year segment of the TIPS yield curve.

We have reduced the structural allocations to fixed income sectors that are not included in the benchmark index, including shorter-maturity corporate bonds and asset-backed securities, which provide diversification benefits and additional income in falling inflation regimes. These segments currently have rich valuations and, while their risk-adjusted returns exhibit positive correlations with unanticipated inflation shocks, would likely underperform TIPS in an inflationary environment of rising interest rates.

In terms of investors' broad asset allocations, we believe that inflation-linked securities are an effective hedge against interest rate risk because TIPS should outperform nominal Treasuries in an environment where stronger growth and inflation concerns pressure nominal rates higher. Following the global financial crisis, breakeven rates have largely traded in line with risk assets such as equities and corporate bonds—in essence, investors viewed higher inflation expectations as supportive for risk assets. We think that the pandemic environment has shifted the narrative for TIPS, with inflation protected bonds now potentially also acting as a hedge against downturns in risk assets that could result if inflation exceeds expectations and begins to pressure corporate profits.

WHAT WE'RE WATCHING NEXT

The core personal consumption expenditure (PCE) price index is an alternate measure of inflation that the Fed prefers over CPI. The year-over-year change in the durables component of PCE recently turned positive for the first time since the mid-1990s. A sustained upturn in this measure, when combined with pent-up consumer demand for services, could signal impending inflationary pressure.

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