Looking Beyond Short-Term Inflation Pressure in TIPS

Rapid Fed tightening makes interest rate risk management key.

July 2022

KEY INSIGHTS

- We expect inflation to stay high in the short term before the Fed's hawkish pivot and tighter financial conditions dampen inflation past the 12-month horizon.
- The Fed is signaling that it is prepared to sacrifice its full employment mandate to lower inflation over the medium term by raising rates at a fast pace.
- We have been positioned for higher inflation in the short term, but we have been taking measures to lower exposure to intermediate-term inflation.

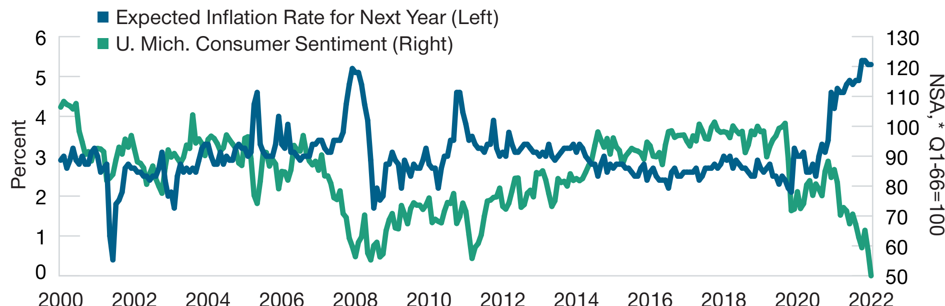
Michael Sewell, CFA
Portfolio manager for U.S. Inflation-Protected Bond and U.S. Short-Term Inflation-Focused Bond Strategies

Blerina Uruci
U.S. Economist

Inflation has shown only tentative signs of slowing from its highest levels in decades, and we expect the Federal Reserve (Fed) to continue to increase rates at a fast pace. Given how hot inflation has been running, some investors in inflation-protected bonds may be surprised by the disappointing returns of the Treasury inflation protected securities (TIPS) asset class as rates have climbed. In our actively managed inflation-protected portfolios, we have been positioned for higher inflation in the short term, but we have been taking measures to lower exposure to intermediate-term inflation and limit interest rate risk. This positioning is essentially a way to buy inflation and sell inflation expectations.

Inflation Outlook Weighs on Consumers

(Fig. 1) Falling confidence, rising inflation expectations.



As of June 30, 2022.
Source: University of Michigan Surveys of Consumers.
*NSA=not seasonally adjusted.

> The Fed is concerned that if the rate of headline inflation persists at current elevated levels, it risks pushing inflation expectations higher.

Upside Inflation Risk for Next Few Months

Inflation remains stubbornly high, and price pressures have broadened beyond areas that are most affected by COVID-related supply bottlenecks. Over the coming few months, we see upside risks from services inflation as consumer spending rebalances toward services and away from goods, supported by a strong labor market and rising aggregate incomes in the economy. Shelter prices should also increase because of strong demand for rental homes at a time when buying a new house has become unaffordable because of higher mortgage rates and elevated prices.

The Fed has historically taken the view that its tools are too blunt to affect the evolution of food and energy prices, which are more volatile and respond to international shocks, not just domestic economic conditions. As a result, the Fed—and most professional forecasters—have focused on core measures of inflation that exclude food and energy.

However, that has changed recently. The Fed is concerned that if the rate of headline inflation persists at current elevated levels, it risks pushing inflation expectations higher. This concern is informed by empirical economic studies showing items purchased frequently, such as food and fuel, are more likely to influence consumers' perception of inflation than items bought infrequently. The central bank clearly wants to keep inflation expectations anchored at moderate levels, preventing a spiral of higher prices driving higher wages.

Rapidly rising energy and food prices, worsened by Russia's invasion of Ukraine, imply further upside to the outlook for headline inflation in the second half of the year. However, the Fed's monetary policy is likely to have less impact on headline inflation because the rise in food and energy prices is, in large part, driven by factors outside of its control, such as oil supply and food commodity harvests.

Several Factors Likely to Dampen Longer-Term Inflation

However, when considering the inflation outlook beyond the 12-month horizon, we see several factors that should dampen price pressures. The most important is the Fed's hawkish pivot, which has led to a significant tightening in financial conditions through higher Treasury yields, lower equity prices, and a stronger dollar. This has already started to slow demand in some sectors of the economy that are particularly sensitive to interest rates.

In addition, the rebalancing of demand toward services and the high level of retail inventories for consumer goods will likely put some downside pressure on goods inflation outside of the automotive sector. Rising borrowing costs for businesses will eventually feed through to slower employment growth, which should dampen consumer demand.

Fed Determined to Prioritize Price Stability

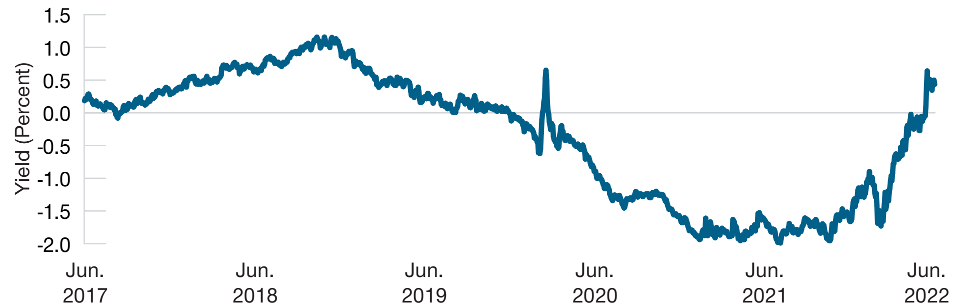
The Fed may not be looking to cause a recession, but it is determined to prioritize the price stability part of its mandate until it sees clear and convincing evidence that inflation—both headline and core—is slowing. By setting a high bar for shifting toward a more dovish policy stance, the Fed is signaling that it is prepared to sacrifice its full employment mandate to lower inflation over the medium term by raising interest rates at a fast pace.

Real Yields Have Room to Move Higher

We anticipate that Fed rate hikes and balance sheet runoff will continue to push real, or inflation-adjusted, yields—best measured by yields on TIPS—higher in intermediate maturities. The five-year TIPS yield increased to 0.44% on June 30 from -1.66% at the end of 2022. The five-year real yield had been solidly negative from the second quarter of 2020 into June 2022, when the effects of the Fed's rate hikes pushed it well into positive territory.

Five-Year Real Yields Turn Positive

(Fig. 2) But five-year TIPS yield is below late-2018 high.



Past performance is not a reliable indicator of future performance.
As of June 30, 2022.
Source: Bloomberg Finance L.P.

> This overall positioning should allow the strategies to deliver on their mandate to provide inflation protection while simultaneously managing interest rate risk.
>
> **— Michael Sewell**
> *Portfolio Manager*

However, five-year TIPS yields climbed above 1.0% in the Fed's 2018 hiking cycle, so they could easily move higher in 2022.

Active Management Allows Tactical Positioning

With this outlook in mind, we have positioned our inflation-protected strategies with a relative overweight to short-maturity (approximately one-year) TIPS and an underweight to intermediate-maturity inflation exposure. Even using conservative inflation assumptions, one-year TIPS have more attractive carry (yield above that of the risk-free rate of return) than five-year inflation-protected Treasuries as well as much lower duration,[1] making their returns less vulnerable to the Fed's aggressive hiking campaign. Our overweight to one-year TIPS is a way of going long near-term inflation.

In the five-year segment of the yield curve, we expect real yields to increase more than nominal (not inflation-adjusted) Treasury yields as the tightening Fed and slowing growth cause inflation expectations to compress. As a result, we have been underweight five-year inflation—essentially shorting inflation expectations. This overall positioning should allow the strategies to deliver on their mandate to provide inflation protection while simultaneously managing interest rate risk.

We believe that our targeted positioning is more prudent for investors in the current environment than owning a passively managed TIPS portfolio that has broad exposure along the TIPS yield curve in line with the benchmark and regardless of the liquidity risk in some thinly traded bonds. Although the principal amount of TIPS adjusts for inflation, the negative price effects of yield increases can more than offset the returns stemming from the inflation adjustment. This dynamic can be seen in the year-to-date performance of TIPS as their relatively high duration created negative returns for their holders—though they held up better than some other fixed income asset classes, like nominal Treasuries.

Soft Landing a Risk to Positioning

The major risk to our positioning is that inflation surprises to the downside for several consecutive months as the economy continues to expand, convincing the Fed to slow the size and pace of its rate hikes. While we think this soft-landing scenario is increasingly unlikely, it would likely lead to

[1] Duration measures a bond's sensitivity to changes in interest rates.

underperformance for short-term TIPS relative to longer-term TIPS, working against our positioning. On the positive side, if this scenario came to pass, most other asset classes within an investor's broad asset allocation would likely generate strong returns.

WHAT WE'RE WATCHING NEXT

The Fed purchased TIPS as part of its quantitative easing programs following the global financial crisis in 2008–2009 and after the onset of the pandemic in early 2020. The central bank now holds nearly 25% of the total amount of TIPS outstanding, so we are closely monitoring the effects of the Fed's balance sheet runoff, or quantitative tightening, on the TIPS market.

General Fixed Income Risks

Capital risk—the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

ESG and sustainability risk—may result in a material negative impact on the value of an investment and performance of the portfolio.

Counterparty risk—an entity with which the portfolio transacts may not meet its obligations to the portfolio.

Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice®

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2022 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/ or apart, trademarks of T. Rowe Price Group, Inc.

ID0005217 (07/2022)
202207-2281078