



# 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.

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 help limit interest rate risk. This positioning is essentially a way to buy inflation and sell inflation expectations.



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## Inflation Outlook Weighs on Consumers

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



As of June 30, 2022.

Source: University of Michigan Surveys of Consumers.

Actual outcomes may differ materially from expectations.

\*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**

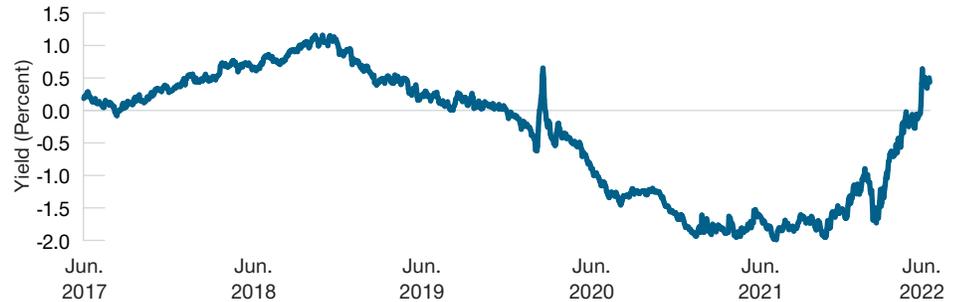
The Fed may not be looking to cause a recession, but it is determined to prioritize the price stability part of its mandate until it sees clear and convincing evidence that inflation—both headline and core—is slowing. By setting a high bar for shifting toward a more dovish policy stance, the Fed is signaling 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 2021. 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 funds 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 rate 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 funds 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<sup>1</sup>) than five-year inflation-protected Treasuries as well as much lower duration,<sup>2</sup> 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 funds 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

<sup>1</sup> Risk-free rate of return is a theoretical return of an investment with zero risk and the measure is used as a rate against which other returns are measured.

<sup>2</sup> Duration measures a bond's sensitivity to changes in interest rates.

we think this soft-landing scenario is increasingly unlikely, it would likely lead to 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 favorable 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.

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