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TIME FOR TIPS?

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Shawn Doty *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

TIPS are a high-quality asset class that can cushion portfolios if inflation begins to increase.

Breakeven inflation has risen since YTD lows in June, but has had difficulty breaking above current levels in recent months.

TIPS may offer an opportunity if breakeven inflation expectations move toward longer-term averages.

Treasury Inflation-Protected Securities (TIPS) are sought after when inflation is expected to rise. Backed by the U.S. government and similar to Treasury bonds in quality, TIPS offer interest payments and principal values that increase with inflation. At the start of this year, the consensus view was that inflation would climb; TIPS prices increased with demand as investors sought protection from anticipated inflation. Thus far, however, U.S. inflation, as measured by the Consumer Price Index (CPI), has failed to materialize. The CPI measures the change in prices for a basket of goods and services, with oil prices functioning as one key component. Declining oil prices have contributed to a lower headline CPI in 2017, moving from 2.5% in January to 1.7% in July.

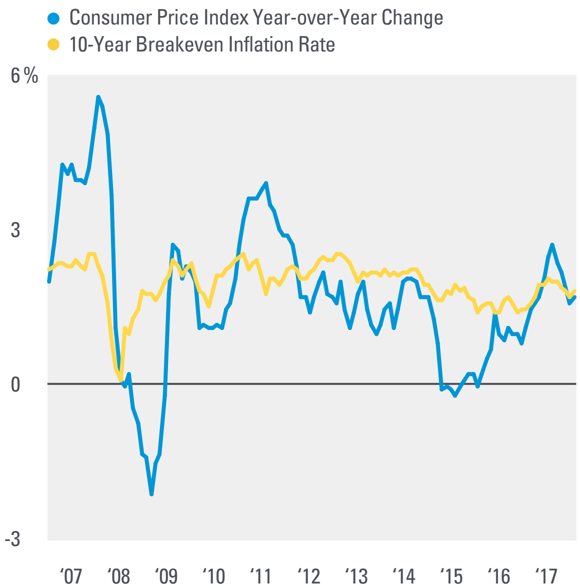
Although inflation is currently tame, that could change quickly if the U.S. economic data were to surprise to the upside, or oil prices were to make a move higher. Only time will tell what happens to inflation, but in the interim a well-diversified allocation to TIPS may be appropriate for investors who are interested in potentially reducing inflation risk, while improving the credit quality of bond holdings.

TIPS VS. NOMINAL TREASURIES

Before investing in TIPS, it is important to compare the market's implied inflation expectation to your own inflation opinion to determine if prices are attractive. The math behind breakeven analysis is relatively straightforward: simply take the U.S. Treasury nominal yield and subtract the TIPS real yield. For example, the current 10-year Treasury yield is 2.22%, and the 10-year TIPS yield is 0.45%, making the current 10-year breakeven inflation expectation 1.77%. This is the inflation rate at which an investor would be indifferent to holding TIPS or conventional Treasuries. Conversely, if the average inflation rate is below this breakeven, then the nominal bond would be a better choice. Generally, a lower breakeven inflation rate implies TIPS are cheaper relative to conventional Treasuries and vice versa.

For perspective, over the past 10 years 10-year breakeven inflation has averaged 2%. If inflation were to move back toward the 2% level (which is also the Federal Reserve's [Fed] target), then today's 1.77% breakeven inflation expectation may prove to be a reasonable entry point.

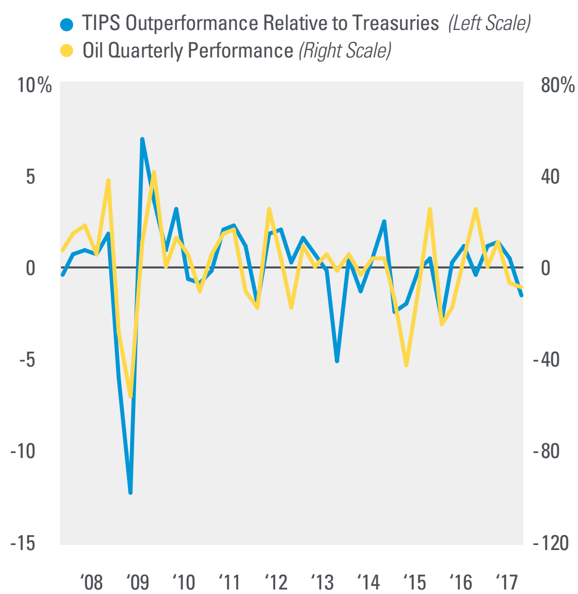
1 **TIPS OUTPERFORM WHEN THE BREAKEVEN RATE IS LOWER THAN THE ACTUAL INFLATION RATE**



Source: LPL Research, Bloomberg 08/15/17

Performance is historical and is no guarantee of future results. Breakeven inflation is measured by the difference between Treasury yields and TIPS yields.

2 **TIPS UNDERPERFORMANCE HAS FOLLOWED OIL CLOSELY**



Source: LPL Research, Bloomberg 08/15/17

Performance is historical and is no guarantee of future results.

TIPS – Treasury Inflation-Protected Securities

CPI & TIPS

Deviations between CPI-derived inflation and breakeven inflation rates occur quite frequently [Figure 1]. Generally, when the breakeven rate is lower than the inflation rate and the CPI is expected to increase, the TIPS investor may benefit because the bond's par value rises with inflation as it adjusts to the higher CPI level. When the bond matures, the investor is paid the adjusted principal or original par value, whichever is greater. Accordingly, the periods of 2007, 2008, and 2011, when inflation expectations were quite low, were good times to buy TIPS.

TIPS PERFORMANCE

The performance of TIPS is highly correlated with the movements in the Treasury bond market, due to similar interest rate sensitivity. Thus far in 2017, as interest rates have declined, TIPS prices have increased along with most other high-quality fixed income sectors. The inflation component of TIPS, which offers little additional compensation to investors when inflation decreases, has been a headwind and the key detractor from the performance of TIPS relative to Treasuries. In addition, crude oil prices, which impact headline inflation, can influence the direction of the overall inflation number. Usually when energy prices decline, the CPI has tended to follow, leading to underperformance of TIPS [Figure 2].

Treasury returns can be just as important, if not more so, than inflation for the overall return of TIPS. Our base case remains that Treasuries are likely to stay in their current range through year-end 2017, with a gradual move to higher yields over the longer term.* Yields could take another turn lower (which would benefit Treasuries and TIPS) due

* We expect the 10-year Treasury yield to end 2017 in its current range of 2.25–2.75%, with a potential for 3%. Scenario analysis based on this potential interest rate range and the duration of the index indicates low- to mid-single-digit returns for the Barclays Aggregate Bond Index.

to either market volatility or surprise central bank moves (foreign or domestic). However, if rates do rise, and the rise is driven by increasing inflation expectations, yields plus the inflation adjustment for TIPS will become a bigger driver of total returns for bonds, making TIPS more attractive than comparable maturity Treasuries.

CONCLUSION

For investors concerned about inflation, TIPS offer the potential for protection if inflation should rise. Like Treasuries, they also enjoy the backing of the U.S. government. With recent CPI data coming in lower than expected, TIPS have cheapened, though breakeven inflation has moved off its late June lows and now sits at 1.77%. With breakevens at current levels and the recent benign inflation readings, we remain neutral on TIPS. However, we do note that current breakeven inflation expectations are below longer-term averages, and that the Fed remains focused on hitting its 2% target in the future. This may offer some opportunity if breakevens move higher, though investors should be aware that TIPS are not perfectly correlated to changes in inflation and are particularly susceptible to underperformance in deflationary, or disinflationary, environments where inflation is either falling or negative. ■

INDEX DEFINITIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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