LPL RESEARCH

BOND MARKET PERSPECTIVES

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TRENDING TIPS

John Lynch *Chief Investment Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

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

Breakeven inflation rates have risen steadily since hitting year-to-date lows in June, leading to outperformance relative to Treasuries.

TIPS may offer an opportunity if breakeven inflation expectations continue higher, but performance should follow Treasuries' lead.

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 are adjusted for changes in inflation. So when prices rise, as measured by the Consumer Price Index (CPI), TIPS typically outperform comparable, nominal Treasuries and help to protect investors' purchasing power. And with inflation recently showing signs of life, investors may now be seeking the inflation protection afforded by TIPS.

BREAKEVEN BREAKDOWN

The math behind breakeven analysis is relatively straightforward: take the U.S. Treasury nominal yield and subtract the TIPS real yield. For example, the current 10-year Treasury yield is 2.37%, and the 10-year TIPS yield is 0.49%, making the current 10-year breakeven inflation expectation 1.88%. This is the inflation rate at which an investor would be indifferent to holding TIPS or conventional Treasuries over that 10-year period. Generally, a lower breakeven inflation rate implies that TIPS are cheaper relative to conventional Treasuries and vice versa.

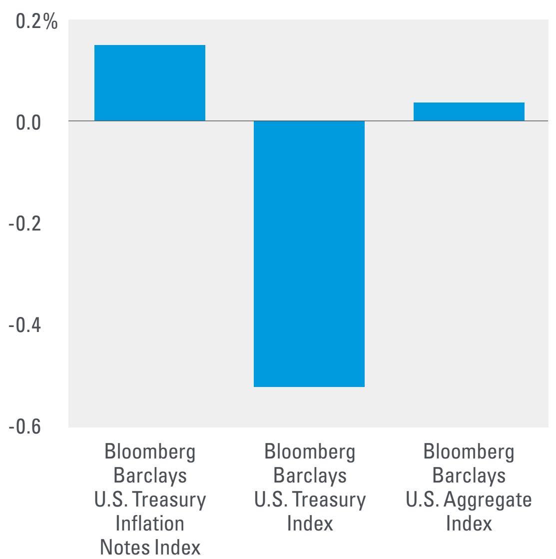
> Before investing in TIPS, it is important to compare the market's implied inflation expectation to your own inflation opinion to determine if prices are attractive.

Over the past 10 years, 10-year breakeven inflation has averaged 2%. In our *Bond Market Perspectives, "Time for TIPS?"*, we made the case that a 1.77% breakeven inflation rate may be an attractive entry point for TIPS investors. That proved to be the case, as over the period from August 15 through October 27, TIPS outperformed not only Treasuries (by a sizable margin) but also the broad, high-quality bond market [Figure 1]. This is because breakeven inflation rose 11 basis points (0.11%) over that period.

Treasury Inflation-Protected Securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI), while providing a real rate of return guaranteed by the U.S. government. Please note: the CPI might not accurately match the general inflation rate; therefore, the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPs do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.

1 **TIPS HAVE OUTPERFORMED TREASURIES DUE TO RISING BREAKEVEN INFLATION LEVELS**

Total Return, 08/15/17–10/27/17



Source: LPL Research, Bloomberg 10/30/17

TIPS – Treasury Inflation-Protected Securities

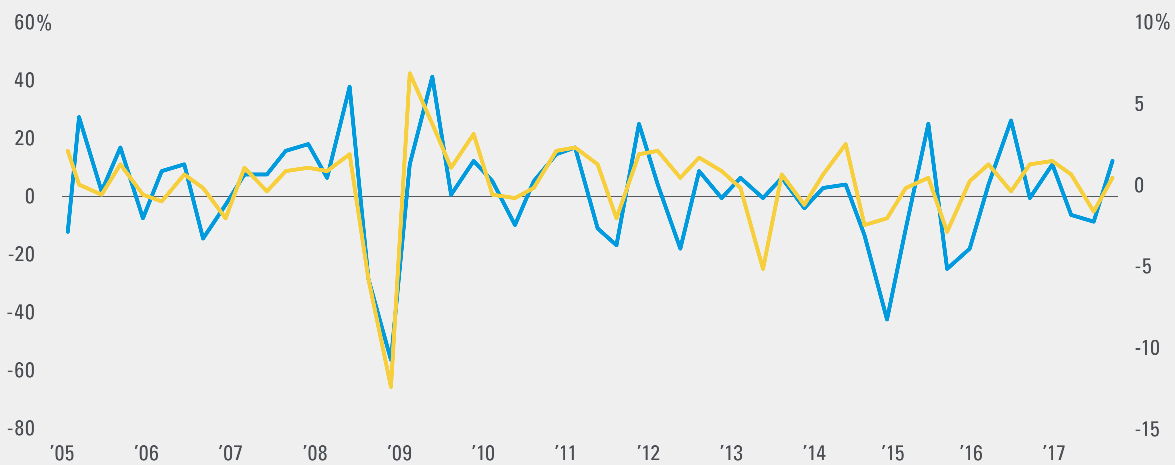
All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

PERFORMANCE DRIVERS AND RISK

The performance of TIPS is highly correlated with the movements in the Treasury bond market, due to similar interest rate sensitivity. The inflation component of TIPS, which offers additional compensation to investors when inflation increases, is a headwind for nominal Treasuries; so increasing inflation expectations have been a tailwind for the performance of TIPS relative to Treasuries since mid-August. Crude oil prices are key input in the CPI calculation and therefore an important driver of headline inflation and inflation expectations. CPI's recovery from its 1.7% reading in July to 2.2% in September is largely attributable to oil's 13.4% rise from August 15 to October 27, which has pressed inflation expectations higher and led to the outperformance of TIPS relative to Treasuries [Figure 2]. Although hurricane-related impacts may have affected CPI readings for the third quarter, there are still signs that inflation may continue higher, including: a tightening labor market, higher gross domestic product (GDP) growth, and rising inflation expectations.

2 **OIL HAS BEEN DOMINANT DRIVER OF TIPS PERFORMANCE RELATIVE TO TREASURIES**

TIPS Outperformance Relative to Treasuries *(Left Scale)*
Change in the Price of Oil *(Right Scale)*



Source: LPL Research, Bloomberg 10/30/17

Indexes referenced: Bloomberg Barclays U.S. Treasury Index and Bloomberg Barclays U.S. Treasury Inflation Notes Index.

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Despite inflation's (and expectations thereof) importance to TIPS returns relative to Treasuries, it is critical to remember that the returns of the overall Treasury market will dominate the absolute level of TIPS returns. Markets are forward looking, so anticipated changes in the CPI may already be priced into TIPS investments via a pickup in breakeven inflation levels, leaving them less attractive relative to nominal Treasuries than one may expect. So although one may benefit from increased interest and principal payments, the lack of market price changes in a rising CPI environment may disappoint investors.

3 **TIPS PERFORMANCE IS HEAVILY CORRELATED WITH TREASURY PERFORMANCE**

	TIPS	Treasuries	10-Year Breakeven Inflation Rate
TIPS	1		
Treasuries	0.77	1	
10-Year Breakeven Inflation Rate	0.15	-0.47	1

Source: LPL Research, Bloomberg 10/30/17

Periodicity is monthly from 10/30/2012 to 10/30/2017.

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

Correlation ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

Correlations help to illustrate this point: while TIPS have a reasonably strong correlation with Treasuries overall, they have a positive, but only weak, correlation with breakeven inflation [Figure 3]. Rising breakevens may mean that performance relative to Treasuries is positive, but on an absolute basis, TIPS historically follow Treasuries' lead. Treasuries' negative correlation with breakeven inflation makes sense: higher breakeven inflation levels usually mean higher interest rates overall, leading to pressure on Treasuries—which don't have the benefit of inflation protection, as TIPS do.

CONCLUSION

TIPS offer the potential for protection if inflation should rise, and they can be a good alternative to Treasuries for investors concerned about inflation. With recent CPI and breakeven inflation levels moving higher over the last couple months, TIPS have outperformed Treasuries; but we remain neutral on TIPS going forward, mainly due to our view of interest rates grinding higher over the short and medium term, and the pressure that will put on TIPS and Treasuries alike. However, current breakeven inflation expectations are still below longer-term averages, and the Federal Reserve remains focused on hitting its 2% inflation target. This may offer some opportunity, though investors should be aware that TIPS performance is highly influenced by the overall direction of interest rates and is not perfectly correlated to changes in inflation. TIPS remain particularly susceptible to underperformance in deflationary, or disinflationary, environments where inflation is either falling or negative. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Treasury Inflation-Protected Securities, or TIPS, are subject to market risk and significant interest rate risk as their longer duration makes them more sensitive to price declines associated with higher interest rates.

INDEX DESCRIPTIONS

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

Bloomberg Barclays U.S. Treasury Inflation Notes Index consists of Inflation-Protection securities issued by the U.S. Treasury.

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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