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TIPS ON TIPS

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KEY TAKEAWAYS

TIPS are a high-quality asset class that can potentially cushion portfolios if inflation continues to increase, but performance could follow Treasuries' lead.

Breakeven inflation rates have risen meaningfully since hitting lows two years ago, leading to outperformance relative to Treasuries.

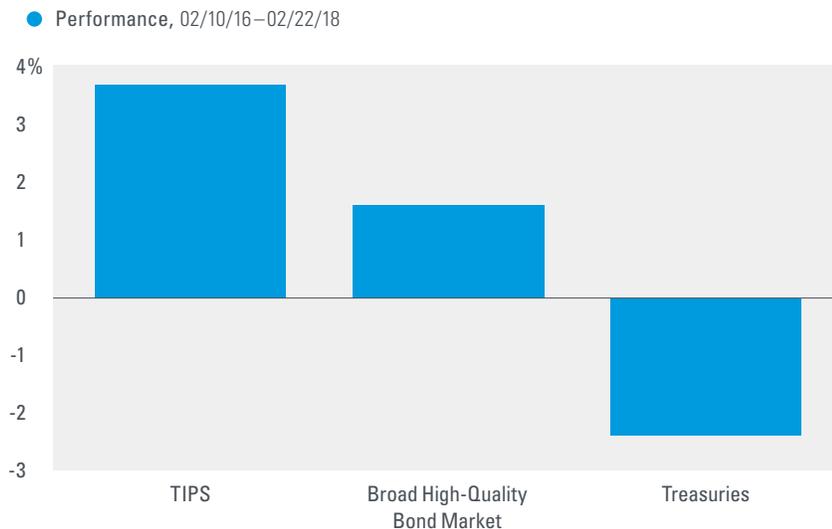
TIPS' large outperformance relative to Treasuries may be behind us, and headwinds remain for TIPS and Treasuries alike.

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. As a result, when prices rise, as measured by the Consumer Price Index (CPI), TIPS typically outperform comparable, nominal Treasuries and help to protect investors' purchasing power. Considering that inflation has recently shown signs of life, investors may now want to seek the inflation protection afforded by TIPS.

BREAKING DOWN BREAKEVENS

To arrive at the current breakeven inflation rate, take the U.S. Treasury nominal yield and subtract the TIPS real yield on a comparable maturity issue. For example, the current 10-year Treasury yield is 2.85%, and the 10-year TIPS yield

1 TIPS HAVE OUTPERFORMED TREASURIES MEANINGFULLY OVER THE LAST TWO YEARS



Source: LPL Research, Bloomberg 02/23/18

Indexes are unmanaged index 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.

Indexes: Bloomberg Barclays U.S. Treasury Inflation Notes Total Return Index, Bloomberg Barclays U.S. Aggregate Total Return Index, Bloomberg Barclays U.S. Treasury Total Return Index

is 0.72%, making the current 10-year breakeven inflation expectation 2.13%. This is the market-implied expectation for the rate of inflation over the next 10 years; it is also the inflation rate at which an investor would be indifferent to holding TIPS or conventional Treasuries over that same 10-year period. Generally, a lower breakeven inflation rate implies that TIPS are cheaper relative to conventional Treasuries and vice versa.

Over the past 10 years, 10-year breakeven inflation has averaged 2%. When 10- and 30-year breakevens hit a cycle low on February 10, 2016, the following two years produced outperformance not only relative to Treasuries, but to the broad high-quality bond market overall [Figure 1].

The impressive absolute and relative performance of TIPS may not continue, however, as inflation

has normalized somewhat from its very depressed levels of early 2016. Inflation expectations, both 10- and 30-year, are above the 2% target specified by the Federal Reserve (Fed); though many market-based measures, including the Fed's preferred measure, the U.S. Personal Consumption Expenditure, remain below 2%. The recent run-up in inflation expectations has been significant, and at 2.1%, the market's 10-year breakeven inflation expectation is now above the Fed's target level. If markets start to price in a significant rise in inflation from this point, it could lead to a more aggressive path of Fed rate hikes, which would in turn potentially put downward pressure on both growth and inflation. In fact, the recent concern about an inflation upside surprise has prompted some market participants to plan for a more aggressive pace of Fed rate hikes; the fed funds futures market is now pricing in 2.8 rate hikes during 2018, compared to 2.1 hikes at the end of 2017. Much of this increase is due to inflation finally starting to rear its head amid the backdrop of tight labor markets, deficit spending, and a weaker U.S. currency.

2 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 02/26/18

Periodicity is monthly from 01/31/13 to 01/31/18.

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; the relationship is completely random.

Performance is historical and is no guarantee of future results.

Breakeven inflation is measured by the difference between Treasury yields and TIPS yields.

PERFORMANCE DRIVERS AND RISK

Despite the importance of inflation (and inflation expectations) 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. In that regard, the last two years have been the exception to that rule. 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 might expect. For that reason, although investors may benefit from increased interest and principal payments, the lack of market-price changes in a rising CPI environment may disappoint them.

Correlations help to illustrate this point: while TIPS have a reasonably strong correlation with Treasuries

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overall, they have only a modestly positive correlation with breakeven inflation [Figure 2]. Rising breakevens may mean that performance relative to Treasuries is positive, but on an absolute basis, TIPS will 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 do not have the benefit of inflation protection, as TIPS do.

CONCLUSION

TIPS may be a good alternative to Treasuries for investors concerned about inflation. However, with breakeven inflation levels moving significantly higher over the last two years, TIPS have outperformed Treasuries, potentially limiting

further outperformance. We believe both TIPS and Treasuries may be under moderate pressure going forward, as interest rates continue to move higher. We currently favor TIPS relative to nominal Treasuries, but that may change soon as we reassess the recent pickup in breakeven inflation to determine how much higher it can run.

For now, we remain underweight Treasuries (both nominal and TIPS) relative to other high-quality bond segments, like investment-grade corporates and mortgage-backed securities. Although we expect the potential for yields to proceed higher throughout the remainder of the year, volatility may persist, and we believe bonds remain an important component of a well-balanced, diversified portfolio that could manage risk exposure should we experience equity market pullbacks. ■

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.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

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.

DEFINITIONS

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.

Personal consumption expenditures (PCE) is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, nondurables, and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.

INDEX DESCRIPTIONS

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.

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.

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