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The Bullish Case for TIPS

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About Scott Slayton

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Scott is a partner of the firm and Chief Strategist. Before joining Capital Creek, Scott was the Head of Asset Allocation at UTIMCO, where he served on the firm's Management, Investment, and Risk Committees. Scott has 35 years of investment experience as a strategist, portfolio manager, and asset allocator. Scott spent most of his career in New York, working at Kidder Peabody, Morgan Stanley, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988. Scott is also a Chartered Financial Analyst, CFA.

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**ChatGPT was a research assistant in the writing of this report.*

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"The single greatest risk savers face is the long-term reduction in purchasing power through the process of inflation." (Anonymous)

Back in early 1997, the US Treasury Department issued its first Treasury Inflation Protected Securities ("TIPS"). This was an important innovation in Treasury finance because it gave savers and investors a new way to protect themselves from the long-term ravages of inflation through a very high-quality, liquid security backed by the US Treasury.

By the late 1990s, the bad ole days of the inflation-engorged 1970s and early 1980s were distant in the rear-view mirror. Inflation peaked in 1980 and had been falling consistently for over 15 years. Alan Greenspan was successfully in charge at the Fed for ten years, and inflation expectations were well anchored in the 2-3% zone. The Treasury now had the confidence to issue bonds tied to inflation because they did not expect higher inflation to be a problem for the foreseeable future. They were correct, at least until inflation awoke from its long slumber during the COVID-19 pandemic.

What are TIPS?

TIPS are a type of US Treasury bond specifically designed to safeguard investors from inflation. Unlike traditional Treasury bonds, the principal amount of TIPS adjusts with changes in the Consumer Price Index (CPI), a primary gauge of inflation. TIPS are unique fixed-income securities because their principal and interest are indexed to grow with inflation. *TIPS are designed to protect investors purchasing power from unexpected upside to inflation.*

Why We Think TIPS are Timely

Our strategic view is that inflation has most likely left the "goldilocks" period from 1990 through 2020, when the headline CPI averaged a docile 2.4%. We expect the future "resting heartbeat" for inflation will be higher, somewhere in the 3%-to-5% zone over the next ten years. For perspective, it is helpful to know that headline CPI inflation has averaged 3.3% over the 110-year history of the data. Market-based inflation measures are currently pricing future inflation around 2.3% annually over the next decade.

We think investors should "take the over" on 2.3% headline CPI inflation for the next 10 years. We see inflationary risk to the upside due to a host of structural factors that favor higher inflation for the foreseeable future. These factors include (1) the green energy transition, (2) deglobalization/great power competition, (3) structural labor

shortage, (4) structural housing shortage, (5) reshoring/friend shoring supply chains, (6) global military conflicts, (7) political populism/polarization, (8) uncontrolled fiscal spending, (9) key commodity underinvestment, and (10) de-dollarization. We estimate that these factors will increase the pace of inflation by 100-250 basis points over the next decade. Our best estimate is that headline CPI inflation will average in the 3.0%-to-4.0% zone over the next 10 years. We present this estimate with great humility because we know that inflation has been exceedingly difficult to forecast. Even the Fed has had great difficulty forecasting the future path of inflation. However, we are confident that the above structural factors favoring higher inflation are so significant and numerous that the future does favor structurally higher inflation in the US.

Given our view of higher inflation in future years, we like the fact that TIPS allow an investor to allocate a lot of money into a relatively safe and liquid asset that will protect their wealth from increases in CPI inflation. We also like the entry point for TIPS with real yields close to 15-year highs. The last time real yields were near 2.5% was in the depths of the Global Financial Crisis (GFC).

At current levels, we see TIPS as excellent value relative to other traditional inflation hedges such as gold, oil, and residential real estate. These other inflation hedges are trading near their five-year highs, while TIPS are trading at the lowest prices in almost 15 years. See Exhibit 1 below.

Exhibit 1: iShares Bond ETF (TIP) vs. Gold

Source: Capital Creek Research, Bloomberg

Finally, we find TIPS to be valuable as a diversifying asset. TIPS combine well with more traditional nominal Treasury bonds. We think a mix of 60% TIPS and 40% nominal bonds makes sense for most investors based upon where we believe we are headed in political, economic, and inflation cycles. The nominal bonds will pay a higher coupon and protect investors from the unlikely but devastating consequences of deflation, while TIPS will protect investors from unexpected inflation above the breakeven level of 2.3%. We believe owning both is optimal in our fixed income allocation for clients.

Exhibit 2: 10 Year TIPS Yield Near 15 Year Highs

Source: Capital Creek Research, Bloomberg

How Do TIPS Work?

Principal Adjustment: The initial face value or principal of a TIPS bond adjusts in line with inflation or deflation. If CPI rises by 2% in any given year, the bond principal increases by 2%. Conversely, if the CPI Index deflates over a year, the bond principal adjusts downward. However, the U.S. Treasury guarantees that at maturity investors will get back at least their original principal even in a prolonged deflationary scenario. Therefore, TIPS have both inflation and deflation protection in the sense that TIPS will always mature at a value of at least par.

Coupon Payments: TIPS pay interest semi-annually at a fixed rate. However, because the principal is adjusted, the actual interest payments will vary. For example, if you have a TIPS bond with a $10,000 face value and a 1% fixed interest rate, and inflation rises by 3%, the new principal becomes $10,300. Your next semi-annual interest payment would be $51.50 (=$10,300 x 0.005); instead of the original $50.

Taxation: It is essential to note that while the interest income is taxable at the Federal level, so are the inflation adjustments to the principal. The latter is known as "phantom income," as you will not realize it until maturity or sale of

the bond. Phantom income is a perceived negative for taxable TIPS owners, so many prefer to hold TIPS in 401Ks, IRAs, or other non-taxable accounts.

How Do TIPS Enhance a Portfolio?

Real Return: Traditional bonds can become eroded by unexpected inflation, reducing the bond's real return. With TIPS, the adjustable principal ensures your real return stays intact.

Income Stream: The semi-annual interest payments are calculated based on the adjusted principal, ensuring that your income stream keeps pace with inflation.

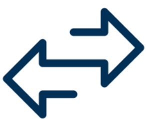
Capital Preservation: Traditional bonds may decline in market value when inflation expectations rise, making them riskier for long-term investment. TIPS, on the other hand, become more attractive in such conditions.

Diversification: Including TIPS in a diversified portfolio can offer a differentiated return stream, especially in high inflationary periods when stocks and traditional bonds may underperform.

Who Should Consider Owning TIPS?

Conservative investors who are focused on maintaining purchasing power should consider TIPS. Investors who value diversification along with liquidity should also explore TIPS. Investors who want to generate income in non-taxable accounts may be attracted to TIPS. Retired investors who want to ensure that their income streams keep up with inflation should consider TIPS.

How Do You Transact in TIPS?



TIPS can be purchased directly from the US Treasury at periodic auctions. TIPS can also be bought and sold in the secondary market. Investors can also gain exposure to a portfolio of TIPS through ETFs or fixed income mutual funds. We prefer owning TIPS directly for clients in appropriately laddered portfolios that allow clients to reinvest in TIPS or other potentially more attractive assets as bonds mature.

Considerations and Risks

Performance: At the end of the day, TIPS are bonds. If interest rates rise sharply as they have over the last three years, performance of both TIPS and nominal bonds will be negative. TIPS will outperform nominal bonds in a scenario where interest rates rise due to higher-than-expected inflation. If interest rates fall

sharply in a recession scenario, the investor is likely to be better off in standard or nominal bonds. TIPS held to maturity are all but certain to protect purchasing power relative to CPI inflation.

Lower Yield: Generally, TIPS offer a lower yield compared to traditional Treasury Notes. Currently, 10-year Treasury Notes yield 4.64%, while 10-year Treasury TIPS yield 2.31%. The difference (4.64%-2.31% = 2.33%) is called the breakeven rate or the inflation breakeven level, where investors are indifferent toward owning standard Treasury Notes versus TIPS.

Tax Implications: Because TIPS are bonds, the semi-annual interest paid on TIPS is taxable as ordinary income. The inflation adjustment to the principal on TIPS is also taxable. This tax on the increase in principal is often referred to as a "phantom income" tax. The taxation on "phantom income" can be complicated and may not suit all investors.

Liquidity: While TIPS are generally liquid, they are less so compared to standard Treasury bonds, potentially making selling them prior to maturity slightly more challenging.

Opportunity Cost: If inflation does not materialize as expected, you might have been better off with a traditional nominal Treasury bond, which would have a higher yield.

Deflation: If the US economy experiences outright price deflation, investors will end up far better off in standard or nominal Treasury bonds than TIPS.

CPI Index: We know from history that the CPI Index has changed over time. There is a moral hazard incentive for the government to change the CPI Index in ways that could depress official inflation to the disadvantage the TIPS holder. There is also the risk that the CPI Index does not accurately reflect the TIPS holder's personal basket of purchased goods and services. The advantage of the CPI Index is that it does include volatile food and energy components, which tend to rise sharply in periods of rapidly rising inflation.

Conclusion

TIPS offer a secure and government-backed means to protect investor wealth from inflation. They can serve as an excellent diversification tool in a well-balanced portfolio, particularly for those concerned about rising inflation. In our view, with TIPS yields near 15-year highs across maturities and realized inflation likely to be structurally higher over the coming years, we think now is an excellent time to consider adding TIPs to a diversified portfolio.