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On the Tricky Timing of Turning to TIPS

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For those lured by past returns as a promising prologue for the future, TIPS might tempt. However, I believe the time is at hand to limit or even reduce allocations to Treasury Inflation-Protected Securities. This opinion is based on pricing in U.S. Treasuries and the outlook for economic growth and inflation. I'll share those forward-looking views after reviewing the alluring image that TIPS have cast in the rear-view mirror.

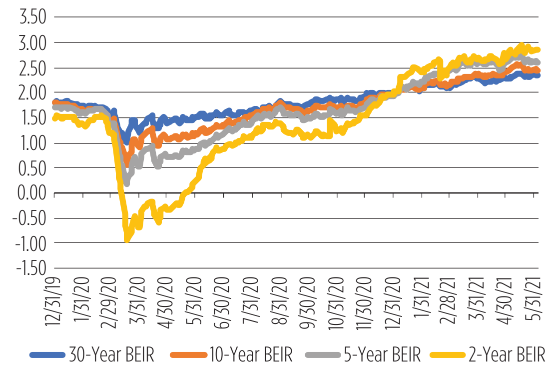
TIPS have been stellar performers over the past 14 months. Market-based inflation expectations are measured by the so-called breakeven inflation rate: the difference in yield between TIPS and conventional (nominal) Treasuries of the same maturity. Breakeven rates reached their lows in March 2020 when the extent of the pandemic-driven drop in global economic activity became evident. They recovered rapidly through August 2020 as the economic recovery came to look nearly as sharp as the preceding downturn.

By December, breakevens exceeded pre-pandemic levels. They have climbed further since then, albeit at a slower pace. The steady rise in inflation expectations drove the Bloomberg Barclays US TIPS Index to a return of 17.38% for the period from March 18, 2020, through the end of May 2021, dwarfing the 0.47% return for the Bloomberg Barclays US Treasury Index. The U.S. Government Securities team at DoubleLine doubts this stunning relative performance can persist.

For the time being, the U.S. is experiencing a sharp uptick in inflation. The year-over-year change in the headline Consumer Price Index (CPI) has surged to 5.0% in May from 4.2% in April, 2.6% in March and just 1.7% in February. This has been entirely expected. While pandemic-related unemployment has been a hardship for many, aggregate income has actually risen through the crisis—due largely to government transfer payments. This income has fueled domestic demand for goods at the same time COVID-19 has forced producers to shed employees and cut production. Supply chains have been disrupted, production bottlenecks have emerged, raw materials have become scarce—and so prices have risen. Many services have been unavailable, channeling demand into goods.

But the same demand that has pushed goods prices higher will inevitably elicit a supply response. Supply chains will be repaired, the 15 million people currently receiving some form of jobless assistance will gradually return to work, and supply and demand will come into better balance. DoubleLine's internal inflation forecast calls for inflation to peak with the May data and then gently decline to about 2.5% over the next 12 months. The consensus of economists polled by Bloomberg forecasts headline CPI rising to 3.4% in 2021, but then falling to an average of 2.5% in 2022 and 2.2% in 2023.

Treasury Inflation-Protected Securities (TIPS) Breakeven Inflation Rates



Source: DoubleLine, Bloomberg Financial

Market-based inflation forecasts are similar. Breakevens show the market expects inflation to average 2.7% over the next two years, 2.5% over the next five years and 2.4% over the next 10 years. These expectations conform with the view of Federal Reserve Chair Jerome H. Powell. He expects inflation to rise in the near term as the economy recovers, but that rise will be transitory, with the Core Personal Consumption Expenditures Price Index settling into the Fed's longer-term target of 2%.

In my view, TIPS have priced in the consensus outlook for growth and inflation. Admittedly, today's confluence of fiscal stimulus, monetary accommodation and economic reopening could produce upside inflation surprises. And the consensus might prove wrong. (As an active manager, I form independent views—sometimes apart from consensus, sometimes in line—while standing watch on a changing world.) With those caveats, I believe that TIPS' past outperformance is indeed a thing of the past. ■

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