Private Bank

# Fixed Income Strategy

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## TIP-toeing

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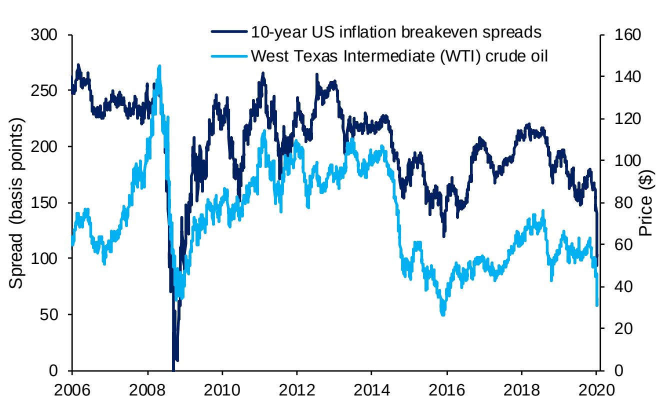
With markets focused more on equity, credit, and interest rate volatility, inflation expectations have also taken a nosedive. Using the US Treasury Inflation Protected Securities (TIPS) market as a gauge, inflation expectations in the US have fallen to their lowest levels since the Global Financial Crisis. 10-year inflation breakeven spreads, which is the difference between nominal US Treasury (UST) yields and TIPS yields, has now dropped below 1.0% **(Fig. 1)**.

US TIPS are unique, in that coupons are linked to the US Consumer Price Index (CPI) *including* food and energy prices. When we consider the 50% decline in crude oil prices this year, the impact on future CPI is likely to be negative. This should lead to lower TIPS interest payments, as a decline in US CPI will result in lower principal values which coupons are derived from.

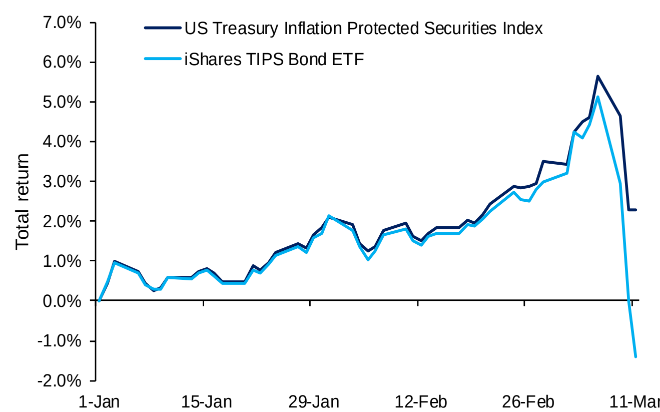
Following the news that Russia and Saudi Arabia would begin to lift oil production over the control of market share, energy prices collapsed. Anticipating the impact to CPI, investors fled the TIPS asset class severely, with the market losing over 3%. The TIPS ETF (exchange-traded funds) market dropped more meaningfully, with some stocks down nearly 5% **(Fig. 2)**. This is likely because many investors use the ETFs for its tax efficiencies and ease of execution.

**Figure 1. 10-year breakeven spreads vs oil price**




Source: Bloomberg Barclays Indices as of March 11, 2020

**Figure 2. YTD performance of TIPS markets vs. ETF**




Source: Bloomberg Barclays Indices, Bloomberg as of March 11, 2020

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

### Where do we go from here?

Unfortunately, we came into this sell-off with an overweight in inflation-protected securities. Trade protectionism, easy monetary policy and relatively cheap valuations left us comfortable with this view. Over the last 12-months, US TIPS have still managed to generate a 9.0% return.

While trade has become less of a near-term concern, central bank policy has shifted meaningfully. The Fed Reserve has recently cut their benchmark rate 50bp and forward markets are largely priced for a 0% Fed Funds rate this year (See our March Bond Market Monthly). Declining inflation expectations are likely to keep the Fed in easing mode, as policymakers are always concerned that these indicators become self-fulfilling. However, while a slowing economy can keep inflation pressures contained, the longer-term effect of easy policy should eventually stimulate the economy, leading to higher consumer prices.

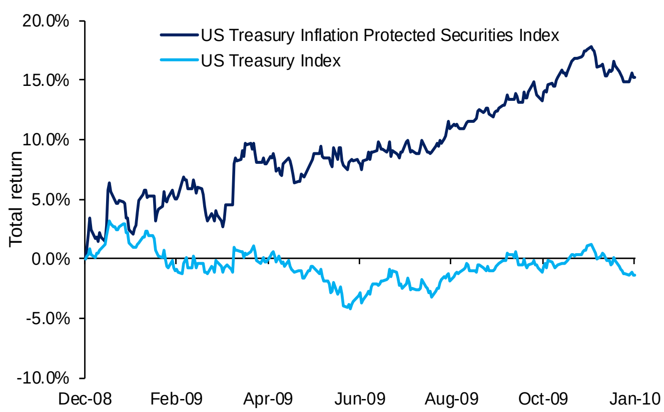
TIPS valuations have also gotten a lot cheaper. A 1.0% 10-year breakeven rate implies that US inflation needs to run at 1.0% (on average), for the next 10 years, for returns to "breakeven" with 10-year nominal UST bonds. While breakeven spreads can certainly remain low for some time, in the decade following the 2008-09 financial collapse, US CPI still averaged 1.7%. In this context, an inflation rate remaining at 1.0% for 10-years appears unattainable.

Therefore, we are inclined to keep our overweight in US TIPS. The collapse in inflation breakeven spreads and decline in real yields has been sharp and already implies a weak economic outlook, in our view. While we should not rely on a similar outcome, the 12-month return in US TIPS following the 2008 collapse in real yields was nearly 15%, or 1700 basis points better than nominal UST bonds **(Fig. 3)**. At the same time, if US yields reprice higher due to overly exaggerated virus fears, TIPS are also in a position to perform better than nominal UST.

The probability of a recession is not zero. If anything, the combination of both coronavirus and the oil price shock has increased the risk of recession. TIPS would not fare well in this scenario. However, the Federal Reserve has a long history of successful inflation targeting, and more recently has shifted discussions of targeting at a higher range. Therefore, we could see the Fed revise *up* their inflation target, in an effort to defend against a meaningful softening in consumer prices.

Other risks include oil prices, which are likely to remain a wildcard for the US TIPS market over the near term. For now, it seems oil prices will remain weak and volatile. This can make trading the TIPS market over the near-term quite challenging. Tactically, we would point out that oil price fluctuations can have greater impact on shorter duration TIPS, while rate volatility can have a larger impact on longer-dated bonds. However, for long-term fixed-income investors, we think current valuations in the TIPS market presents an interesting opportunity.

**Figure 3. TIPS vs. UST performance following '08 collapse**

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