

Fixed Income Strategy

March 11, 2020

TIP-toeing

Kris Xippolitos, Head – Global Fixed Income Strategy | +1 212 559 1277 | kris.xippolitos@citi.com

Malcolm Spittler, Global Strategy | +1 212 559 8651 | malcolm.d.spittler@citi.com

Joseph Kaplan, Global Fixed Income Strategy | +1 212 559 3772 | joseph.kaplan@citi.com

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.

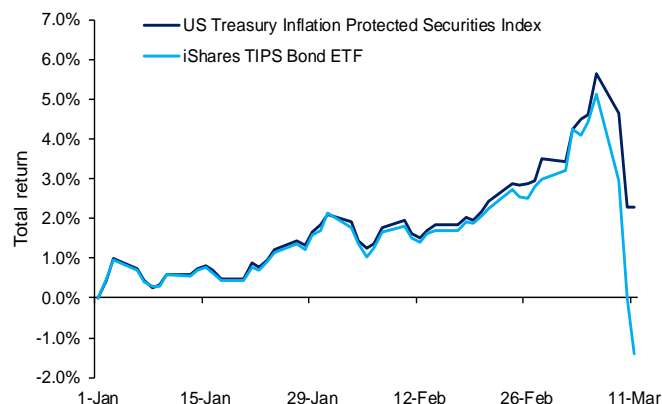
Following the news that Russia and Saudi Arabia would begin to lift oil production over the control of market share, energy prices collapsed. Anticipating the impact to CPI, investors fled the TIPS asset class severely, with the market losing over 3%. The TIPS ETF (exchange-traded funds) market dropped 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.

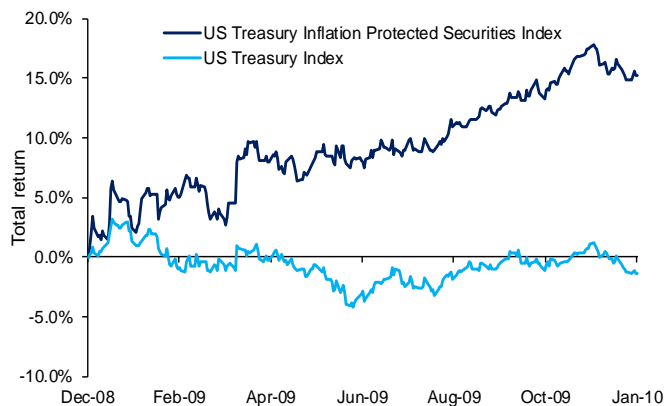
TIPS valuations have also gotten a lot cheaper. A 1.0% 10-year breakeven rate implies that US inflation needs to run at 1.0% (on average), for the next 10 years, for returns to “breakeven” with 10-year nominal UST bonds. While breakeven spreads can certainly remain low for some time, in the decade following 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



Source: Bloomberg Barclays Indices 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.

This email contains promotional materials. If you do not wish to receive any further promotional emails from Citi Private Bank, please email donotspam@citi.com with "UNSUBSCRIBE" in the subject line. Email is not a secure environment; therefore, do not use email to communicate any information that is confidential such as your account number or social security number.

Citi Private Bank is a business of Citigroup Inc. ("Citigroup"), which provides its clients access to a broad array of products and services available through bank and non-bank affiliates of Citigroup. Not all products and services are provided by all affiliates or are available at all locations. In the U.S., brokerage products and services are provided by Citigroup Global Markets Inc. ("CGMI"), member FINRA and SIPC, and also Citi Private Advisory, LLC ("Citi Advisory"), member of FINRA and SIPC. CGMI accounts are carried by Pershing LLC, member FINRA, NYSE, SIPC. CGMI, Citi Advisory and Citibank, N.A. are affiliated companies under the common control of Citigroup.

[Read additional Important Information.](#)

Past performance is not indicative of future results.

Important information, including information relating to risk considerations, appears at the end of this publication.

Views, opinions and estimates expressed herein may differ from the opinions expressed by other Citi businesses or affiliates, and are not intended to be a forecast of future events, a guarantee of future results, or investment advice, and are subject to change without notice based on market and other conditions. Citi is under no duty to update this presentation and accepts no liability for any loss (whether direct, indirect or consequential) that may arise from any use of the information contained in or derived from this presentation.

© 2020 Citigroup Inc. All Rights Reserved. Citi, Citi and Arc Design and other marks used herein are service marks of Citigroup Inc. or its affiliates, used and registered throughout the world.

www.citiprivatebank.com