Private Bank

Fixed Income Strategy

April 23, 2020

Tempering our view on US TIPS

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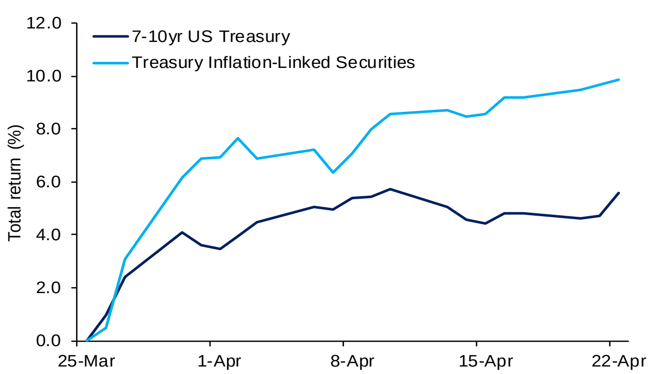
Since we published our favorable note on the US Treasury Inflation Protected Securities (TIPS) market last month, 10-year inflation expectations widened meaningfully. Since reaching a post Global Financial Crisis low of 55bp on March 19, the yield difference – or breakeven spread – between 10-year nominal US Treasuries (UST) and 10-year TIPS had widened 70bp to 120bp. This differential has since settled back down to 100bp but still equates to an 8.5% return since bottoming, outperforming UST by 250bp **(Fig. 1)**.

At this time, we feel it's best to temper our US TIPS view. In general, UST markets have become expensive. With 10-year real yields at -0.90%, US TIPS have joined the party. Real yields could certainly fall further if we see a large rebound in oil, but that is unlikely over the near term. More concerning is that the Covid-19 virus may ultimately leave inflation pressures largely suppressed.

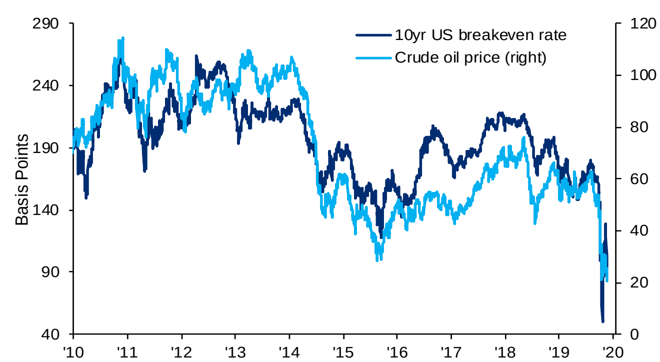
- See our latest global strategy bulletin that discusses the extraordinary collapse in crude oil into negative territory. With many countries on lockdown due to the Covid-19 pandemic, demand for oil and oil related products (i.e., gasoline, jet fuel) has dropped precipitously. Over supply has also led to significant storage issues. We remind investors that US TIPS coupon payments are linked to US Consumer Price Index (CPI) *including* food and energy prices (non-seasonally adjusted). This is why we tend to see a close correlation between oil prices and inflation breakevens **(Fig. 2)**.
- Over the near term, the drop in oil will likely dominate headline CPI. Though TIPS are considered to have an embedded inflation floor, this only pertains to principal repayment at maturity. Index ratios, which are used to calculate coupon payments, have (and can) move below 1.0% during deflationary periods. Meaning, accrued cash flows for short periods could fall below the coupon. Nevertheless, regardless of the ratio, investors at maturity will always receive their $100 par value back.
- Looking beyond the troubles in the oil market, there are strong Covid-19 dynamics to consider. Consumers under public lockdown and social distancing measures have shifted away from services like restaurants and vacations, and have moved towards manufactured goods and home cooked food. It's likely we will see a more immediate impact to the Fed's preferred measure of inflation (the PCE price deflator), as sector weights adjust in real time to reflect actual consumption share. Conversely, US CPI may react more slowly, since sector weights are fixed. Either way, the trend is for a slower pace of inflation.
- Longer term, we should see a slowing in rental price increases as those tenants who still have jobs are prized as stable sources of income. For some, property owners may even lower rents in order to keep a steady income stream. This will gradually enter the rental portion of the US CPI, and eventually impact OER (owners' equivalent rent) over the next 6-12 months. OER is a large weight, making up 24% of US CPI. This would create a potentially substantial headwind to inflation for the next few years, long after the oil price gyrations have worked their way out of the market.

Figure 1. US TIPS have outperformed since bottoming



Source: Haver Analytics as of April 23, 2020.

Figure 2. Inflation expectations track oil prices



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