Tips on TIPS

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In the "Opinion" section of the Wall Street Journal on August 22, 2011, authors Jeremy Siegel and Jeremy Schwartz wrote a piece entitled, "The Bond Bubble and the Case for Stocks." While I have no argument with the idea that dividend-paying stocks are attractive at today's valuations compared to nominal Treasury bonds, I believe the discussion that the TIPS (Treasury Inflation Protection Securities) market "makes no sense to us…" reaches incorrect conclusions. The reason TIPS are trading where they are is not reflective of the general Treasury bond bubble. Here's why:

1. Investors in nominal Treasury bonds systematically under estimate the long-term rate of inflation due to the fact that central banks, financial institutions, and pension plans use nominal Treasury bonds for open market operations, currency hedging, and liability duration hedging reasons that are unrelated and insensitive to the inflation rate. Since their introduction in the U.S. in 1997, in just one simple example, the CPI has risen at a 2.40% annual rate whereas the "imbedded" rate of inflation expectations (the difference between the yield to maturity on nominal 10-year T-bonds and 10-year TIPS) has averaged only 2.06% (using month-end averages). The 34 basis point average compounded substantially to the benefit of the annual rate of return on TIPS versus nominal Treasuries.

2. Today's stagflation-like environment is the second best for TIPS (the best being in the late 1990's when real rates were high and inflation expectations were low with no where to go but up). Fed Chairman Bernanke has just told us he plans to continue the folly of maintaining today's 0% interest rate policy for short Treasuries into 2013. This is a recipe for worsening stagflation (anemic real growth with rising inflation rates), and it is an environment in which real returns fall or stay low while inflation remains uncomfortably high and/or rising. Indeed, real TIPS yields have never been lower at close to 0% for 10-years. Yet with the Fed artificially suppressing nominal yields, the imbedded inflation forecast in 5-year TIPS (at 1.7% annually) is half of the actual year-to-year change in the CPI at 3.6%. Since the PAR value of TIPS accrete every six months by the rise in the CPI over the prior six months (and the resulting income produced by the coupon also rises), the current return on TIPS is well above nominal Treasuries of the same maturity, even with a negative real yield. This isn't such a bad deal, particularly for shorter maturity TIPS.

3. Furthermore, today's imbedded inflation rate forecast by TIPS is 1.7% for the next five years, 2.0% for 10 years, and 2.3% for 30 years. This means investors expect inflation to accelerate over time, not decelerate, and this likely again indicates that Fed policies are artificially suppressing the Treasury curves' ability to price in higher inflation expectations at short maturities. In addition,

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these forecasts probably still under estimate the future level of the inflation rate due to the free money the Fed is passing out that will continue to fuel commodity price speculation and CPI acceleration.

If government policies were pursued that created robust real economic growth and if the Fed allowed nominal short-term interest rates to rise from zero, real returns would have to rise again and move back into positive territory. This would result in a substantial improvement in equity markets, and a likely deterioration in both nominal and real Treasury bond prices. Until then, there are few real inflation hedges available to investors. Gold is one and TIPS is another. One shouldn't forsake the value of TIPS for this purpose just because the nominal Treasury market reflects a "bubble" environment.

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