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Commentary from New Century Advisors – March, 2021

What Exactly is Priced into TIPS?

Introduction: Rich TIPS!

There's been a lot written about the TIPS market lately, in particular about how rich they've become. Thanks in part to easy monetary policy, ongoing fiscal stimulus, and rising commodity prices (particularly oil), the breakeven spreads between the U.S. Treasury's nominal and inflation-linked debt have risen sharply. A proxy for inflation expectations, TIPS breakevens briefly traded below 1% during the lockdowns a year ago but have since recovered, surpassing pre-pandemic levels. 10yr breakevens trade at 2.27%, just off new eight year highs. Meanwhile 5yr breakevens trade even higher, at 2.59%, their highest level since before the Great Financial Crisis!

The impact of the reflation trade has been felt far beyond just the TIPS market, pushing nominal interest rates higher and putting downward pressure on equities, growth stocks in particular given the more distant nature of their expected cash flows. The market also brought forward the timing of the Fed's expected tightening, with three rate hikes now priced in for 2023 vs. none just a couple months ago.

In recent days and weeks a number of sell-side research pieces have said the rise in TIPS breakevens has gone too far, pointing to the 5yr point in particular. The breakeven curve is normally upward sloping, with investors historically willing to pay up to hedge inflation risk further out the curve. In fact, when 5 year breakevens surpassed 10s in the first week of January, it was the first time since 2008 – prior to the Global Financial Crisis – that the breakeven curve had inverted. At -30bps today, it sits at an all-time record!

Given the importance that the inflation outlook has on the monetary policy outlook and on financial markets more broadly, it's important to understand exactly what TIPS prices are telling us.

What is Actually Priced into TIPS?

In a word, carry…lots of carry.

Here's where we get a little technical. In addition to paying investors a coupon, TIPS also pay inflation. Every month, TIPS accrue interest based on the prior month's CPI print (specifically, the non-seasonally-adjusted, or NSA series). January CPI, reported in February, accrues to TIPS in March. The February CPI report was released just this week and will accrue to TIPS in April. As such, we know enough currently to calculate TIPS' exact value, including carry, out to May 1st. Beyond that will depend on what happens to CPI going forward.

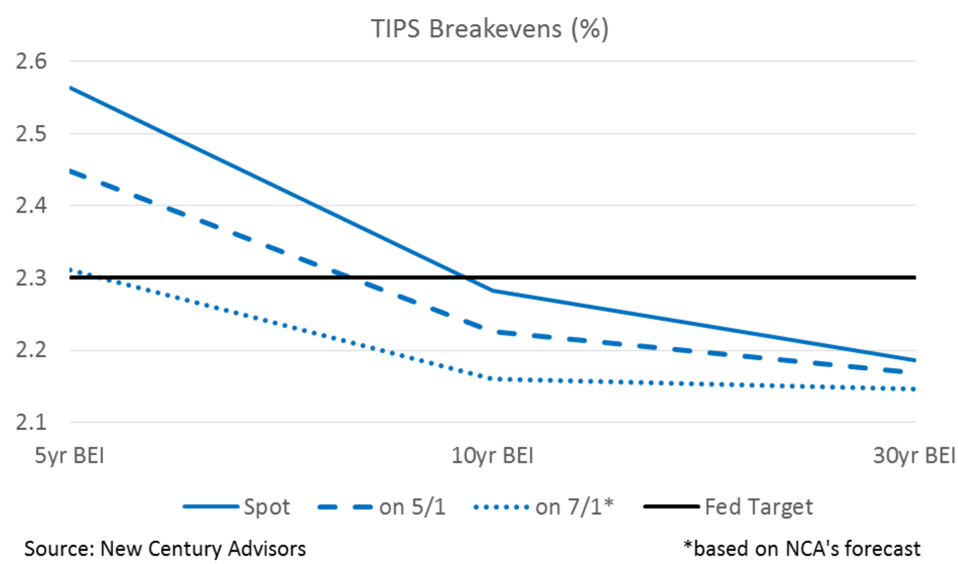
The beginning of the year often sees a big jump in non-seasonally-adjusted CPI and this year was no different. NSA CPI rose 0.43% MoM in January and another 0.55% MoM in February, the biggest two-month increase to start the year since 2018. Those gains accrue to TIPS in March and April, raising the value of their principal. 5yr TIPS will earn 16bps of inflation carry between now and May 1st. The carry for longer-dated TIPS is a little less, with 10yr TIPS earning 7.5bps of inflation interest between now and May 1st while 30yr TIPS will earn a little less than 3bps.

As with any market, TIPS price in that carry ahead of time. As that carry rolls in, the quoted prices for TIPS adjust accordingly, as do their yield. Think of it like stocks trading ex-dividend. In months of above-average inflation accrual, the elevated carry is offset by a rise in TIPS yields, pushing the breakeven spread lower. Today's 2.59% 5yr breakeven is equivalent to 2.48% on May 1st after adjusting for that carry. 10yr breakevens at 2.27% today drop to 2.22% when calculated as of May 1st, while the 30yr drops from 2.20% to 2.18%. So all else equal, not only will breakevens naturally drift lower in the weeks ahead, but the breakeven curve should also become less inverted.

Of course, all else is never equal – markets can and will move in the meantime. But all we can do is try and understand what is priced in today.

Using our forecast for the next few CPI prints, we can extend this analysis even further ahead. NCA's CPI model currently has NSA CPI rising another 0.58% in March followed by a 0.39% gain in April. Much of the expected gain comes from the ongoing rise in gasoline prices, which are up over 35 cents in the last four weeks alone. When you add those monthly prints to the base effects from last year's plunge in prices during the lockdown, NCA's model sees YoY CPI spiking higher in the coming months, peaking at 3.7% in May. Again, it's all baked into today's spot breakeven levels, which will be lower once the pig has finished making its way through the python.

Here's what the breakeven curve should look like in a few months, based on today's prices and expected carry going forward. While this is based on NCA's model estimates for the March and April CPI prints (accruing to TIPS in May and June), street forecasts paint a similar picture.



NEWPERSPECTIVES

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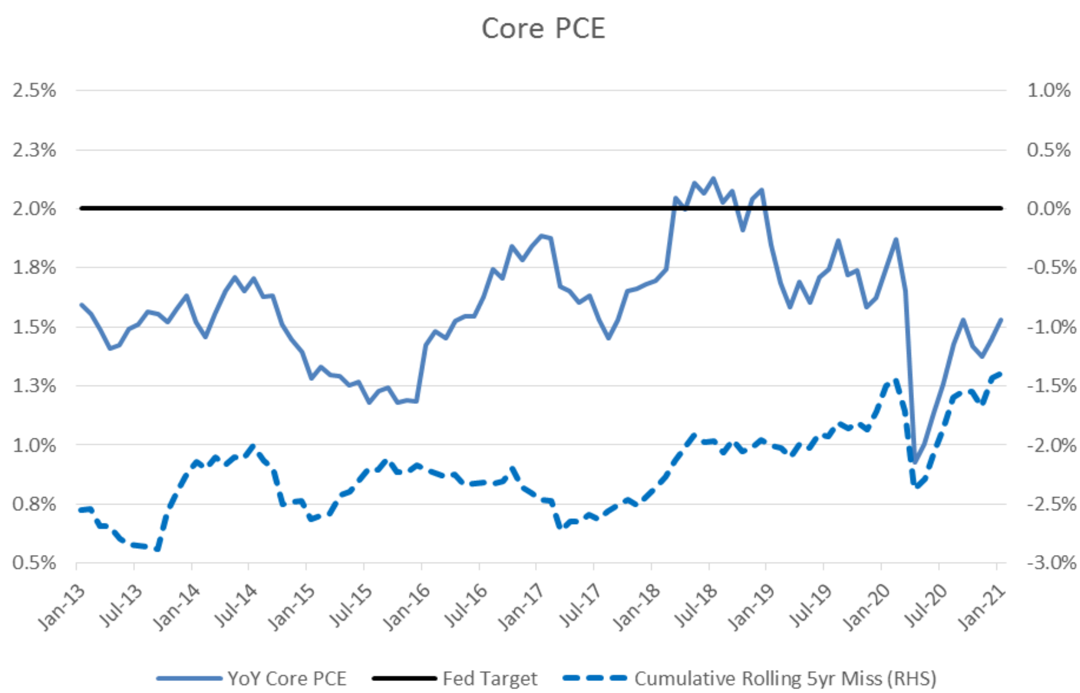
Bringing it Back to the Fed

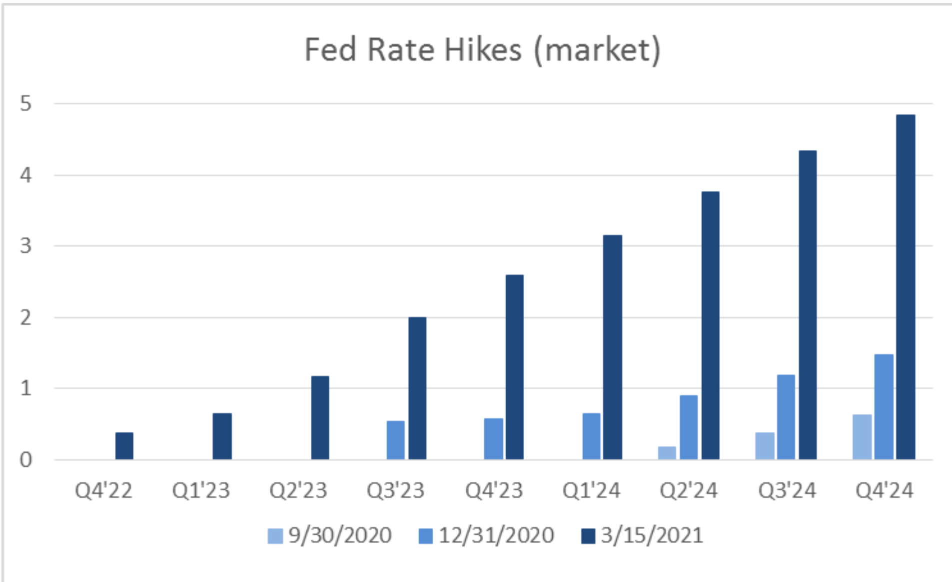
So depending on the next couple of CPI prints, today's 2.59% 5yr breakeven equates to ~2.32% on July 1st. That's still higher than it's been in several years, but it merely matches the Fed's stated inflation target of 2% for Core PCE. (Historically, CPI runs 30-40bps higher than PCE.) In other words, the market is pricing for reflation but no inflation. No overshoot. In addition, the market sees inflation sliding *back below the Fed's target in the longer term*, with 10 and 30yr breakevens sliding to 2.17 and 2.15, respectively.

The Fed recently shifted their monetary policy framework, adopting a flexible average inflation target (FAIT) going forward. According to Fed Chair Powell, "following periods when inflation has been running below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time."[i] Given that inflation has run well below their 2% target for years (see chart, below), then if the Fed is to be taken at their FAIT word they won't hike until inflation runs moderately above 2% *for some time*. But the TIPS market is **not** currently pricing in such an overshoot, and as such, there should be no reason for the Fed to hike.



Source: Bureau of Economic Analysis

And yet, the market, which until recently wasn't pricing in the first rate hike until 2024, now looks for as many as three rates hikes in 2023 (chart).



Source: New Century Advisors

We would argue that either TIPS continue to *underprice* the upside risk to inflation, or the market is too aggressive in pricing Fed rate hikes. Or possibly both.

The investment implications are clear, regardless: we see further upside for the ongoing reflation/inflation trade.

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help your fixed income allocation, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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[i] Powell, Jerome H. (2020), "New Economic Challenges and the Fed's Monetary Policy Review." In Federal Reserve Bank of Kansas City, ed, *Navigating the Decade Ahead: Implications for Monetary Policy: A Symposium Sponsored by the Federal Reserve Bank of Kansas City,* Jackson Hole, Wyo., August 27 (via webcast)