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TIPS Market: Paying Too Much For Insurance

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Consumer price inflation, as measured by a wide array of indexes, has declined smartly in recent months. Yet, the future inflation rate implied by Treasury inflation-protected securities (TIPS) has increased to its highest level since April 2011. It appears that investors are willing to pay a significant premium for protection against the risk of a sustained rise in inflation. To some extent, the pricing of TIPS reflects the paucity of good hedges against inflation. Still, from our perspective, the risk of inflation rising to levels that justify the investment in TIPS is low. Moreover, given the likelihood of another episode of global instability and modest deflation in the next several years, nominal Treasury bonds remain the better bet for protecting capital.

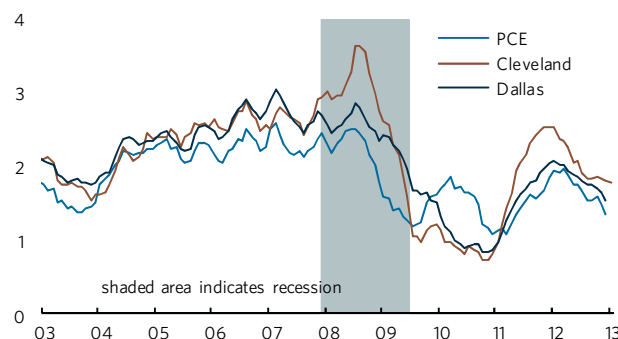
The latest CPI release showed a pickup in core inflation in January, but the overall trend in consumer price inflation is still down significantly over the past several months (chart 1). Consumer price inflation across a range of measures has now declined to its lowest level since early 2011 (chart 2). Not surprisingly, the Cleveland Fed's measure of inflation expectations—which tracks well with the current trend in inflation—

shows that inflation expectations remain well below 2%, annualized rate, and barely above the 2012 low (chart 3).

Yet, TIPS prices indicate a rising demand for protecting against the risk of higher inflation. In other words, the inflation risk premium has surged. In contrast to the inflation and inflation expectation gauges, the breakeven inflation rate implied by TIPS (that is, the yield on nominal Treasuries minus the yield on

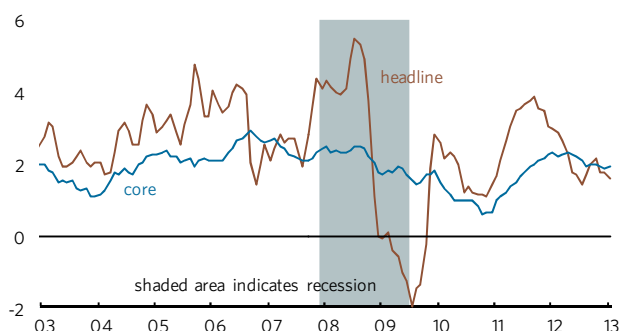
Other Inflation Measures Showing Weakness CHART 2

Core PCE, Cleveland Fed and Dallas Fed Trimmed-Mean Price Indexes year-over-year % change, Cleveland through Jan 2013, rest through Dec 2012



Moderating CPI Inflation CHART 1

BLS: Consumer Price Index year-over-year % change, last data point January 2013



Low Inflation Expectations CHART 3

Cleveland Fed 5-Year Expected Inflation Rate % per annum



TIPS) has increased sharply since mid-2012 (chart 4). In fact, the spread between the breakeven inflation rate implied by TIPS and expected inflation is unusually wide (chart 5). Yields on TIPS have remained deeply negative (chart 6) despite the rally in risk assets.

The TIPS pricing is largely reflecting the poor choices facing investors seeking to protect the real purchasing power of their capital. The roll yield on commodities—the yield from continuously rolling over commodity futures contracts—has been negative for a while, meaning that investing in commodities to protect against inflation also comes at a cost. Furthermore, commodities are subject to significant downside risk unlike TIPS, which provide a floor in the event of deflation.

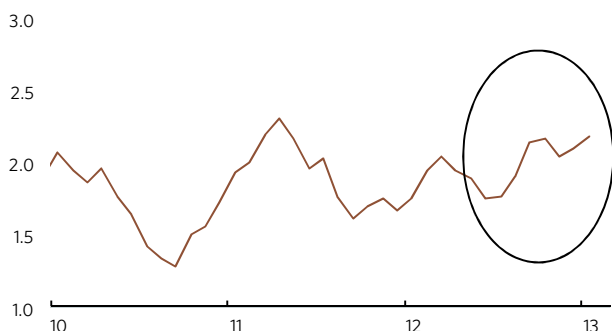
That said, it is extremely unlikely that inflation will be high enough over the next several years to justify investing in TIPS at

current prices. Compensation inflation, the dominant driver of inflation over the long term, is still trending down (chart 7), and the large slack in the labor market will continue to put a lid on wage and salary gains. In the absence of wage inflation, any substantial spike in consumer price inflation—which would most likely reflect soaring energy prices—is likely to quickly set in motion deflationary forces, as happened in 2008. Rising outlays for energy would force consumers to cut back on other spending, exerting downward pressure on margins for non-energy goods and services.

U.S. and global economic conditions remain disinflationary, and paying close to 1% to protect against a nonexistent threat of rising inflation over the next several years is buying unnecessary insurance.

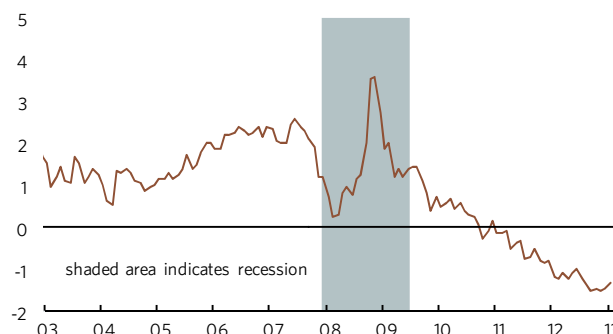
Breakeven Rate Rises CHART 4

Federal Reserve: 5-Year Nominal Treasury Minus 5-Year TIPS Rate
% per annum



5-Year TIPS Yields Near Record Lows CHART 6

5-Year TIPS Yield
% per annum, end of period, last data point February 12, 2013



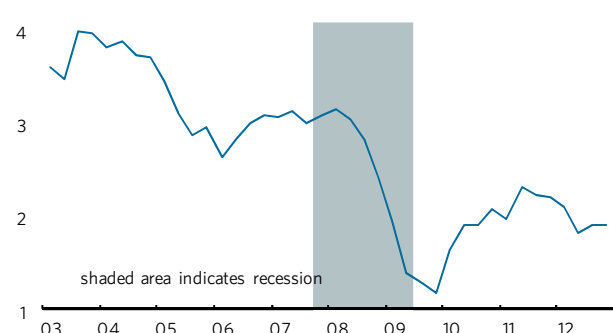
Unusually Wide Spread CHART 5

5-Year Breakeven Inflation Minus Cleveland Fed Expected Inflation
% per annum



Compensation Inflation Still Under Pressure CHART 7

Employment Cost Index: Private Industry Compensation
year-over-year % change, last data point Q4 2012





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