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TIPSy Investing

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Investor anxiety over growth has supplanted last spring's angst over inflation. While we see little risk for a meaningful acceleration in inflation over the next year, we also think the risks of deflation are overblown, a fact echoed by last Thursday's rise in core inflation. Recently, investors have been piling into US inflation-linked bonds, or TIPS. Whether this represents explicit inflation fears or is simply a by-product of the general flight-to-quality is unclear. What is clear is that the recent buying has pushed the real return on TIPS close to negative territory, suggesting that unless you expect Japanese style stagnation, TIPS look expensive. For investors worried about long-term purchasing power, we would prefer large and mega-cap stocks as a more reasonably priced inflation hedge.

Lining Up For No Return

A stalling global economy, the downgrade of US debt, and an existential crisis in the European Union have created a number of market distortions, including record low bond yields, soaring gold prices, and developed market equities trading for less than book value. Recently, there is another oddity to add to the list: zero real-yields on US inflation-protected bonds. Since the spring, the yield on the US 10-year TIP has collapsed from 1% to effectively zero. In other words, in the interest of safety, investors are accepting no real return on their investment for the next 10 years.

Since the US TIPS market was launched in 1997, real yields on the 10-Year TIPS have averaged around 2.5%. This is consistent with the long-term historical spread – 1959 to present – between the yield on the nominal 10-year Treasury and headline inflation. It is also close to what most economic textbooks suggest investors should demand as a real-rate of return.

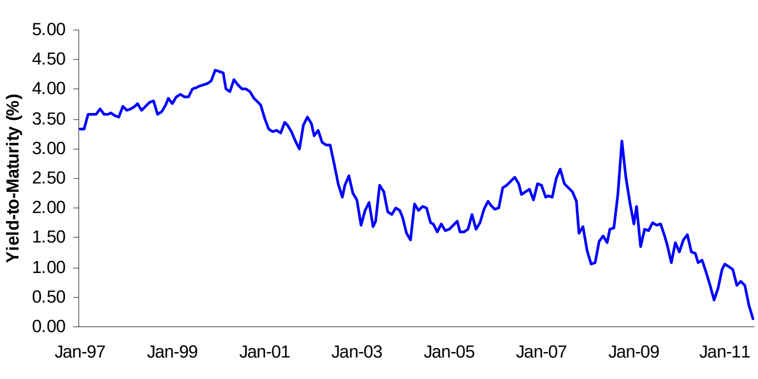
For some investors, current real yields are justified by the pace of the economic recovery. When economic activity is stronger, the price of capital rises as consumers and businesses increase their demand for money. When growth is weak to non-existent, as it currently is, there is much less demand for capital so the price of money naturally drops. Some investors argue that given the prospects for another recession, real yields should be low.

While this argument has merit, even when you account for zero growth and a high unemployment rate, it looks as if investors are accepting too little in the form of a return on their investment. In the past, US real yields have had a high correlation with unemployment, a reasonable proxy for economic activity. Historically, you can explain roughly 50% of the variation in real yields simply by watching the change in the US unemployment rate.

While unemployment in the US is extremely high, it is not so high as to justify a zero real-return. Based on the historical relationship between real yields and unemployment, you would expect the yield-to-maturity on the 10-year TIPS to be around 1.10%, not zero. In fact, current real yields are actually suggesting a much more significant collapse in the labor market, with an unemployment rate of roughly 12%!

Chart 1

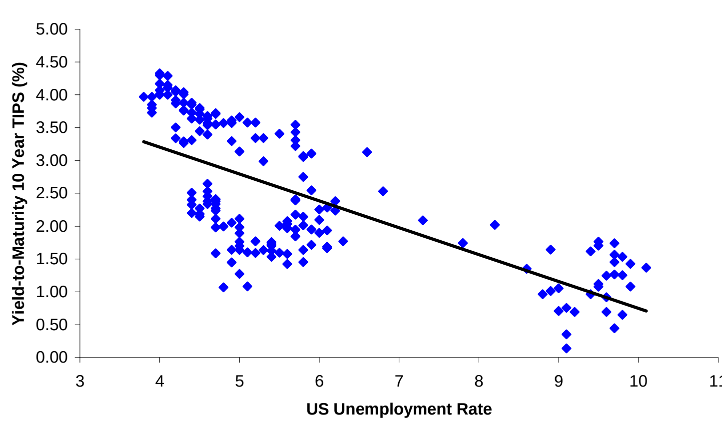
United States 10 Year TIPS Yield
1997 to Present



Source: Bloomberg, as of 8/31/2011

Chart 2

TIPS Real Yield vs. US Unemployment Rate
1997 to Present



Source: Bloomberg, as of 8/31/2011

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Following in the Footsteps of Japan?

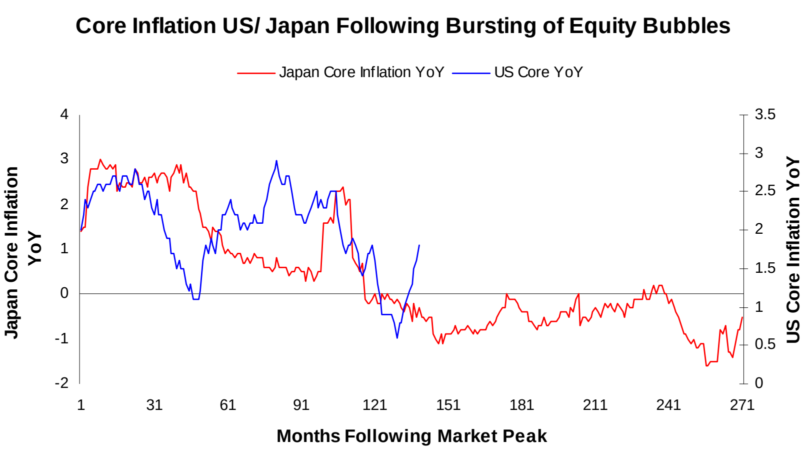
So if economic activity cannot justify a zero return, what about the threat of a Japan-style "lost decade?" Arguably, TIPS might be a good investment if real yields were to fall further on the back of a prolonged economic slump. Given the ongoing consumer deleveraging, deteriorating demographics and the aftermath of the credit bubble, this is certainly a possibility. However, there are two arguments against buying TIPS, even under this more dire scenario.

First, for now the United States appears to be following a different path than Japan. The Fed has been much more aggressive than the Bank of Japan was in the mid-1990s, following the bursting of the Japanese stocks and real-estate bubble.

Inflation expectations, the primary focus of the Federal Reserve's Quantitative Easing program (QE2), have stabilized in the United States. In addition, contrary to recent fears the United States does not appear to be following Japan into deflation. By this point in Japan's cycle, core inflation was already negative (see Chart 3). In contrast, as of August core inflation had tripled since the end of 2010 and is currently at its highest level since the spring of 2009. Whatever is in store for the US economy, as of now we don't appear to be going the route of Japan.

And even if we do succumb to a lost decade, arguably investors would be better off buying nominal bonds, rather than TIPS. Plain vanilla bonds would still benefit from a further drop in real yields, a possibility if the economy gets worse. At the same time, nominal bonds offer the additional advantage of at least some nominal yield. So for investors envisioning the worst case scenario – a slow slide into economic stagnation – a better trade might be either a plain-vanilla bond or perhaps cash.

Chart 3



Source: Bloomberg, as of 8/31/2011

For Inflation Protection, Buy Equities

While the run-up in inflation-protected bonds looks extreme, the motivation is understandable. Given unconventional and extreme monetary policy in much of the developed world, investors are reasonably concerned about long-term inflation and protecting purchasing power, while at the same time trying to avoid any risk. We share those concerns; we simply believe there are better ways to accomplish this.

Historically, equities have done a good job of hedging inflation. Earnings rise, albeit with a lag, with nominal prices. Today, large and mega cap stocks are trading at between 8-11x next year's earnings, and less than 1.5x book value. We have no doubt that equity investors will need to accept a good amount of volatility in the intermediate term. Nevertheless, unless you believe that the US is about to enter a Japanese lost decade, for long-term investors buying large, quality companies for 8x earnings seems a better inflation hedge than accepting a zero-real yield for the next decade.

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Sources: Bloomberg
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