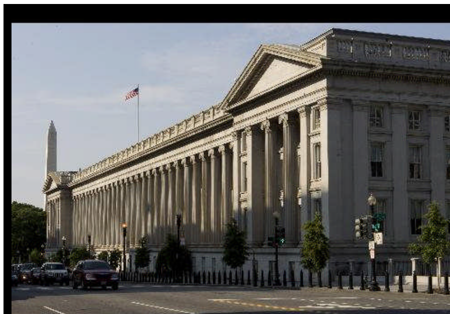
TIPS Show Bernanke Isn’t Whipping Inflation Concerns (Update2)

By Daniel Kruger



Oct. 13 (Bloomberg) -- Treasury Inflation Protected Securities are the bonds money managers can’t afford not to own.

BlackRock Inc., Pacific Investment Management Co. and Vanguard Group Inc., which together manage $3.45 trillion, say investors are pouring money into inflation-linked debt even as consumer prices post the longest series of contractions since **Dwight D. Eisenhower** was president in 1955. TIPS have gained 7.9 percent this year, according to Merrill Lynch & Co. indexes, while Treasuries overall lost 2.8 percent. That’s the biggest outperformance since the U.S. first issued TIPS in 1997.

After getting bludgeoned by the subprime mortgage collapse, investors are preparing for another potential crisis: a surge in the cost of living spurred by the $11.6 trillion the Federal Reserve and the government have lent, spent or guaranteed to shore up the economy and the financial system. While inflation is tame now, they see danger signs in the doubling of crude oil futures since January, gold trading at record highs and the 14.5 percent tumble in the trade-weighted **Dollar Index** since March.

“Investors are really taking the long view and trying to hedge inflation risk,” said **Mihir Worah**, who oversees the $15.4 billion **Real Return** Fund for Newport Beach, California-based Pimco, the world’s biggest bond manager. “That’s the biggest reason why we’re seeing the flows.”

The Real Return Fund’s assets under management have increased 25 percent this year, Worah said. The fund has returned 16.5 percent since December, according to Bloomberg data. Pimco manages $60 billion in inflation-linked debt.

TIPS Performance

Returns are accelerating, with TIPS rallying 2 percent in September, the most this year after a 6 percent surge in March. Returns are similar elsewhere around the world. Excluding the U.S., a Merrill Lynch index that tracks the performance of inflation-linked bonds has gained 7.63 percent so far this year.

TIPS returned 1.1 percentage points on average more than Treasuries each year since 1999. In each of the five years when the difference was 2 percentage points or more, inflation accelerated the following year by an average of 0.8 percentage point. The biggest rise was 1.2 percentage points in

1999, with the smallest being a 0.4 point gain in 2004. Consumer prices rose after TIPS outperformed in 2003, 2005 and 2008.

Fed Chairman **Ben S. Bernanke** said at a Board of Governors conference Oct. 8 in Washington that while "accommodative policies" will be in place for an extended period, the central bank will be prepared to tighten monetary policy "to prevent the emergence of an inflation problem down the road."

'First Brick To Fall'

Last week's auction by the Treasury of $7 billion of 10- year TIPS shows the strength of demand for the securities. The Oct. 5 sale drew bids equal to 3.12 times the amount offered, the highest bid-to-cover ratio since January 1999. The notes drew a yield of 1.51 percent, compared with a forecast of 1.56 percent in a Bloomberg News survey of seven of the 18 primary dealers that underwrite U.S. debt auctions.

Pension funds, central banks and individuals are all buying TIPS, according to **Brian Weinstein**, who manages $9 billion of the securities for BlackRock in New York.

"The first brick in the inflation wall to fall is the **expectation brick**," said Weinstein. "If people are calling me worried about inflation it means that they're acting differently. It means they're actually starting to worry about **inflation**, and that should scare the heck out of central banks."

BlackRock's TIPS fund for individual investors, the **Inflation Protected** Bond Portfolio, has more than doubled its assets to $1.75 billion from $800 million at the start of the year, Weinstein said, while the firm's overall inflation-linked assets have risen to $19 billion from $12 billion. Weinstein's fund gained 8.2 percent this year, according to Bloomberg data.

Breakeven Rate

By historical measures TIPS remain cheap. The difference in yield between 10-year TIPS and 10-year notes is 1.86 percentage points, compared with an average of 2.18 over the past five years. The gap, known as the breakeven rate, has been 2 percentage points or more for 79 percent of that time, Bloomberg data shows.

Weinstein and Pimco's Worah both recommend 10-year TIPS because of the risk falling prices still pose for securities maturing in less than five years.

The Labor Department will report on Oct. 15 that the consumer price index rose 0.2 percent in September from August, while declining 1.4 percent from the year-earlier period, according to a Bloomberg survey. It would be the seventh consecutive monthly decline on an annual basis.

Rope-A-Dope

"TIPS are the rope-a-dope strategy of the bond market," said **Mitchell Stapley**, the Grand Rapids, Michigan-based chief fixed-income officer for Fifth Third Asset Management. Rope-a- dope refers to boxer **Muhammad Ali's** strategy of hunkering into a protective stance against which his opponent would flail, wearing himself out -- at which point Ali would strike. “These things perform best when people are talking about deflation.”

The benchmark 1.875 percent 10-year inflation-indexed Treasury note ended last week at 103 4/32 to yield 1.53 percent, according to BGCantor Market Data. The breakeven rate rose 14 basis points, or 0.14 percentage point, in the period, the most in seven weeks. The coupon compares with 3.625 percent on the benchmark 10-year Treasury.

Investors are willing to accept lower yields on TIPS because the principal increases annually at the rate of the consumer price index. The securities pay semi-annual interest on the adjusted principal. Their face value is protected against deflation, because the principal can’t fall below par.

‘Going To Suffer’

Some policy makers say deflation is a greater threat to economic recovery than inflation.

“We would not need much of a decline in inflation to run the risk of an outright deflation,” Fed Bank of New York President **William Dudley** said in a speech in New York on Oct 5. “Outright deflation, in turn, would be a dangerous development because it would drive up real debt burdens and make it much more difficult for households and businesses to deleverage.”

Investors concerned about falling prices should buy **long- term Treasuries**, said **Alex Li**, an interest-rate strategist in New York at primary dealer Credit Suisse Group AG.

The benchmark 30-year bond, a 4.5 percent security due August 2039, closed last week at 104 20/32 to yield 4.23 percent, or 3.26 percentage points more than the two-year note. The so- called **yield curve** is steeper than the mean of 1.5 percentage points over the last 20 years.

“At the beginning of next year or later this year people are going to realize low inflation’s going to stay with us at least over the near- to medium-term,” Li said. “That’s the time when TIPS are going to suffer.”

TIPS Risk

September’s larger-than-forecast decline in non-farm payrolls indicates the recovery may take more time to take root. A sluggish economy is a negative for TIPS investors, who could lose money if consumer prices rise on average less than the 1.86 percent breakeven rate.

“The risk to owning TIPS would be a double-dip zero percent or negative inflationary period for a number of years,” said **Kenneth Volpert**, who oversees $180 billion as head of taxable fixed-income at Vanguard Group in Valley Forge, Pennsylvania.

TIPS holders also run the risk of getting burned if the Fed begins **raising interest rates** “with greater force than is customary,” as Fed Governor Kevin Warsh warned on Sept. 25, when an economy recovery takes hold.

Issuance Boost

The Fed has kept its **target rate** for overnight loans between banks at zero to 0.25 percent since December in an effort to hold down borrowing costs and boost lending. The seizure in credit markets triggered $1.62 trillion of writedowns and credit losses at financial institutions since the start of 2007, sending the global economy into its first recession since World War II.

Inflation expectations as measured by the Fed's five- year/**five-year forward breakeven** rate rose to 2.80 percentage points on Oct. 6 from a low of 2.03 percentage points on Nov. 20. The rate plots forward rates measuring investor expectations for inflation in five years. The gauge was at 3.06 percentage points on June 30, 2004, when the Fed last raised its target rate.

Crude oil futures are more than double their January low of $32.70. Spending by U.S. consumers climbed by 1.3 percent in August, the most since 2001, and followed a 0.3 percent gain in the prior month that was bigger than previously estimated, the Commerce Department reported on Oct. 1 in Washington.

'A Good Buy'

The cost of living will rise 2.3 percent in 2011, according to the median estimate of 45 forecasters in another survey that puts a greater weighing on the most recent projections.

Karthik Ramanathan, the Treasury Department's acting assistant secretary for financial markets said on Oct. 1 during a speech in Boston that the Treasury is considering boosting **issuance of TIPS** as much as 70 percent to $100 billion in 2010, particularly the extension of "longer-dated TIPS by shifting issuance from 20-year TIPS to 30-year TIPS."

The breakeven rate on 10-year TIPS may rise to 4 percentage points in two years, according to **John Brynjolfsson**, chief investment officer of Aliso Viejo, California-based hedge fund Armored Wolf, as record **budget deficits**, expansionary **monetary policy** and a "debased currency" spur inflation. Gold, which reached an all-time high of $1,062.70 on Oct. 8, could reach $2,000 an ounce by 2012, he said.

"It ultimately comes down to, are policies sustainable and how will the U.S. and global economies navigate themselves through the current challenges that we face," Brynjolfsson said. "If you can buy TIPS with a 1.5 percent year yield locked in, that's a good buy."

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Last Updated: October 13, 2009 09:51 EDT