



A Short-Term Buying Opportunity for Long-Term TIPS

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Fixed income investors should consider a short-term buying opportunity for Treasury Inflation Protected Securities (TIPS) with maturities of ten or more years.

The key measure for TIPS valuation is the level of stagflation in the current economy, which determines whether investors should be holding TIPS or nominal Treasury bonds in their portfolio. We have our own measure of stagflation that explains about 50% of the variability in TIPS yields. When we account for stagflation, an interest rate risk measure and the volume of purchases of Treasury bonds by foreign banks, we can explain about 95% of the variability in TIPS yields. We can then extrapolate these three variables using an autoregressive moving average (ARMA) time-series model. After some statistical tests to verify variable significance, stability and the model's effectiveness with minimal forecast error we can determine whether TIPS are under- or over-valued compared to other bond asset classes.

According to our data, TIPS will be mostly overvalued for the remainder of 2010, but the second quarter of 2010 presents a short-term buying opportunity for longer-term TIPS. As of March 31, on-the-run TIPS with maturities of five, seven and ten years had yields of 0.72%, 1.23% and 1.60% (and break-even inflation rates of 1.83%, 2.05% and 2.24%, respectively). We forecast those medium-term TIPS yields to rise over the coming quarter and year (leading to a decline in the break-even rates for the five- and seven-year on-the-run TIPS). The rising yields will mostly account for the decline in the break-even rate, meaning that Treasury bonds with the same maturities should outperform comparable TIPS.

We also expect the ten-year TIPS yield to rise this year, but we predict it will actually decline in the short term because long-term inflation expectations will rise. This is somewhat of an anomaly for TIPS yields, as inflation expectations are typically reflected more in shorter-term TIPS before they reach longer-term TIPS.

In short, overweighting long-term TIPS in the second quarter of 2010 will help a core bond fund portfolio outperform. Given that we are forecasting a decline in



yield of 22 basis points for 10-year TIPS and a 6-basis-point decline for the 10-year nominal Treasury bond, the 10-year TIPS should have a total return anywhere from 30 to 40 basis points greater than the comparable nominal Treasury bond. Fixed income portfolio managers and investors buying individual bonds can take advantage of this short-term buying opportunity by buying ten-year TIPS directly. For ETF investors, PIMCO offers a 15+ Year TIPS fund (Ticker LTPZ), but as long as a TIPS ETF has a duration longer than that of a comparable aggregate or Treasury bond index it should out-perform in 2Q10. Vanguard, American Century, Fidelity, BlackRock and T. Rowe Price all offer inflation-protected mutual funds as well.

It is rare to find only a certain part of the TIPS curve that is significantly undervalued when other TIPS maturities are not. The drivers of TIPS performance explain this anomaly. TIPS tend to outperform other fixed income asset classes when inflation is strong, unemployment is high and economic growth is minimal, conditions which collectively reflect stagflation. Those stagflationary measures all grew throughout 2009. Though it will be some time before unemployment and growth return to more normal levels, unemployment will decline at least slightly between now and the end of 2010 and GDP will see some increase. The stagflationary measure used by our yield model indicates that for every 1% decrease in the index, the 10-year TIPS yield will rise 0.03%. (The sensitivity declines for longer-maturity TIPS; this is likely because investors expect long-term price stability even in the face of short-term deviations from target-inflation rates.) The five-year and seven-year TIPS have respective sensitivities of 0.13% and 0.11%.

The inverse relationship between the sensitivity of the stagflation coefficient and the TIPS maturity gives rise to the current short-term buying opportunity for longer-term TIPS. Though stagflation is moderating, it is putting more pressure on TIPS yields of five- and seven-year maturities than it is on 10-year TIPS. When we account for other factors influencing TIPS (i.e., the slope of the TIPS curve and a market-wide risk premium measure), the current opportunity to buy TIPS with maturities of 10+ years becomes clear.

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