Views from the Desk

Using U.S. TIPS in Keeping up with Inflation

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After nearly a decade of deflationary concerns, the fear of inflation has risen in recent months as the investors have become more optimistic of a global economic re-opening. Since the beginning of November 2020, when news of the efficacy rates of Pfizer's vaccine hit headlines, the U.S. 10-year Treasury yield gained as much as 65bps to 1.52% in late February. Furthermore, the 10-year U.S. breakeven (the difference between the yield on a nominal bond and an inflation-linked bond on the same maturity) hit as high as 2.24% in mid-February. This is interesting as breakeven rates are seen as the market's expectation for inflation (implied), whereas the Consumer Price Index (CPI) is seen as backward looking inflation (realized).

It should be noted that it is not uncommon to see reflationary pressures coming out of recessions. The 10-year U.S. breakeven reached as high as 2.65% in 2011, coming out of the Great Financial Crisis ("GFC"). Coming out of the present COVID-19 related crisis, it can be argued that there are additional factors that potentially may lead to additional inflationary pressures.

Concerns of inflation/reflation have grown in recent months due to:

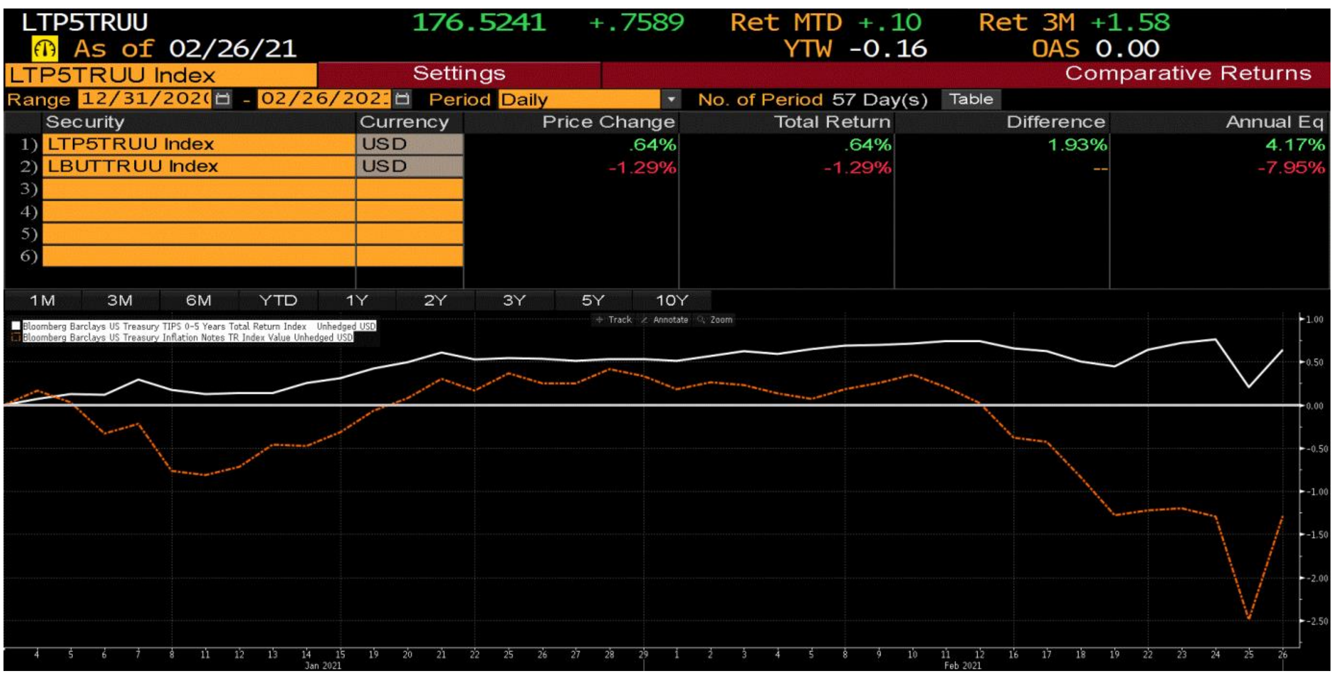
- Central bank balance sheet growth due to the COVID-19 pandemic. Due to increased monetary and fiscal stimulus, U.S. Debt to GDP has risen to levels not seen since post-World War 2. Though followers of Modern Monetary Theory (MMT) may argue otherwise, a larger monetary base potentially leads to inflation, all-else being equal.
- The U.S. Federal Reserve ("Fed") looking to target long-term average in inflation rather than focusing on short-term levels. Market historians will know that part of the reason why inflation got out of hand in the 1970s was due to short-term inflation going unchecked.
- Supply chain disruptions due to COVID shutdowns have led to shortages in many areas. Already we are seeing the effects of this in industries from lumber, used cars to semi-conductors, leading to cost-push inflation.
- Demand has been low, but upon reopening will significantly increase, leading to demand-pull inflation. Pent up demand in many areas would further exacerbating supply/demand imbalances.
- Money velocity, or the rate at which currency turns over, has been rather muted in recent years. However, has been ticking up in recent months and would likely rise further upon an economic reopening.

Positioning a Portfolio in U.S. TIPS:

While we are not anticipating runaway inflation, we would not be surprised to see inflation run above the Fed's target inflation levels. With the recent rise in interest rates, particularly on the back-end of the yield curve, which has led to a significant steepening, investors should look for ways to offset duration risk in a portfolio. The recent uptick in the market's implied inflation (breakeven rates), is further evidence that investors may want to hedge or protect against rising rates and/or reflationary pressures. Investors may want to re-allocate 3-5% of a portfolio from a core bond exposure to U.S. TIPS (Treasury Inflation Protected Securities), which benefit in a rising rate environment.

U.S. TIPS have been gaining significant traction amongst investors over the last several months, particularly after the Pfizer news in early November of 2020. However, given the recent steepening in the yield curve, investors may want to consider avoiding U.S. TIPS with longer term to maturity, given their higher duration. As rates have surged on the back-end of U.S. yield curve, short-term U.S. TIPS have held in much better than full-term U.S. TIPS exposure. By focusing on U.S. TIPS that have a term of maturity between 0-5 years, investors get the inflation protection benefits, while avoiding the interest rate sensitivity of long-term bonds.

<u>Chart 1: Short-Term U.S. TIPS Have Been More Stable Than Full Term</u>



Source: Bloomberg (LTP5TRUU: Barcap 0-5 Years TIPS Total Return Index, LBUTTRUU: Barcap US TIPS Total Return Index)

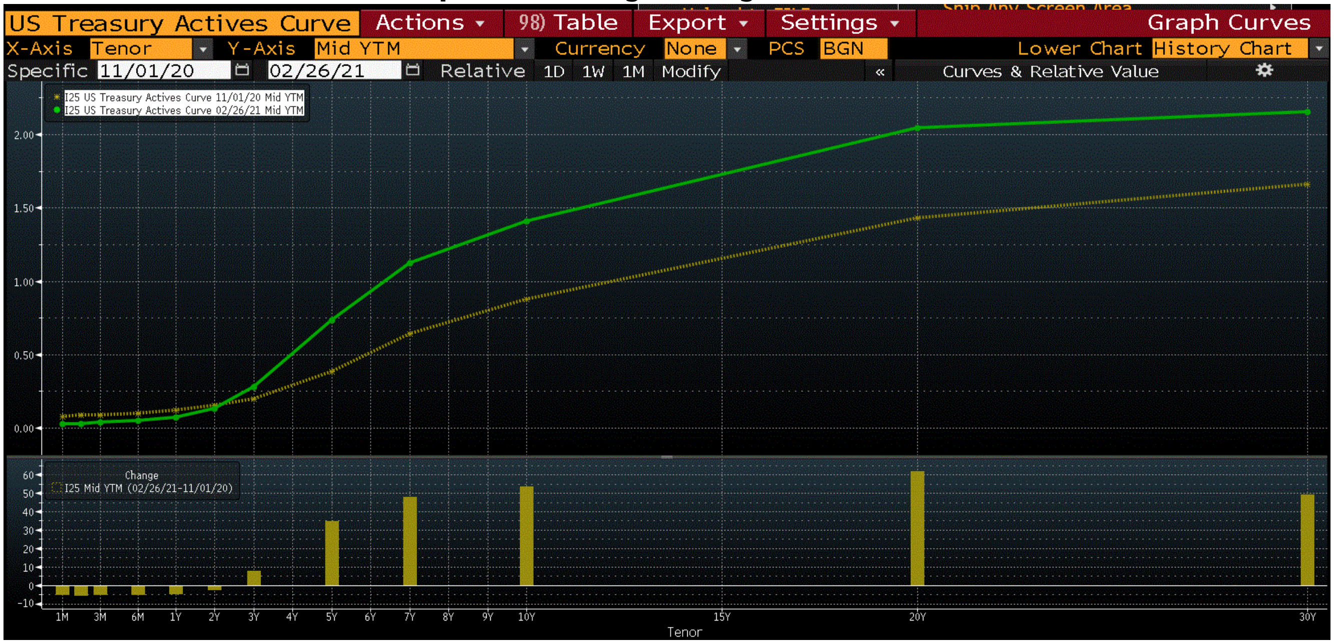
<u>When using TIPS to hedge inflation in the current environment, here are some considerations:</u>

- The market's expectation of inflation has gone up as noted with the US 10-Year breakeven rate now at 2.16%
    - Coming out of the Great Financial Crisis in 2009, as assets reflated, the 10-year U.S. breakeven, hit as high as 2.65%, but there are far more inflationary factors this time around.
    - The 5-year is trading above the 10-year U.S. breakeven as the market is anticipating more inflationary pressures over the short-term as supply/demand imbalances will likely alleviate over the longer-term (Chart 2).
- The yield curve has significantly steepened since the Pfizer news (Chart 3)
    - Long bond yields have risen on the reflation trade (inflation concerns and also a rotation into equities).
    - Short-term bonds yields have remained relatively flat (Bond yields less than 5 years have remained flat) as market expects Fed to keep rates low over the next several years.
- Investors looking for Short-term U.S. TIPS Exposure may want to consider
    - **BMO Short-Term US TIPS Index ETF (ZTIP, ZTIP.U, ZTIP.F),** which holds U.S. TIPS with a maturity between 0-5 years. This allows investors to efficiently access the asset class through the ease of an ETF and minimize duration risk by holding only short-term bonds.
    - ZTIP provides exposure to Short-term U.S. TIPS and U.S. dollars without having to exchange currency into U.S. dollars. ZTIP provides exposure for those investors that want to hold in U.S. dollars and ZTIP.F is currency hedged allowing investors to mitigate the currency effects of US/CAD exposure.

Chart 2: 5-Year U.S. Break-evens Now Trading Above 10-Year

Source: Bloomberg (USGGBE05 Index: 5 Year U.S. Breakeven Rate, USGGBE10 Index: 10 Year U.S. Breakeven Rate)

Chart 3: U.S. Yield Curve Has Steepened with Higher Long-term Rates



Source: Bloomberg (U.S. Treasury Active Curve)

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