

# Just Like That – TIPS Enter the Spotlight

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## The agility of central banks is currently being put to the test.

Charged with managing inflation and supporting full employment, the Federal Reserve and other global central banks are confronting rising inflation expectations and multiple supply shocks that are undermining the outlook for economic growth potential.

The supply chain ramifications of COVID-19 left its mark on prices. According to the Bureau of Labor Statistics, inflation increased 7.9%<sup>1</sup> year over year in February. Those same influences led many investors to moderate their economic growth expectations for 2022.

<sup>1</sup> *Bureau of Labor Statistics, as of 10 March 2022.*





However, even the more modest growth projections are being called into question as global markets endure another supply shock. The Russia-Ukraine war has destabilized the energy markets and raised the potential for higher oil prices to weaken global growth and increase inflation. Consider that every 5% increase in oil prices could contribute a 0.5% increase in headline CPI and a direct negative impact on GDP.<sup>2</sup>

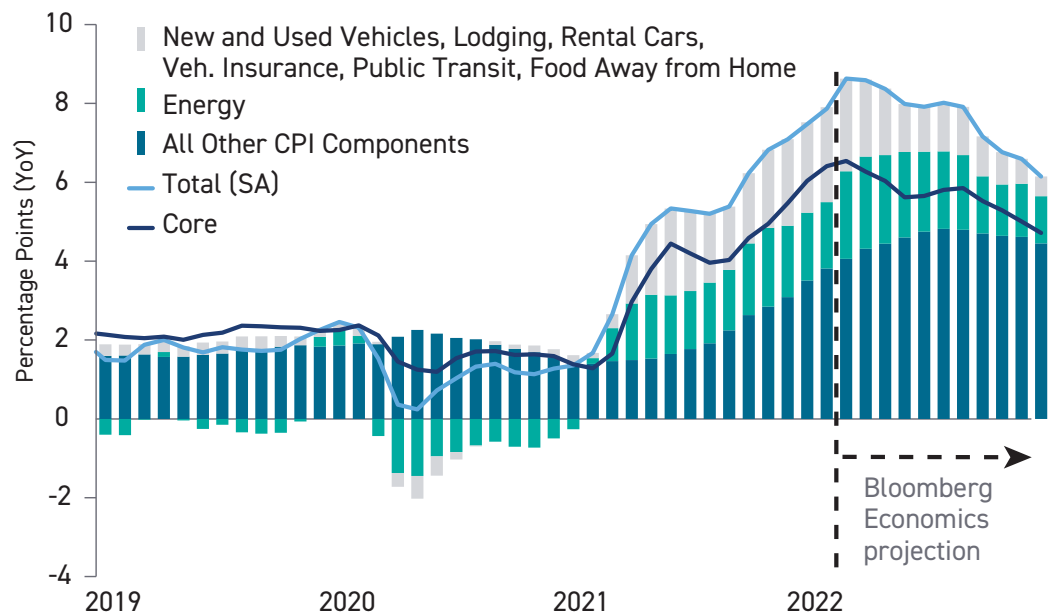
## Inflation and Growth Pressures Abound

We think the pressure around oil prices is unlikely to abate soon. We believe there are a number of variables that could contribute to continued inflation and growth pressures:

- A lack of oil alternatives. The global economy finds itself in a messy transition from oil reliance to a more ESG-aware focus. The US is woefully unprepared for this shift. The fallout during this period has been declining oil inventories and lower investments in energy exploration amid slow progress toward achieving clean, renewable energy.
- War-related shocks, including surging metals and wheat prices.
- China's zero-COVID policy has caused it to lock down major cities in reaction to rising cases. This could contribute to further tangling the supply chain.
- Manufacturing labor costs, in the US and abroad, increased substantially even before the pandemic and are unlikely to shift downward.

### CPI COMPONENTS

Source: Bloomberg, as of 10 March 2022.





## TIPS in a Stagflation Environment

The prospects for stagflation may be gaining a hold on the global economy in our view. In the fixed income universe, we believe this environment could provide a solid base for healthy TIPS<sup>3</sup> return potential.

Total returns for TIPS and nominal Treasuries are linked to real economic growth in the long run. In an environment of rising inflation and low growth, we would expect real yields to fall and TIPS to outperform nominal Treasuries.

A breakeven inflation rate is the annualized rate of CPI-U<sup>4</sup> inflation that makes the total return of a TIPS equal the total return of a similar-tenor Treasury. Breakeven rates are a proxy for the market's inflation expectations. Five-year breakeven inflation (expected inflation for the next five years) is currently hovering around 3.5%.<sup>5</sup> The 2022 CPI forecast of 7% to 8%<sup>6</sup> indicates room for the five-year breakeven to potentially widen further.

## Conclusion

While the Fed practices its agility exercises, investors may adapt to the evolving environment. When will inflation peak? It's unknown. However, we do know TIPS can act as a hedge against inflation and may be worth consideration.

<sup>3</sup> Treasury Inflation Protected Securities.

<sup>4</sup> According to the Bureau of Labor Statistics, The Consumer Price Index (CPI-U) measures the change in prices paid by consumers for goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers. The all urban consumer group represents about 93 percent of the total U.S. population.

<sup>5</sup> Source: Bloomberg, as of 11 March 2022.

<sup>6</sup> Source: Bloomberg, U.S. PREVIEW: CPI to Touch 8%, Peak Higher, Later in Spring, as of 9 March 2022.

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