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Market Facts

Revisiting TIPS, Treasuries And Insurance

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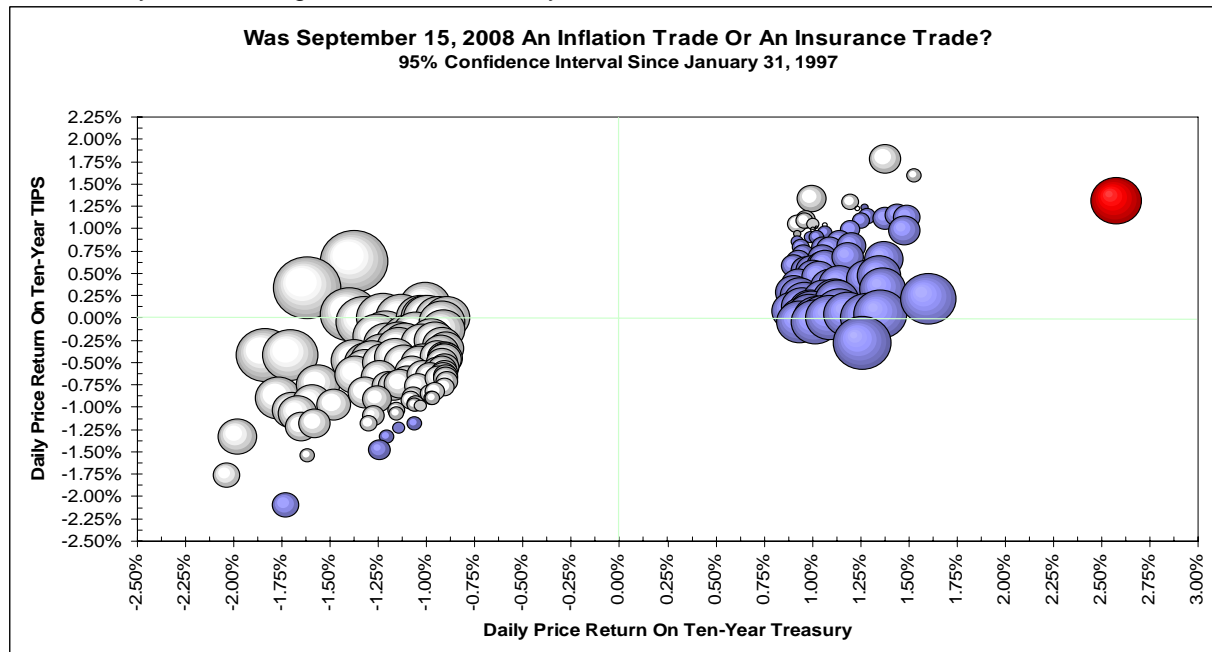
Of all of the grim market news yesterday, anyone could be forgiven for ignoring the sharp decline in TIPS breakeven rates of inflation. Breakeven rates of inflation at the two-, five- and ten-year maturities narrowed by 67.5, 27.5 and 17.3 basis points, respectively.

We noted in a September 2007 [Special Report](#) how flights into conventional Treasuries distort the breakevens; conventional Treasuries serve as crash insurance, and the lower rate compresses the breakeven. This is irrespective of any of the valid reasons inflation expectations might be declining in the current environment.

We can illustrate the distortion by mapping price returns for nominal ten-year TIPS against those for ten-year

Treasuries, both series converted into constant-maturity bonds, at a 95% two-tailed filter for Treasury returns. The size of the bubbles corresponds to the price return difference, UST-TIPS; negative spreads are marked with white bubbles and positive spreads with blue bubbles. Yesterday's datum is marked in red.

Yesterday's price return on UST was the largest of the post-January 1997 era. If the normal relationship between TIPS price returns and UST price returns for large UST price gains prevailed, the price return on TIPS would have been 2.06% instead of the observed 1.31%. **The panic into conventional Treasuries was so intense, even TIPS were left behind. This trade is likely to self-correct in short order.**



Conclusion

The breakeven rate of inflation on the two-year TIPS collapsed to 0.158%. Even in a world filled with dire events that would be a dire outcome.

TIPS contain several options, one of which is a put option on deflation: Should the CPI-U be negative over

the TIPS' life, the principal on the TIPS will not go below par at maturity.

Should that odd event materialize – a statement, not a forecast – TIPS would become quite valuable relative to conventional Treasuries, their relative yield would fall and we would have to explain rising breakeven rates of inflation in a deflationary environment.

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