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Global Reflation? Treasury Inflation Protected Bonds vs Regular Bonds

Income in portfolios primarily comes from stock dividends and more stable and secure coupon interest payments on bonds. Higher inflation, when observed as a broad and sustained increase in the price level of goods and services, acts as a tax on money holdings, so the practical reality for individuals receiving an income stream could be reduced purchasing power under higher inflationary regimes. We are far from that situation, so there is no need for alarm. Recently, we have seen a slight uptick in levels of consumer inflation not just here in the U.S., but globally, which according to some beliefs is a welcomed development indicating a move from the post Global Financial Crisis era of low levels of inflation and growth. Below is a graph of Consumer Price Index (CPI) inflation (top) and levels of 10-year interest rates (bottom) in the three major developed economies of the U.S., Germany and Japan from the summer of 2016 to the present. We can see a synchronized reflation characterized by higher levels of inflation and interest rates. A major question for participants is whether or not this reflation truly signals a new and more permanent shift or whether it is simply a temporary cyclical move from the crisis era lows which will fade in time as less reflationary optimism creeps back.

Managers have a few tools to help control this uncertainty in regards to the income requirements of a portfolio. First, the bond portion of the portfolio can hold varying maturities of regular nominal bonds which mature in short, medium and long-term durations so if a secular shift higher in interest rates occurs, then the lower yielding shorter term bonds will mature and be replaced by new and higher yielding paper priced off the higher levels of growth and inflation. Second, inflation protection can be purchased with inflation protected bonds when appropriate. A Treasury inflation protected bond, mechanically does two things: It adjusts coupon payments and provides an inflation accrual which adjusts principal paid out at maturity according to prevalent inflation dynamics as measured by the CPI. The subtle but important point about this instrument is that it may be a useful guard against a higher future inflation trend that comes into being provided that the higher trend that emerges was not previously expected. The breakeven inflation rate priced into 5-year Treasury inflation protected bonds at present is around 2% which means investors should be indifferent to owning a Treasury inflation protected bond vs a nominal bond if the belief is that the next five years will produce a 2% core CPI inflation rate. If inflation actually comes in higher than this, then investors will have been better off in the Treasury inflation protected bond.

Source of Chart: Bloomberg