MI2 Trader: TIPS the Next Pain Trade?

8th December 2021

Comment

To say this has been a challenging year in fixed income is an understatement. Once again, the bond market has discovered that the assurances of central bankers (or rather their economic forecasts) aren't worth the paper they are written on. Instead, like the rest of us, central bankers are simply slaves to the data, only with a slower reaction function. Therefore, as the numbers change, their apparent rock-solid resolve at first wavers and is then simply cast aside. In that sense, they are the very definition of the "unreliable boyfriend".

While the RBA's sudden abandonment of YCC must take first prize in terms of the brutality of the ensuing market fallout, the damage was somewhat contained because of the limited size of the Australian market. While not so radical, there is no question that the Fed has cost people the most money this year. Let's not forget that the Fed entered 2021 with its New Policy Framework. This pivot to wokeness saw J Powell touring D.C. homeless shelters in the spring! At the time, we wrote that while socially laudable, their stance would have market implications, especially as we feared they were wrong about inflation ("The Fed: The Consequences of Woke" 28th Apr). Fast forward a couple of months, and in the face of far stronger data, June's hawkish FOMC pivot was the kiss of death to two years of very profitable but rather crowded curve steepeners. This first leg of the pain trade has now been compounded by the "retirement" of "transitory" and talk of faster hikes preceded by accelerated tapering. We believe the latter has the most potential to shake things up. ("The Fed's Balance Sheet: The Definition of Insanity" 16th Aug).

As discussed in last month's Virtual Roadshow, a slowing of the Fed's balance sheet growth is perfectly consistent with curve flattening. Unfortunately, this has hit a real money constituency that has logically been underweight fixed income in their asset allocation. The result is yet more pain and a 2-30's yield curve that, even before tapering has started, has already dropped to within spitting distance of the 60-70bps consistent with no QE at all.

That brings us to Treasury Inflation-Protected Securities or TIPS. Over the last 18 months, these have been a fantastic trade, offering one of the few refuges to fixed income investors trying to protect themselves from inflation. The momentum of the trade has been helped by the fact that the Fed's QE has absorbed the lion's share of new issuance. Unfortunately, these extended positions now face the possibility that the Fed is serious about shifting back to being a sound money institution. Ok, stop laughing! We ultimately doubt it too. But with the politics of inflation shifting, there may be a window where they look serious, and if they do, TIPS could be in for a world of pain. P.S. These are complicated instruments, hence the longer Trader piece than usual. But we will try and keep things as simple as possible.

Even before Powell's recent hawkish twist, higher assumed levels for r* and the dot plot supported the idea of earlier hikes and ultimately higher yields than is currently priced. Indeed, using the Eurodollar curve, the negligible differential between EDZ3 and Z4 suggests a peak in rates at the end of 2023, with a terminal rate of around 1.7% for 3 months Libor.

9) Dec22	↑98.925
10) Mar23	98.700
11) Jun23	98.495
12) Sep23	98.340
13) Dec23	98.265
14) Mar24	98.245
15) Jun24	98.240
16) Sep24	↑98.230
17) Dec24	98.210
18) Mar25	98.230

Given that the last two tightening cycles have ended with sharp equity wobbles and ignominious policy reversals, such a low terminal rate may make sense. However, as we have discussed, ultimately, the Fed's objective isn't a specific level for EDs but overall financial conditions (a cocktail of the dollar, credit spreads, equities, 2yr and 10yr yields). These are at sitting at historically easy levels, and courtesy of equities, seem utterly immune to fixed-income's prices. Unfortunately, as we highlighted in our Virtual Roadshow, and as Bill Dudley explained, the longer this dynamic persists (i.e., until stocks get the memo), the more likely "the Fed will have to raise short-term rates by considerably more than what is currently anticipated." P.S. He specifically referenced the period 2004-6, when 5yr TIPS yields went from 40 to almost 280bps in a straight line.

Ultimately, a major risk-off event would benefit all bond markets, including the TIPS market, which would begin to price the risk of accelerating inflation on renewed easing. But that's jumping the gun. It's getting to that point, i.e., as the Fed tightens, that could be challenging for TIPS. This necessitates a short technical discussion.

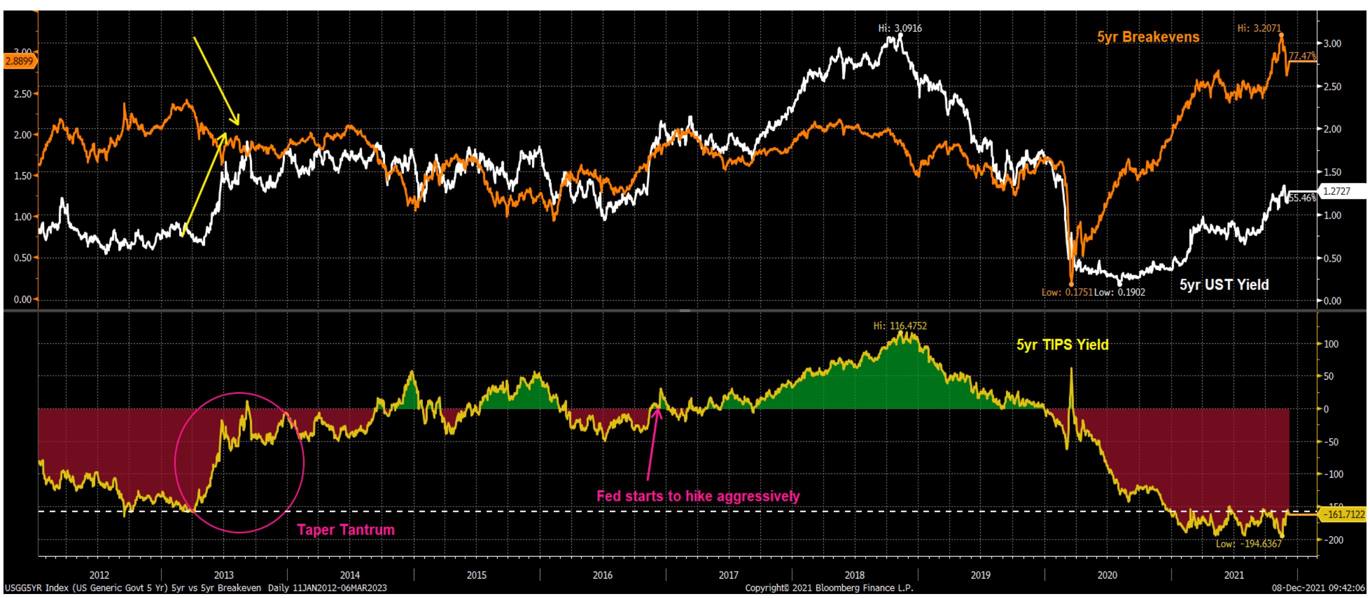
Like a conventional Treasury, TIPS owners receive a fixed semi-annual interest payment. However, in addition, they also receive a "bonus" based upon the prevailing CPI inflation rate, which is added or (under deflation) deducted from the principal. Also, while a conventional Treasury always matures at par, a TIP can mature either at par or at the adjusted principal, whichever is greater.

That brings us to the topic of Breakevens. This is important because the breakeven inflation rate is the level of inflation that a TIPS holder needs in order to be indifferent between owning a conventional Treasury or a TIP of the same maturity. Hence, when people talk about buying "breakevens," they mean being long a TIP and short the equivalent maturity conventional. To calculate the breakeven rate, you simply take the conventional yield (say 1.22% in 5 years) and deduct the TIPS yield (currently -1.58%). Thus, 1.22% minus -1.58% is 2.8%. (double negative is correct.) This means you would currently require inflation to average more than 2.8% over the next five years to prefer owning the TIP instead of the conventional.

Buying 5yr Breakevens was one of our first trade suggestions in the Covid risk swoon, and while we switched our focus to selling various frontends some time ago, the trade has been an excellent expression of inflation's relentless rise ("MI2 Chart Point: Watch Inflation" 24th Mar). However, there are signs that this one-way bet could be challenged. For example, following Powell's recent hawkishness, 5yr Breakevens lurched lower and are now challenging the uptrend that has held the move from the lows. Without wanting to go into too much detail, note how oil, as an integral part of headline inflation, correlates closely with Breakeven yields. Hence, it needs to be considered in assessing what's likely to happen next.

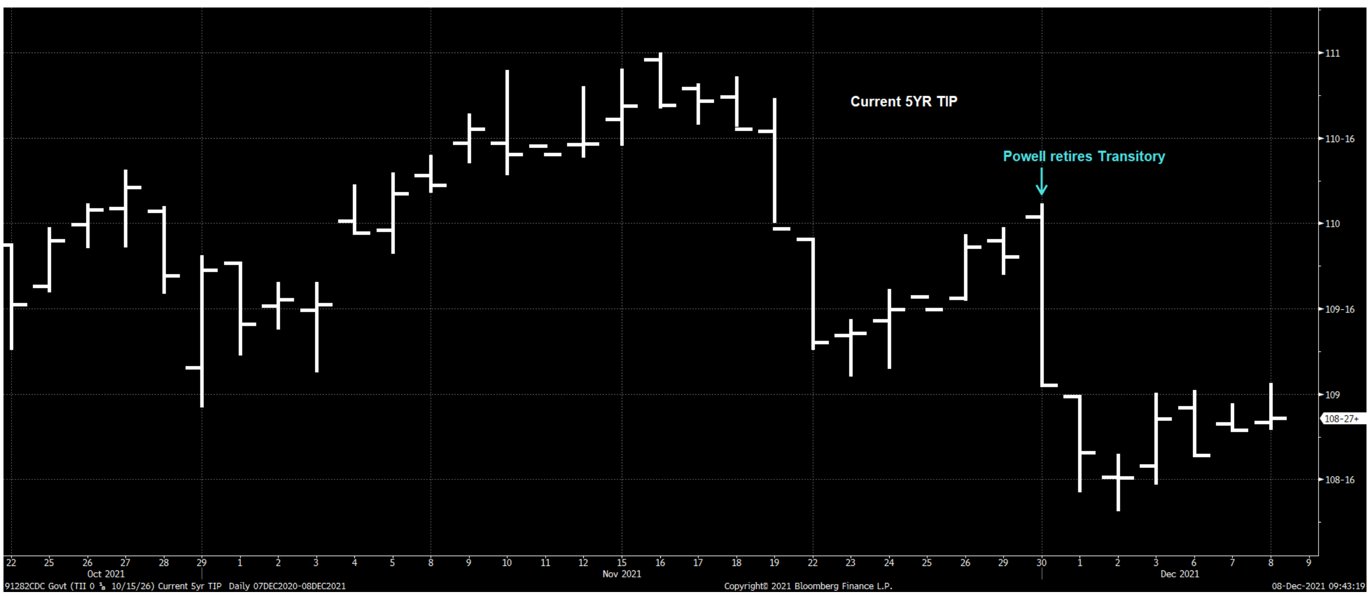
It is also noteworthy that even as 5-year Breakeven yields recently broke through 3%, the 5y5y forward Breakeven (a measure often wheeled out by the Fed to justify their dovishness) has been stuck not materially higher than their 2% inflation target. This is a warning sign because an inverted Breakeven curve implies lower future inflation expectations and is both consistent with the conventional curve flattening and a red flag to the spot breakeven inflation assumptions.

That brings us to a chart we have shown you on repeated occasions. It illustrates the divergence between conventional Treasuries and inflation expectations as measured by Breakevens. However, more importantly, it highlights just how vulnerable TIPS can be to Fed pivots. The Taper Tantrum was an extreme example when TIPS were crushed (yields become less negative) following rising nominal 5yr rates higher step for step. However, while less severe, TIPS were also a horrible trade during the late 2016-18 Fed tightening cycle as 5-year yields rose and breakevens adjusted lower.



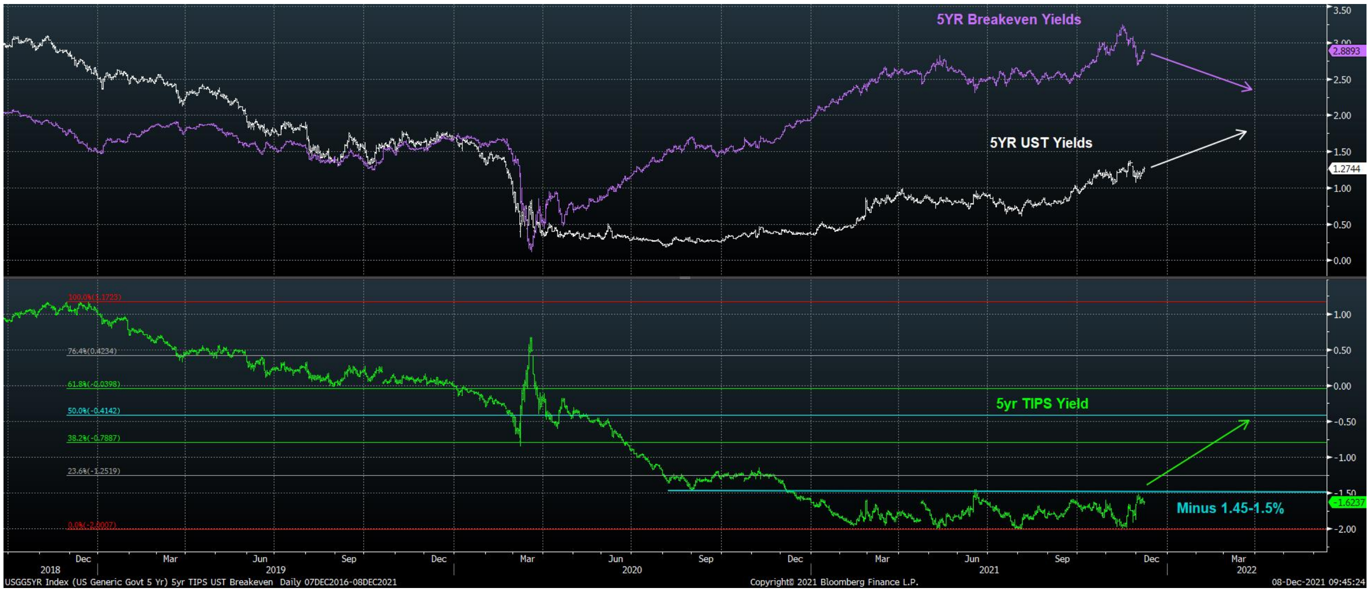
To sum up, having ravaged the P in fixed income P/L this year, we are afraid that there will be one more victim before the Fed is finished. Ultimately, we believe that any hawkish pivot will be the actual "transitory" event of 2022. But for now, faced by bulletproof equity markets, a newly re-nominated Powell seems resolute and girded for the fight. Don't forget it now appears that the Fed believes that the labour participation rate isn't going to recover as quickly as they had hoped. Hence, we are far closer to full employment than they'd expected. (As we discussed in the video, we hear that this FOMC believes that rate to be 3.8%.) Therefore, even if headline inflation slows, the Fed needs to slow the economy via tighter financial conditions to prevent wage inflation from becoming engrained. This suggests that the first rate hike could come at the start of spring and that ultimately rates will have to go a lot higher than is currently priced. Add this to an accelerated taper, which will remove the market's biggest buyer of TIPs, and we fear this is a significant threat to a highly extended, over-owned TIPS market.

Trade:
Sell the current 5yr 0 1/8th% 15th Oct 2026 TIP, priced at 108-28/32nds with a target about 5 points lower and a stop over 110, i.e. where it was trading before Powell's "Retire transitory" remarks. Risk/Reward plus or minus 4:1.



That may sound a lot. But a move of that magnitude could be achieved with 5yr yields rising towards our target of 1.75% ("MI2 Chart Point: 5 Year UST" 23rd Sept) together with a modest fall in Breakevens towards the band of support around 2.3-2.4%. That combination would drive 5-year TIPS yields 100 basis points higher to around minus 0.5%. That would represent a 50% retracement of the drop from the Christmas 2018 highs of just over +1% to the sticky 2021 lows of about -2%.

If we were to finesse the trade, we would sell ½ here and then add once TIPS yield breaks the minus 1.45-1.5% level, which has contained the market since last September. However, this isn't the most liquid of markets, so we believe it is better to act while you can. It is also worth noting that this trade is consistent with shorts in Eurodollars or conventional 5 years Treasuries, both of which we still like ("MI2 Chart Point: Running the Hedges" 30th Nov). Therefore, if the instrument or liquidity prevents you from playing TIPS, we suggest that you maintain shorts in these markets.


5YR Breakeven Yields
2.8893
5YR UST Yields
1.2744
76.4%(0.4234)
61.8%(-0.0398)
50.0%(-0.4142)
38.2%(-0.7887)
23.6%(-1.2519)
5yr TIPS Yield
Minus 1.45-1.5%
-1.6237
USGG5YR Index (US Generic Govt 5 Yr) 5yr TIPS UST Breakeven Daily 07DEC2016-08DEC2021
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