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In this week's recap: Stocks slip after Powell comments.

Weekly Economic Update

Presented by Ed Papier, November 7, 2022

THE WEEK ON WALL STREET

Hawkish comments by Fed Chair Jerome Powell, following the announcement of another 75 basis points interest rate hike last week, cast a pall over financial markets, sending yields higher and stocks lower.

The Dow Jones Industrial Average slipped 1.40%, while the Standard & Poor's 500 declined 3.35%. The Nasdaq Composite index lost 5.65% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, fell 1.04%. [1,2,3]

POWELL DISAPPOINTS

The official statement released following the Federal Open Market Committee (FOMC) meeting appeared to suggest a potential for future easing of interest rates. Investors cheered the news, sending stocks higher. But the optimism was crushed 30 minutes later on hawkish comments by Fed Chair Powell during his post-meeting press conference.

Losses accelerated into Thursday, led by technology names, which were under pressure due to rising bond yields. The yield on the two-year Treasury note rose to its highest level since 2007. The sentiment took damage from workforce reduction/freeze news from multiple technology companies; some considered it a sign of a pending recession. Stocks managed to erase some of the week's losses on Friday following a strong employment report and a drop in the U.S. dollar. [4]

FROM DOVE TO HAWK IN 30 MINUTES

In the statement accompanying the 75-basis point rate increase, the FOMC said that future increases would consider the cumulative monetary tightening to date and the lag in impact such tightening involves. [5]

But in his post-meeting press conference, Fed Chair Powell struck a more hawkish tone. He said that current inflation data did not support any slowdown in rate increases and that the terminal rate (the point at which rates will no longer rise) may be higher than initially expected. [6]

THE WEEK AHEAD: KEY ECONOMIC DATA

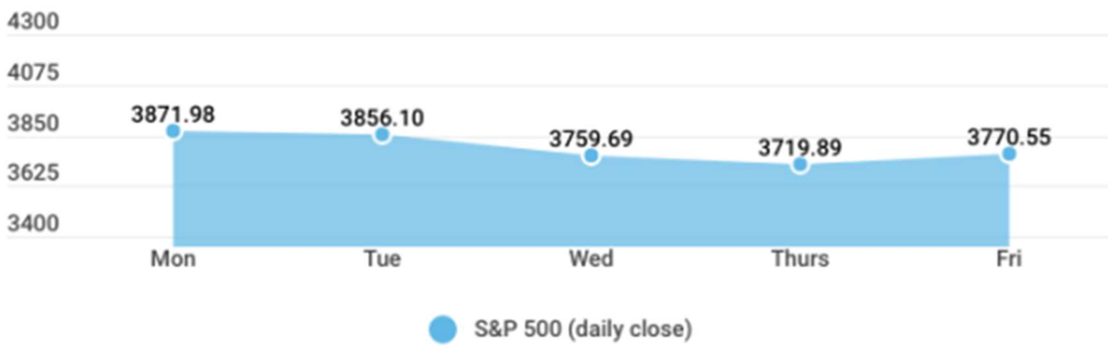
Thursday: Consumer Price Index (CPI). Jobless Claims.
Friday: Consumer Sentiment.

QUOTE OF THE WEEK

"Europe's green future is cold and dark"

JAMES GORRIE

Market Index	Close	Week	Y-T-D
DJIA	32,403.22	-1.40%	-10.83%
NASDAQ	10,475.25	-5.65%	-33.04%
MSCI-EAFE	1,730.74	-1.04%	-25.91%
S&P 500	3,770.55	-3.35%	-20.89%



	Treasury	Close	Week	Y-T-D
	10-Year Note	4.17%	+0.16%	+2.65%

Sources: The Wall Street Journal, November 4, 2022; Treasury.gov, November 4, 2022
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, October 28, to Friday, November 4, close. Weekly performance for the MSCI-EAFE is measured from Friday, October 28, open to Thursday, November 3, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Treasury Inflation-Protected Securities can be a buffer against long-term inflation, but it's possible for TIPS price declines to outpace principal adjustment in the short term.

Investors holding Treasury Inflation-Protected Securities, or TIPS, as a hedge against inflation may be confused by their performance this year: TIPS prices have declined sharply despite the surge in inflation. Many may wonder: Is this normal and how is it possible?

It's not "normal" for TIPS to fall so much, but it's common for TIPS returns and the rate of inflation to diverge over short periods of time. TIPS can help protect investors against inflation over the long term, but they aren't a hedge against inflation in the short run, because price changes may more than offset the principal adjustment over shorter periods of time. While this year's performance may have investors worried about the outlook for TIPS, the rise in yields and the decline in breakeven rates makes them more attractive today than they have been recently.

Investing in TIPS isn't always straightforward. They have many unique characteristics that can make the investing experience a bit confusing. Here are answers to some of the most frequently asked questions about the TIPS market:

1. What are TIPS? TIPS are a type of Treasury security whose principal value is indexed to inflation. When inflation rises, the TIPS' principal value is adjusted up. If there's deflation, then the principal value is adjusted lower. Like traditional Treasuries, TIPS are backed by the full faith and credit of the U.S. government. The coupon payments are based on a percent of the adjusted principal, so investors can benefit from higher income payments when inflation is rising as well. At maturity, however, a TIPS investor would receive either the adjusted higher principal or the original principal value. In other words, TIPS never pay back less than the initial principal value at maturity.

2. Why have TIPS performed so poorly when inflation is so high? TIPS prices have fallen more than the principal has adjusted higher, resulting in negative total returns for the year. TIPS are still bonds, meaning their prices and yields move in opposite directions. Like most fixed income investments this year, TIPS yields have surged, pulling their prices lower.

The average price of the TIPS index has dropped by more than 19% this year. The plunge in price is a key reason why TIPS don't necessarily protect against inflation over the short run, as price movements can be larger than those principal adjustments. Keep in mind that TIPS prices in the secondary market do not include the adjusted principal value. When buying or selling TIPS in the secondary market, for example, the transaction amount may be different than what the price would suggest because of the adjusted principal value.

3. How have TIPS performed relative to traditional Treasuries this year? The Bloomberg U.S. TIPS Index is down 13% this year through October 18th, while the Bloomberg U.S. Treasury Index is down a bit more, with a negative 14% total return over the same period. So even though the Consumer Price Index is up 8.2% in the 12 months ending September 31, 2022, the price decline more than offset that positive principal adjustment.

4. Is this normal? The magnitude of the losses this year isn't normal, with the 12-month return of the TIPS index through the end of September being the worst on record. But historically, over one-year time horizons, there hasn't been much of a relationship between the total return of the TIPS index and the change in the consumer price index.

5. What sort of yields do TIPS offer today? TIPS yields are all positive. That might not seem like much, but TIPS yields generally spent much of 2020 and all of 2021 in negative territory. Today, most TIPS yields are around 1.5% or above, significantly higher than where they ended last year.

TIPS yields are "real" yields, meaning they are already adjusted for inflation. But another way to consider those "real" yields is to consider the impact of inflation on the nominal returns. The annual rate of inflation over the life of a TIPS is ultimately added to the stated yield when held to maturity. If inflation averages 3% for the next five years, for example, that 3% inflation rate would get added to the roughly 1.8% "real" yield that five-year TIPS offers today—resulting in a nominal return of 4.8% annually. The higher (or lower) inflation comes in, the higher (or lower) that nominal total return would be. That can be an important concept for investors who are worried that inflation will remain very elevated for a while.

6. How can I compare TIPS to traditional Treasuries? Breakeven inflation rates. The breakeven rate is the difference between the yield of a nominal Treasury and the yield of a TIPS with a similar maturity. For TIPS investors, the breakeven rate can be considered a hurdle rate—it's what inflation would need to average over the life of the TIPS for it to outperform the nominal Treasury. Breakeven rates are well off their recent highs. At 2.5%, the five-year TIPS breakeven rate is well off its recent high of 3.7% hit this past March. If the CPI were to average more than 2.5% over the next five years, the five-year TIPS would outperform a five-year nominal Treasury. (Likewise, if inflation averaged less than 2.5%, the nominal Treasury would outperform.) While the current breakeven rates are elevated relative to the last 20 years, they are still well below the current rate of inflation. Considering that the CPI rose by 8.2% during the 12 months ending September 2022, a 2.5% breakeven rate seems relatively low.

7. When we look at various mutual funds or exchange-traded funds (ETFs) that hold TIPS, why are the stated yields so different? TIPS' mutual fund or ETF yields may appear distorted due to short-term fluctuations in the CPI, and they might not be reflective of the market yield of the underlying securities. Yield calculations may also differ across fund sponsors. For example, the SEC yield—a standardized yield developed by the Securities and Exchange Commission (SEC)—may be distorted when there's a lot of fluctuation in the monthly payments. While the SEC yield is designed to allow for a fairer comparison of bond funds, there are pitfalls to using it with bond funds that hold TIPS. The yield for a TIPS fund is adjusted monthly based on changes in the rate of inflation, and these changes can cause the yield to vary substantially from month to month. Very high or low yields are attributable to the rise and fall in inflation rates and might not be repeated.

8. Is there anything else I should know? Yes—consider the potential for deflation for TIPS with short-term maturities. TIPS mature at the greater of the adjusted principal or the initial value at issuance. Investors who buy new-issue TIPS are therefore protected against deflation, but that's not the case when buying TIPS in the secondary market. If you buy a TIPS that already has been adjusted higher, and then the CPI begins to decline, you could actually lose money. That might seem unlikely given that inflation continues to run relatively hot, but the "headline" CPI index that TIPS are referenced to

includes volatile food and energy prices. If energy prices (or any other prices, for that matter) resume their downward trend, monthly CPI readings potentially could begin to fall.

Consider TIPS if you're looking for long-term inflation protection. With real yields well above zero, investors can finally earn higher income with TIPS while also helping protect against inflation over the long run. While TIPS yields likely won't rise much further as the worst of the price declines is likely behind us. However, Treasury market volatility has been elevated this year, and it could continue as the Fed tightens financial conditions. Additional price declines are therefore still possible, reiterating the view that TIPS shouldn't be considered short-term hedges against inflation—but they can help over the long run.

For individual TIPS holders, any potential price declines might not matter if they're held to maturity. For those who invest in TIPS through ETFs or mutual funds, that could mean modest declines from here, but that doesn't mean you need to abandon your holdings. If yields rise and the funds rebalance, investors may be rewarded with higher income payments to help offset some of the potential price declines, while additional increases would result in positive principal adjustments to the underlying holdings. [7]

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Know someone who could use information like this?
Please feel free to send us their contact information via phone or email. (Don't worry – we'll request their permission before adding them to our mailing list.)

CITATIONS:

1. The Wall Street Journal, November 4, 2022
2. The Wall Street Journal, November 4, 2022
3. The Wall Street Journal, November 4, 2022
4. The Wall Street Journal, November 3, 2022
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7. advisorperspectives.com/commentaries/2022/10/21/inflation-is-up-so-why-are-tips-returns-down?topic=fixed-income