

Powell's Revelation And A TIP For Defense

*?I think we would need to see a **really significant** move up in inflation that?s **persistent** before we **even consider** raising rates to address inflation concerns.? ?*
Jerome Powell 10/30/2019

The recent quote above from Federal Reserve Chairman Jerome Powell is powerful, to say the least. We cannot remember a time in the last 30 years when a Fed Chairman has so clearly articulated such a strong desire for more inflation.

In particular, let?s dissect the bolded words in the quote for further clarification.

- **?Really Significant?**- Powell is not only saying that the Fed will allow a substantial boost to inflation but does one better by adding the word ?really.?
- **?Persistent?**- Unlike the prior few Fed Chairman who claimed to be vigilant towards inflation, Powell is clearly telling us that he will not react to inflation that is not only a ?really significant? leap from current levels, but a rate that lasts for a while.
- **?Even Consider?**- The language he uses here conveys the seriousness of the Fed?s commitment. The rise in inflation must not only be ?really significant? but also ?persistent.? Powell is saying both conditions must be met before they will even discuss rate hikes. A significant rise in inflation but one they do not deem to be persistent will not suffice. Nor would a persistent move in inflation but one they do not measure as significant. Both conditions must be present together based on his language.


We are stunned by the choice of words Powell used to describe the Fed?s view on inflation. We are even more shocked that the markets and the media are ignoring it. Maybe, they are failing to focus on the three bolded sections.

In fact, what they probably think they heard was:

I think we would need to see a move up in inflation before we consider raising rates to address inflation concerns.

Such a statement is more in line with traditional Fed-speak. The other alternative is that Powell has altered his language in so many different ways over the past year that nobody seems to be paying attention to his words anymore. If so, he has lost credibility.

This article presents Treasury Inflation-Protected Securities (TIPS) as a hedge against Jerome Powell and the Fed getting what they want.



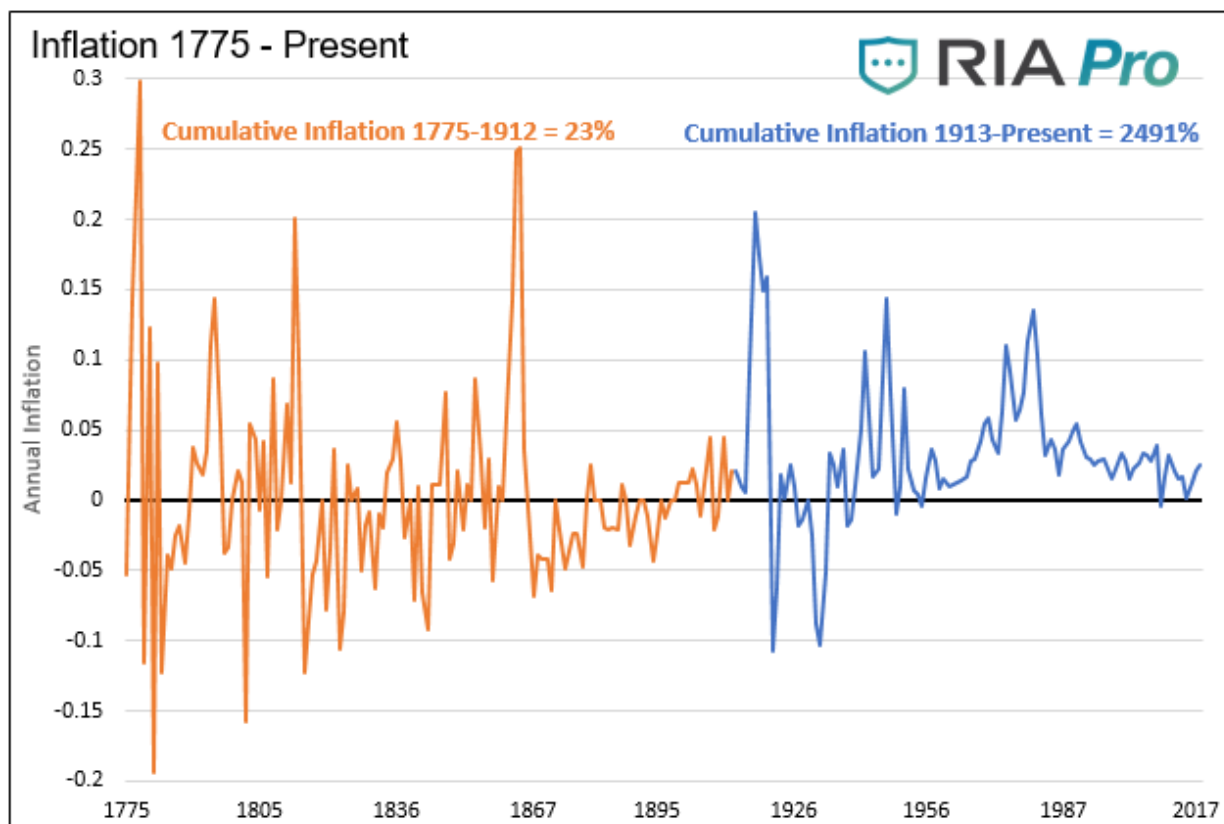
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Inflation and Stable Prices ? Apples and Oranges

Before a discussion on using TIPS as a way to protect your investments from the deleterious effects of inflation, we need to examine how the Fed gauges inflation and debunk the narrative that terms inflation and price stability as one and the same. Price data going back about 250 years, as shown below, shows the stark difference between inflation and price stability.



Data Courtesy: Lawrence H. Officer and Samuel H. Williamson, 'The Annual Consumer Price Index for the United States, 1774-Present'

The orange line plots annual price changes before the Fed was established in 1913. As shown, prices were volatile year to year, but cumulative inflation over the entire 138 year period was negligible at 23% or .15% annualized. Dare we say prices were stable?

Compare that to the era after the Fed's creation (represented by the blue line above). Annual inflation rates were less volatile but largely positive. The cumulative growth of prices has been an astonishing 2491% in the post-Fed area, which equates to 3.1% annually. There is nothing stable about such massive price inflation.

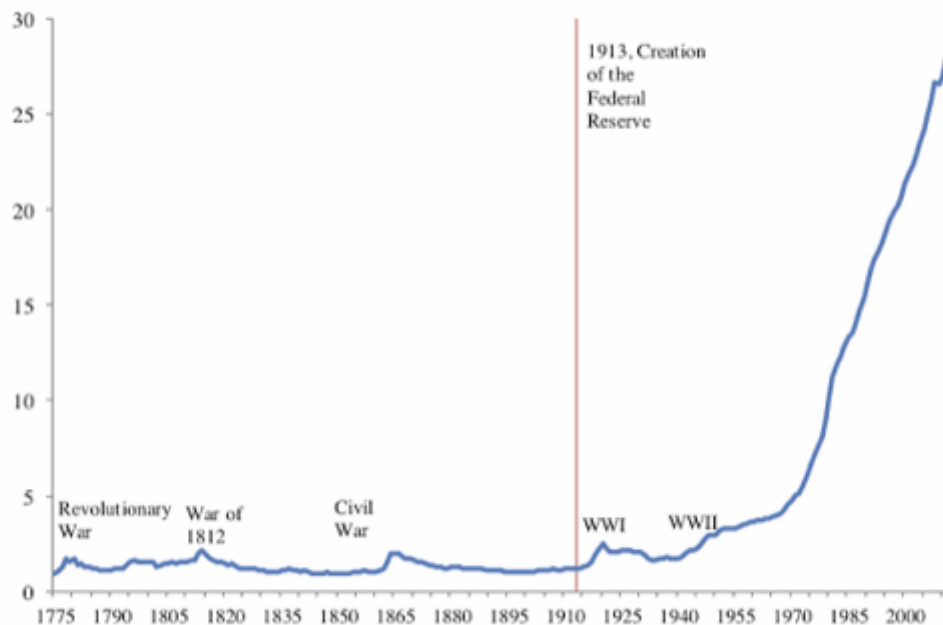
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Here is another graph to shed more light on price stability.

Figure 1. Consumer Price Index, United States, 1775-2012
(level, 1775=1)



Sources: Bureau of Labor Statistics, Historical Statistics of the United States, and Reinhart and Rogoff (2009).

Stable prices should be defined as prices that are constant. In other words, a dollar today can purchase the same basket of goods that it did yesterday. Inflation must be near zero over longer periods for this to occur.

The Fed's definition of stable denotes a consistent rate of annual inflation. Based on their actions and words, they have little regard for the destruction of a dollar's purchasing power caused by a steady inflation rate. The Fed benefits from this linguistic imprecision because it allows for economic expansion via the accumulation of debt while their Congressional mandates are achieved. **This is why the Fed wants to produce inflation. It reduces the amount of debt on an inflation-adjusted basis. The Fed wants inflation but disguises it under the banner of price stability.**

With Federal deficits now topping \$1 trillion and corporate debt and consumer debt and financial liabilities at all-time highs as a percentage of GDP, we must think about hedging our equity and fixed income portfolios in case the Fed gets more inflation than the 2% goal *they* consider stable.

Despite what the Fed leads us to believe, they have little control over the rate of inflation and they do not know how to accurately measure it. As occurred 50 years ago, they can easily lose control of prices.

We urge you to focus on the forgotten leg of wealth, purchasing power. The opportunity costs of owning TIPS are minimal and the potential hedge value of TIPS tremendous. Change can happen in a hurry, and the only way to protect yourself or profit from it is to anticipate it.

Part two of this article is for RIA Pro subscribers only. If you are not a subscriber and want to learn about the mechanics of TIPS and how they can protect you in an inflationary or deflationary environment, please [SIGN UP HERE](#) for a 30-day free trial.

TIPS Mechanics

Few investors truly understand the mechanics of TIPS, so let's review the basics.

TIPS are debt securities issued by the U.S. government. Like most U.S. Treasury securities, TIPS have a stated maturity and coupon. Unlike other securities, the principal value of TIPS adjust based on changes in the rate of inflation. The principal value can increase or decrease but will never fall below the bond's initial par value. The semi-annual coupon on TIPS are a function of the yield of a like-maturity Treasury bond less the expected inflation rate over the life of the security, known as the break-even inflation rate.

The tables below compare the cash flows of a typical fixed coupon Treasury bond, referred to as a nominal coupon bond, and a TIPS bond to help further clarify.

Fixed Coupon Bond					
	Investment	Coupon %	Principal	Annual Coupon	Maturity
Year 0	\$ 1,000.00				
Year 1		4%	\$ 1,000.00	\$ 40.00	
Year 2		4%	\$ 1,000.00	\$ 40.00	
Year 3		4%	\$ 1,000.00	\$ 40.00	
Year 4		4%	\$ 1,000.00	\$ 40.00	
Year 5		4%	\$ 1,000.00	\$ 40.00	\$ 1,000.00

The table above shows the cash flows that an investor pays and receives when purchasing a five-year bond with a fixed coupon of 4% a year. The investor initially invests \$1,000 in the bond and in return receives \$40 or 4% a year plus a return of the original investment (\$1,000) at maturity. In our example, the annual return to the bondholder is 4%. While the price and yield of the security will change during the life of the bond, an investor holding the bond to maturity will be guaranteed the cash flows, as shown.

TIPS						
	Investment	Coupon %	Inflation Rate %	Principal	Adjusted Principal	Annual Coupon Maturity
Year 0	\$ 1,000.00					
Year 1		2%	2.50%	\$ 1,025.00	\$ 25.00	\$ 20.50
Year 2		2%	3.00%	\$ 1,055.75	\$ 30.75	\$ 21.12
Year 3		2%	-1.00%	\$ 1,045.19	\$ (10.56)	\$ 20.90
Year 4		2%	1.50%	\$ 1,060.87	\$ 15.68	\$ 21.22
Year 5		2%	4.00%	\$ 1,103.31	\$ 42.43	\$ 22.07 \$ 1,103.31

The TIPS table above shows the cash flows an investor pays and receives when purchasing a five-year TIPS bond with a fixed coupon of 2% a year. Like the fixed coupon bond, the investor initially pays \$1,000 to purchase the bond. The similarities end here. Every six months the principal value

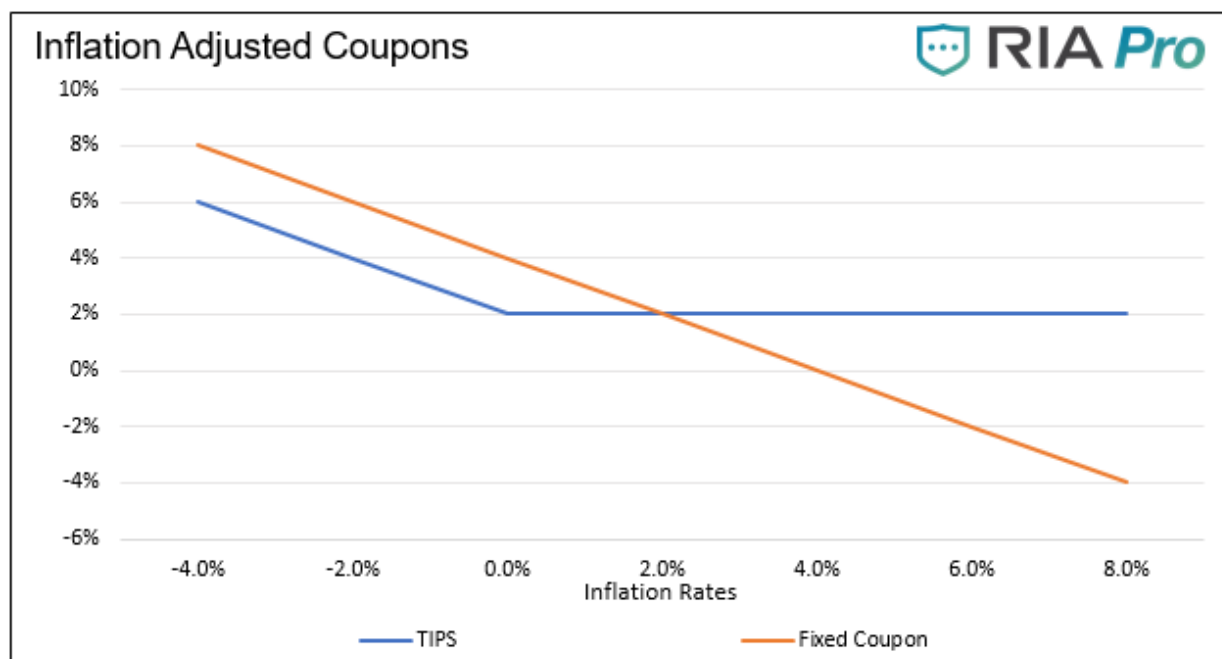
adjusts for inflation. The coupon payment for each period is then calculated based on the new principal value (and not on the original par value. The principal value can adjust downward, but it cannot fall below the original value. This is an important safety feature that guarantees a minimum return equal to the coupon times the original principal value. At maturity, the investor receives the final adjusted principal value, not the original principal value. Please note that if a TIPS is bought in the secondary market at a principal value exceeding its original value, the investor can lose the premium and returns can be negative in a deflationary environment.

In the hypothetical example above and excluding reinvestment of coupon payments, an investor in the nominal bond will receive \$1,200 in cumulative cash flows over the life of the security. The TIPS investor would receive \$1,209.12 in cumulative cash flows.

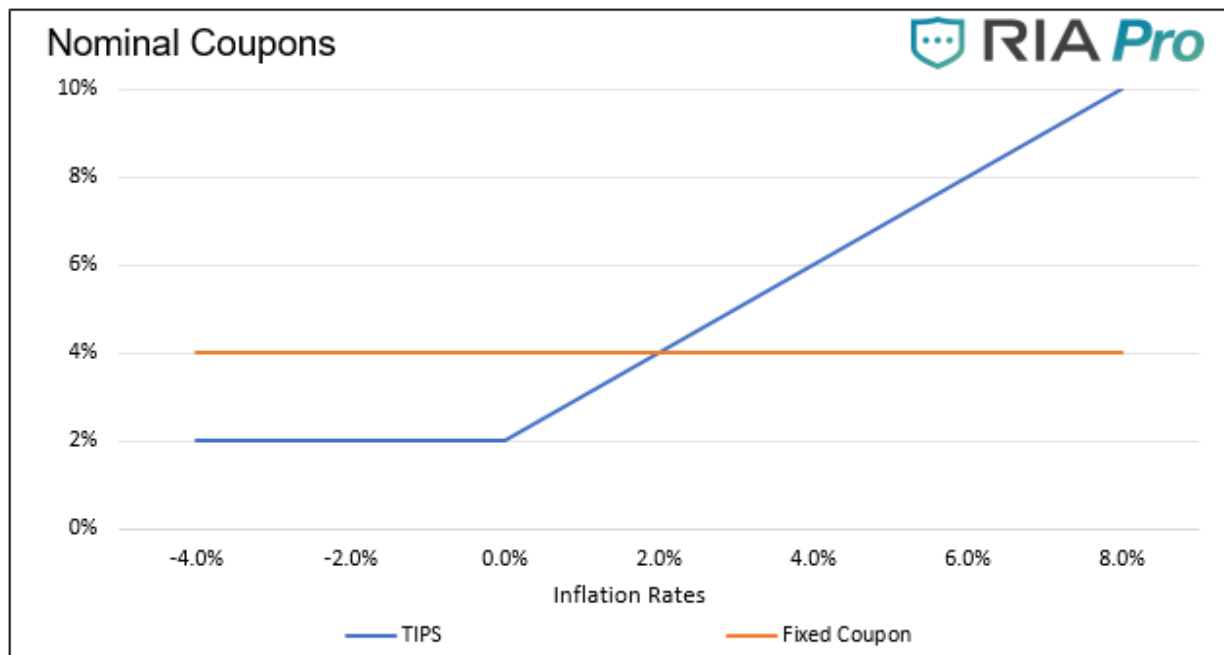
TIPS are a bet or a hedge on the breakeven inflation rate. If realized inflation over the life of a **TIPS is less than the breakeven rate the investor earns a lower return than on a nominal Treasury bond with the same coupon rate. As shown in our example, if inflation is greater than the breakeven rate, then the TIPS investor earns a higher return than a nominal Treasury bond with the same coupon.**

The following charts show the return profiles under various inflation scenarios, for the fixed coupon and TIPS examples used in the tables above.

The first graph shows the real (inflation-adjusted) coupon payments at various levels of inflation and deflation. In deflationary environments, both bonds provide positive real returns with the fixed coupon bond outperforming by the 2% breakeven rate. As inflation rises above the breakeven rate, the real return on the TIPS bond increasingly outperforms the fixed bond.



The next graph shows the nominal coupons of both bonds, assuming the investor holds them to maturity. The fixed bond earns the 4% coupon through all inflation scenarios. The TIPS bond earns a constant 2% coupon through all deflationary scenarios while the coupon rises in value as inflation increases.



At any point in a TIPS life, investors may incur mark to market losses, and if the bonds are sold before maturity, this can result in a permanent loss. Any TIPS bond held from issuance to maturity will have a real positive gain assuming the coupon is above zero, the same is not true for a fixed rate bond.



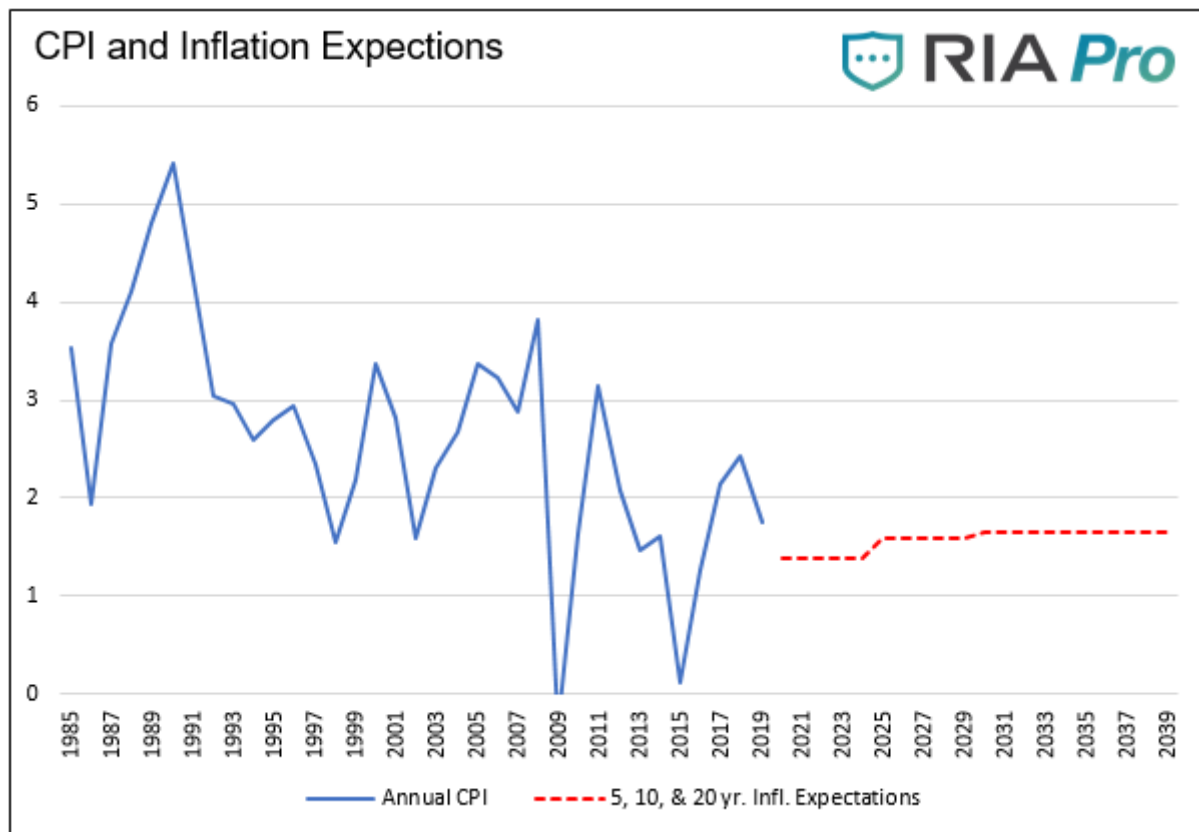
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Current environment

Various inflation surveys, as well as market-implied readings, suggest investors expect low levels of inflation to continue for at least the next ten years. The following graph provides a historical perspective on inflation trends and current long term inflation expectations as measured by 5, 10, and 20-year TIPS breakeven inflation rates.



Data Courtesy: St. Louis Federal Reserve (FRED)

The rate of inflation over the last 20 years, as measured by the consumer price index, has generally been decelerating. In other words, prices are rising but at a progressively slower pace. Since 1985, the year over year change in inflation has averaged 2.6%, and since 2015, it has averaged 1.5%.

The market determined break-even inflation rate, or the differential between TIPS yields and like maturity fixed coupon yields, for the next 5, 10, and 20 years is currently 1.39%, 1.59%, and 1.65%, respectively. Inflation expectations for the next twenty years are consistent with the actual rate of inflation for the last ten years.

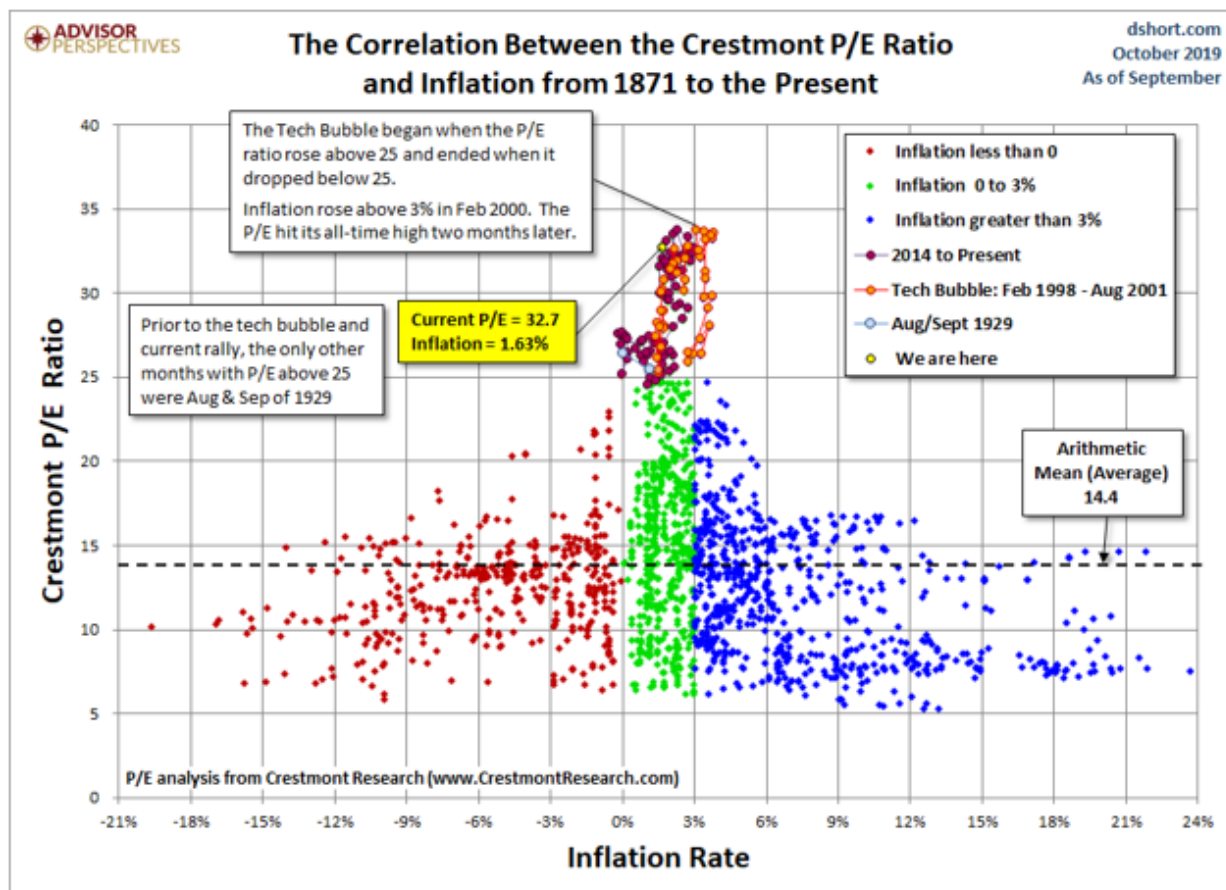
The Case For TIPS

While most forecasts are based on the past and therefore do not predict meaningful inflation, we must remain cognizant that since the Great Financial Crisis in 2008/09, the Federal Reserve (FED) and many other central banks have taken extraordinary monetary policy actions. The Fed lowered their targeted interest rates to zero while central banks in Japan and Europe have gone even further and introduced negative interest rates. Additionally, banks have sharply increased their balance sheets. These actions are being employed to incentivize additional borrowing to foster economic growth and boost inflation. More recently, as we are now seeing with a new round of QE, it appears the Fed is now using monetary policy to help facilitate trillion-dollar Federal deficits.

Investors must be careful with the market's assumption that the Fed's efforts to stimulate inflation will lead to the same inflation rates of the past decade. Further, if warranted, a central bank can literally print money and hand it out to its citizens or directly fund the government. These alternative methods of monetary policy, deemed "helicopter money" by Ben Bernanke, would most likely cause prices to rise significantly.

?Too much? inflation would be a detriment to the equity and bond markets. **If inflation rates greater than three or four percent were to occur, a large majority of investors would pay dearly. Such circumstances would depreciate investor asset values and simultaneously reduce their purchasing power. With this double-edged sword in mind, TIPS should be considered by all investors.**

The graph below, courtesy Doug Short and Advisor Perspectives, shows that equity valuations tend to be at their highest when inflation ranges between zero and two percent. Outside of that band, valuations are lower. Currently, the market is making a big bet that valuations can remain near historical highs **and** inflation will remain in its recent range.



The worst case scenario for TIPS, as shown in the graphs, is a continuation of the inflation trends of yesterday. In those circumstances, TIPS would provide a return on par with or slightly less than comparable maturity nominal Treasury bonds. Investors also need to incorporate the opportunity cost of not allocating those funds towards stocks or riskier bonds should inflation remain subdued.

For those conservative investors sitting on excess cash, TIPS can be effectively employed as a surrogate to cash but with the added benefits of coupon payments and protection against the uncertainty of inflation. In a worst case scenario, TIPS provide a return similar to those found on money market mutual funds. In the event of deflation and/or negative rates, TIPS should outperform these funds, which could easily experience negative returns.

Summary

Markets have a long history of assuming the future will be just like the past. Such assumptions and complacency work great until they don't. We do not profess to know when inflation may pick up in earnest, and we do not have a good economic explanation for what would cause that to happen.

That being said, monetary policy around the world is managed by aggressive central bankers with strong and misplaced beliefs about the benefits of inflation. At some point, there is a greater than zero likelihood central bankers will be pushed to take actions that are truly inflationary. While the markets may initially cheer, the inevitable consequences may be dire for anyone not focused on preserving their purchasing power.

We urge you to focus on the forgotten leg of wealth, purchasing power. The opportunity costs of owning TIPS are minimal and the potential hedge value of TIPS is tremendous. Change can happen in a hurry, and the only way to protect and or profit from it is to anticipate it. As has been said, you cannot predict the future, but you can prepare for it.

We leave you with an important quote from our recent article- [Warning, No Life Guards on Duty.](#)

Another "lifeguard" is Daniel Oliver of Myrmikan Capital. In a recently published article entitled [QE for the People](#), Oliver eloquently sums up the Fed's policy situation this way:

*"The new QE will take place near the end of a credit cycle, as overcapacity starts to bite and in a relatively steady interest rate environment. Corporate America is already choked with too much debt. As the economy sours, so too will the appetite for more debt. This coming QE, therefore, will go mostly toward government transfer payments to be used for consumption. This is the "QE for the people" for which leftwing economists and politicians have been clamoring. It is "Milton Friedman's famous "helicopter drop" of money." **The Fed wants inflation and now it's going to get it, good and hard.**"*