TIPS Gain Most Since '11 With Treasuries as Taper Delayed (1)
2013-09-30 04:01:47.611 GMT

(Adds today's Treasury yields in 15th paragraph.)

By Daniel Kruger and Liz Capo McCormick

Sept. 30 (Bloomberg) -- For almost a year Wan-Chong Kung avoided U.S. government debt insured against inflation as consumer prices stagnated. Now, the bond-fund manager at Nuveen Asset Management whose inflation-indexed fund has beaten 95 percent of its peers the last three years, is loading up on Treasury Inflation-Protected Securities.

Her change comes as Federal Reserve Vice Chairman Janet Yellen, who voted for every stimulus measure since 2008, became the favorite to succeed Ben S. Bernanke as the next Fed chief and the central bank maintained its $85 billion a month in bond buying. Policy makers also said their target interest rate for overnight loans between banks may rise at a slower pace than suggested by historical measures.

That last "big dovish surprise" shows the Fed is "continuing to err on the side of promoting sustained job growth potentially at the risk of higher inflation," Kung, who helps manage $125 billion at Nuveen, said in a Sept. 24 telephone interview from Minneapolis.

Kung has plenty of company. TIPS, as the inflation-indexed bonds are known, have gained 3.5 percent since Sept. 5, the best three-week rally since August 2011, after losing 8.7 percent in the first eight months, the most ever in that period, according t0 Bank of America Merrill Lynch's U.S. Inflation-Linked Treasury Index.

TIPS Favored

Now, fund companies from Nuveen to SEI Investments Co. say the Fed's continued stimulus will lift market expectations for faster increases in the consumer price index, leading to more gains for TIPS. Inflation-protected debt pays a lower coupon than non-indexed Treasuries. In exchange, investors receive an adjustment on the principal equal to the rise in the CPI.

Societe Generale AG recommends the debt even as economists at France's second-biggest lender forecast inflation will remain subdued. The bank's fixed-income strategists suggested buying TIPS after the Federal Open Market Committee Sept. 18 maintained the pace of bond buying and signaled that benchmark rates will remain low into 2016.

"The Fed was willing to lose a little bit of its credibility to be dovish," Jorge Garayo, a fixed-income strategist at Societe Generale in London, said in a telephone interview on Sept. 23. It isn't clear if the Fed's reaction "to inflation will be different or not, but market participants believe it will," he said.

Little Inflation

Treasuries that aren't indexed for inflation, which erodes the value of bonds by reducing the purchasing power of a security's fixed payments, have gained 1.9 percent since Sept. 5, Bank of America indexes show, indicating little concern that inflation will get out of control.

Even after the Fed purchased more than $3.1 trillion in government and mortgage bonds and held its benchmark lending rate at about zero since December 2008, signs of rising prices remain scarce. The Fed's preferred measure of inflation, the personal consumption expenditures deflator, rose 1.2 percent in August, down from a 1.4 percent increase the month before, the Bureau of Economic Analysis said Sept. 27. It has remained below policy makers' 2 percent target since April 2012.

The gauge fell at an annual rate of 0.1 percent in the second quarter, the Bureau of Economic Analysis said Sept. 26.

"As far as I can see, you don't have any inflationary pressure," Dan Heckman, a fixed-income strategist at the U.S. Bank Wealth Management unit of U.S. Bancorp, which manages $110 billion, said in a Sept. 24 telephone interview.

Break-Even Rate

Yields on 10-year TIPS fell 5 basis points last week, or 0.05 percentage point, to 0.45 percent, according to Bloomberg Bond Trader prices. Non-indexed Treasury yields of similar maturity declined 11 basis points to 2.63 percent.

The 2.18 percentage-point gap in yields, which has expanded from this month's low of 2.07 percentage points on Sept. 9, is known as the break-even rate and reflects investors' expectations for inflation over the life of the securities.

The price of the benchmark 10-year TIPS note, a 0.375 percent security due in July 2023, rose 14/32, or $4.38 per $1,000 face amount, to 99 9/32. The 2.5 percent Treasury maturing in August 2013 increased 30/32, or $9.38 per $1,000 face amount, to 98 29/32, Bloomberg Bond Trader prices show.

Yields fell to 0.41 percent on the TIPS and to 2.59 percent on the non-indexed notes today as of 12:37 p.m. in Tokyo.

Both types of bonds have benefited this month from signs of a slowing U.S. economy that prompted the Fed to maintain its program of buying of $45 billion a month of Treasuries and $40 billion of mortgage bonds.

Economic growth is also threatened with Congress locked in a budget stalemate that raises the risk of the first government shutdown in 17 years. The Senate is schedule to reconvene later today, when it is forecast to reject a House plan seeking to delay and limit President Barack Obama's Affordable Care Act.

Declining Confidence

Retail sales rose 0.2 percent in August, the least in four months and compared with the 0.5 percent advance predicted in a Bloomberg News Survey of economists. The Conference Board's September consumer confidence index declined to 79.7, the weakest since May, from 81.8 a month earlier, the New York-based private research group said Sept. 24.

After creating an average of 199,000 jobs a month this year through May, the pace slowed to about 148,000 from June through August, Labor Department data show. The unemployment rate of 7.3 percent exceeds the 6 percent average the past two decades.

The Fed said in its Set. 18 statement that the "exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6.5 percent" and inflation isn't more than 2.5 percent. The Labor Department will release September jobs data Oct. 4.

"The dovishness that the Fed is portraying, that's setting up the groundwork for an inflationary environment at some point," Sean Simko, who oversees $8 billion at SEI in Oaks, Pennsylvania, said in a telephone interview on Sept. 23.

'Potentially Complacent'

The five-year, five-year break-even rate, a gauge of inflation expectations used by the Fed help guide policy, rose to 2.63 percent on Sept. 24 from 2.5 percent on Sept. 13 and from an 18 month low of 2.33 percent in June. That compares with an average of 2.74 percent for the past decade.

"This continues to be a Fed that wants to be pro-growth and is potentially complacent about inflation," said Kung of Nuveen. "You can price in a higher inflation risk premium. The Fed actions in terms of monetary policy could potentially translate into a higher value for inflation insurance."

The stimulus has boosted stock markets. The Standard & Poor's 500 Stock Index has risen 19 percent this year, one of the best performances in developed markets. Japan, which has also been using asset purchases to boost its economy, has seen the nation's Topix soar 42 percent.

'Spillover Effects'

Part of the Fed's goal was to "inflate risky assets and potentially to have some spillover effects in the real economy," Alan Wilde, head of fixed-income and currencies in London at Baring Asset Management, which oversees $57.4 billion, said in a telephone interview on Sept. 26.

With unemployment above its two decade average, the central bank should be "keeping a historically unusual amount of monetary stimulus in place -- and possibly providing more stimulus," even if the medium-term inflation outlook temporarily rises and asset prices reach "unusually high levels," Fed Bank of Minneapolis President Narayana Kocherlakota said Sept. 26 in remarks prepared for a speech in Houghton, Michigan. Kocherlakota votes on policy next year.

The Fed estimates that interest rates will stay not far from record lows for the next three years.

The federal funds rate target will be 2 percent at the end of 2016, according to the median of estimates by Fed board members and regional presidents detailed on Sept. 18 in the central bank's quarterly Summary of Economic Projections.

GDP Forecast

That forecast compares with the median estimate of 4 percent for where the rate should be at a time of full employment and stable prices, according to the report, which also includes individual forecasts for gross domestic product, inflation, unemployment and interest rates.

Officials estimated the economy would expand 2.5 percent to 3.3 percent in 2016, driving unemployment down to 5.4 percent to 5.9 percent with inflation at 1.7 percent to 2 percent.

Yellen, 67, is the leading candidate to replace Bernanke when his term expires on Jan. 31, according to people familiar with White House discussions. She has been picking up support from Democratic senators and party leaders including former President Bill Clinton, after former Treasury Secretary Lawrence Summers said Sept. 15 that he wouldn't seek the post.

"The Fed is going to err on the side of having inflation as opposed to risking us falling into a deflationary environment," James Barnes, a money manager in Wyomissing, Pennsylvania, for National Penn Investors Trust, which oversees $1 billion in fixed-income assets and has 8 percent to 10 percent of its holdings in TIPS, said in a Sept. 24 telephone interview.

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