

TIPS Drive Away Biggest Bond Bulls Seeing Inflation (Update3)  
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(Updates Barclays TIPS sales forecast in 24th paragraph.)

By Oliver Biggadike and Daniel Kruger

Feb. 16 (Bloomberg) -- Treasury Inflation-Protected Securities are posting the biggest losses since Lehman Brothers Holdings Inc. collapsed in 2008 as investors say they're too expensive when consumer prices are barely rising.

Blackrock Inc., Pacific Investment Management Co. and FAF Advisors Inc., which oversee about \$4.5 trillion, are selling TIPS, contributing to a 1.1 percent loss this month after they gained 1.5 percent in January and 10 percent in 2009. The bonds are on pace for their worst month since falling 8.47 percent in October 2008, the month after Lehman went bankrupt.

Investors who were piling into TIPS as recently as four months ago on concern that a recovering economy and \$8.2 trillion of U.S. stimulus spending would ignite inflation are reversing course. They see little need to protect against price increases as the dollar rallies, banks restrict credit and expanding government deficits around the world threaten to slow global growth.

"I've been a pretty aggressive seller in the last month or so," said Mihir Worah, who manages Newport Beach, California-based Pimco's \$15.6 billion Real Return Fund, the largest TIPS fund. "Over the next year I see inflation south of 1 percent."

At least for now, a slow-growing economy, which Pimco calls the "new normal," and declining inflation concerns in the bond market may reduce pressure on Fed Chairman Ben S. Bernanke and President Barack Obama to rein in stimulus measures. That may change when investors start to pressure the government into dealing with budget deficits that the administration estimates will reach \$4.3 trillion during the next five years.

#### Fed's Take

"Household spending is expanding at a moderate rate but remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit," the central bank's Federal Open Market Committee said after its last policy meeting on Jan. 27. "Inflation is likely to be subdued for some time."

Bonds linked to inflation are losing around the world. A Bank of America Merrill Lynch index measuring returns on similar

securities issued from the U.K. to Australia is down 1 percent this month, the worst performance since last February, when the market fell 2.5 percent.

The U.S. government is likely to release data this week showing inflation remains in check. Excluding food and energy, consumer prices in the U.S. rose 0.1 percent in December, the Labor Department said Jan. 15. That's less than the 0.2 percent average of the last decade. The agency may say Feb. 19 that prices again rose 0.1 percent in January, according to the median estimate of 61 economists surveyed by Bloomberg.

### Breakeven Rates

TIPS pay interest on a principal amount that rises with consumer prices. Their face value is protected against deflation, because the principal can't fall below par. The benchmark 1.375 percent 10-year Treasury-Inflation Protected Security due January 2020 yields 1.46 percent as of 8:48 a.m. in New York.

That's 2.25 percentage points less than Treasuries of similar maturity that don't provide protection from rising prices. The difference, known as the breakeven rate, reflects the pace of inflation investors expect over the life of the securities. The spread has fallen from the peak this year of 2.49 percentage points on Jan. 11.

Worah was buying TIPS as recently as October as the dollar fell and the Fed and lawmakers showed no urgency to withdraw stimulus money. Since November, the U.S. currency as measured by the Bloomberg Correlation-Weighted Index has risen about 6.2 percent from a 15-month low. A strengthening dollar reduces the cost of imported goods, damping inflation. He's buying German, Australian and Canadian inflation-linked debt instead.

### Relationship Upended

The financial crisis upended the traditional link between TIPS and consumer prices. In 2008, with inflation at 3.85 percent, investors switched to Treasuries and abandoned TIPS as the bankruptcy of Lehman boosted demand for securities that were easiest to trade. Inflation-protected securities posted the first annual loss since their creation in 1997, falling 1.13 percent, Bank of America Merrill Lynch bond indexes show.

Higher consumer prices are inevitable, as the rising U.S. budget deficit weakens the dollar, according to Mark MacQueen, a partner and portfolio manager at Austin, Texas-based Sage Advisory Services, which oversees \$8.5 billion.

“The dollar is the pressure valve” and the U.S. will allow the currency to devalue to reduce its debt burden, he said. “If I owe a trillion dollars, why not pay it back with 50 cents?”

### ‘Leverage Unwind’

Slower-than-average growth and reduced consumption will keep prices under control, said John Hollyer, who helps manage \$29 billion of TIPS as a principal at Vanguard Group Inc. in Valley Forge, Pennsylvania, which holds a smaller percentage of the securities than is contained in benchmark indexes.

“This period of ease is likely to be very long relative to other historic periods,” said Hollyer, who recommended TIPS in October. “This is a multigenerational leverage unwind, and will take a substantial time to work through.”

Consumer borrowing fell in December for an 11th straight month, the longest on record, according to a Fed report released on Feb. 5. The Labor Department said the same day the economy lost almost a million more jobs in the 12 months ended in March 2009 than it had previously estimated.

“In December people were getting over-optimistic about the economy, and January’s been wiping the slate clean,” said Brian Weinstein, a managing director who oversees \$9 billion in TIPS at New York-based BlackRock.

### China’s Engine

China, an engine of world growth, is trying to keep its economy from overheating by limiting credit expansion to prevent asset bubbles and restrain inflation. The nation’s central bank said Feb. 12 it will raise the amount of money banks need to keep in reserve for the second time in a month.

“Growth in the U.S., growth globally is going to be quite modest in the next year or two,” said Wan-Chong Kung, who helps oversee \$89 billion as a money manager at FAF in Minneapolis, the asset-management arm of U.S. Bancorp. “So with that, inflation should be fairly well contained and well behaved.”

Yields on two-year Treasuries, which dropped to an eight-week low of 0.72 percent on Feb. 5, show diminishing concerns about inflation. Investors sought the safety of U.S. debt as growing deficits threatened Europe’s economic stability. Lower yields also suggest investors expect the Fed to keep interest rates near record low levels.

### Rising Dollar

The dollar approached a nine-month high versus the euro on Feb. 12 after the European Union offered few details of an agreement to help Greece weather its debt crisis.

"I see a return to disinflation or deflation," said Michael Cheah, who used to work at Singapore's central bank and now manages \$2 billion in bonds at SunAmerica Asset Management in Jersey City, New Jersey. "I don't need any protection against inflation."

The shift in demand comes as the Treasury considers more frequent auctions of TIPS to make them easier to trade. The U.S. will sell 30-year TIPS on Feb. 22 for the first time since 2001. Sales will likely total a record \$80 billion to \$85 billion this year as the Treasury raises \$2.5 trillion in the bond market, according to London-based Barclays Plc, the biggest dealer of the securities among the 18 that trade directly with the Fed.

"We expect TIPS to have negative returns this year," said Barclays strategist Michael Pond. "The market will need to absorb a considerably greater amount of supply this year than they did last year simply because the Fed won't be around to take down a significant portion of fixed-income supply."

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