Investors expect 2018 to be a year of faster growth for the U.S. economy, propelled by tax cuts, prospects for increased infrastructure spending, and further deregulation. In such an environment, one risk that investors may want to be mindful of is the potential for rising inflation.

To be sure, despite periodic signals that prices of goods and services may accelerate, especially in the wake of the 2016 U.S. presidential election, inflation has remained persistently low, even as the U.S. economy has strengthened. Still, as a recent Wall Street Journal report noted, some market indicators suggest inflation expectations have been climbing in recent weeks, reflecting the factors mentioned above, as well as rising energy prices. As former U.S. Federal Reserve (Fed) chair Ben Bernanke noted in a July 2007 speech, inflation expectations are an important indicator, for they “greatly influence actual inflation and thus the [Fed’s] ability to achieve price stability.”

In response to these rising expectations, demand for funds that protect against inflation has increased. For the full year 2017, mutual funds in the Morningstar inflation-protected category took in $12.5 billion in flows. When combining mutual funds and exchange-traded funds (ETFs), that number increases to $19.5 billion.

In particular, higher U.S. inflation expectations have spurred demand for Treasury inflation-protected securities (TIPS), a type of U.S. Treasury bond widely used by inflation-protection funds. (See box, “TIPS: A Closer Look.”) But while investors are attracted to the inflation-adjustment component of TIPS, they might not be interested in having exposure to another aspect of these securities: their relatively high duration. Essentially, the benchmark 10-year TIPS is a low-yielding U.S. Treasury security, which now has an effective duration of approximately nine years. The typical TIPS mutual fund has a duration of 5.4 years, according to Morningstar data, while the typical TIPS ETF has a duration of 7.8 years.

Since they are long-duration, government-related securities, TIPS have had high correlation with U.S. Treasuries and other high-quality fixed-income securities (as represented by the Bloomberg Barclays U.S. Aggregate Bond Index). As a result, during periods of rising interest rates, investors in TIPS have been disappointed with their experience, realizing the negative effects of greater interest-rate sensitivity just when they were expecting protection. For example, in 2013, a year marked by a pronounced increase in rates reflecting the U.S. bond market’s so-called “taper tantrum,” TIPS posted negative returns. As a result, the Morningstar fund category average return for the year was -7.9%, while the benchmark TIPS ETF’s return was -8.5%. For the year, the Morningstar fund category experienced more than $27 billion in outflows.
TIPS: A CLOSER LOOK

TIPS [Treasury inflation-protected securities] are Treasury securities indexed to inflation in order to protect investors from the negative effects of inflation. The principal of a TIP is adjusted according to the Consumer Price Index for All Urban Consumers (CPI-U), more commonly referred to as the Consumer Price Index (CPI). With a rise in the index, or inflation, the principal increases. With a fall in the index, or deflation, the principal decreases. Though the rate is fixed and paid semiannually, interest payments vary because the rate is applied to the adjusted principal. Specifically, the amount of each interest payment is determined by multiplying the adjusted principal by one-half the interest rate. Upon maturity, TIPS pay the original or adjusted principal amount, whichever is greater.

Because TIPS are adjusted for inflation, a change in real interest rates, which adjusts for inflation (but not nominal interest rates), will affect the value of TIPS. When real interest rates rise, the value of TIPS will decline, and when real interest rates fall, the value of TIPS will rise.

There are alternatives for fixed-income investors who want to counter the effects of an increase in inflation on their investment returns without exposing themselves to heightened interest-rate risk. One strategy they might consider employs a portfolio of professionally managed swaps tied to the U.S. Consumer Price Index (CPI). By capturing movements in inflation expectations and changes in headline CPI, the value of CPI swaps is more directly targeted toward inflation, without the interest-rate exposure of a traditional TIPS strategy. (See box, “CPI Swaps: A Closer Look.”) Unlike TIPS, CPI swaps historically have a negative correlation with Treasuries (see Chart 2), which may lead to more efficient diversification for investors’ fixed-income holdings.

These qualities could make CPI swaps an important part of an alternative inflation-protection strategy. By combining a portfolio of short-term, credit-sensitive bonds with an overlay of CPI swaps, asset managers have the potential to create a portfolio with a higher yield and lower duration than a traditional TIPS strategy. This strategy may provide the inflation protection that investors want without the potential duration risk of TIPS.

For example, as inflation and inflation expectations increase, the value of the CPI swap will increase and add to the returns of the underlying bond portfolio. Conversely, if inflation expectations decrease, the value of the swap will detract from the underlying bond portfolio. If actual inflation exactly matches what had been expected at the initiation of the swap agreement, the CPI swap will have no impact on the returns of the underlying bond portfolio. Note, however, that in certain environments when inflation expectations are falling sharply, CPI swaps may generate negative returns. However, such periods of falling inflation expectations and interest rates are generally very positive environments for high-quality bond holdings.

What about other traditional inflation-protection strategies, such as commodities and real estate? These approaches come with significant drawbacks that may undercut their hedging capability. For example, returns for these asset classes can be driven by idiosyncratic factors removed from the actual trajectory of inflation. CPI swaps represent more of a “pure play” on inflation—without the duration risk of TIPS.

Investors have been burned by inflation before. While there is no assurance that recent data will accurately signal a resurgence in prices, the risk remains that inflation could erode fixed-income returns. We believe hedging that risk in an effective manner is critical. By pairing a portfolio of CPI swaps with a short-term bond portfolio, investors may get the inflation protection they desire, with the potential for higher income and lower duration risk than a typical TIPS strategy.

CHART 2. STRATEGIES EMPLOYING CPI SWAPS COULD ADD DIVERSIFICATION TO A FIXED-INCOME PORTFOLIO

FIVE-YEAR CORRELATION COEFFICIENTS WITH INDICATED BENCHMARKS, AS OF DECEMBER 31, 2017

| Benchmark                | CPI Swaps | TIPS  
|--------------------------|-----------|------
| Bloomberg Barclays Aggregate | 0.86      | 0.77 |
| U.S. Government Bonds    | -0.21     | -0.36 |

Source: Morningstar and Bloomberg.


Past performance is not a reliable indicator or guarantee of future results. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

CPI SWAPS: A CLOSER LOOK

Interest-rate swaps consist of a contract between two parties that stipulates that one party will make fixed payments, while the other will make variable payments.

CPI swaps are a type of interest-rate swap in which the fixed payment is based on the current, expected rate of inflation, while the variable payment is based on the actual rate of inflation. The actual rate of inflation is measured by the cumulative change in the headline Consumer Price Index (CPI), which includes food and energy.

CPI swaps come in a few varieties, the most common of which is a zero-coupon swap. These are called “zero-coupon” because the only payment occurs when the contract matures. Thus, there is no cash commitment when a party enters a zero-coupon swap agreement or during the life of the contract.

If the actual rate of inflation exactly matches the expected rate of inflation at the beginning of the swap agreement, the swap expires with no value. The value of the swap will increase or decrease with changes in the actual rate of inflation. Although a zero-coupon swap has only one form of cash flow at maturity, the swap is marked to market on a daily basis, driven by changes in inflation and inflation expectations.
IMPORTANT INFORMATION CONTINUED

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise, and as interest rates rise, the prices of debt securities tend to fall. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan’s value. Longer-term debt securities are usually more sensitive to interest-rate changes. The longer the maturity date of a security, the greater the effect a change in interest rates is likely to have on its price.

Market forecasts and projections are based on current market conditions and are subject to change without notice. No investing strategy can overcome all market volatility or guarantee future results. This Market View may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements.

TIPS (Treasury Inflation-Protected Securities) are U.S. Treasury securities indexed to inflation in order to protect investors from the negative effects of inflation. The principal of a TIP is adjusted according to the CPI-U. A rise in the index, or inflation, the principal increases. With a fall in the index, or deflation, the principal decreases. Though the rate is fixed and paid semi-annually, interest payments vary because the rate is applied to the adjusted principal. Specifically, the amount of each interest payment is determined by multiplying the adjusted principal by one-half the interest rate. Upon maturity, TIPS pay the original or adjusted principal amount, whichever is greater. Because TIPS are adjusted for inflation, a change in real interest rates (but not nominal interest rates) will affect the value of TIPS. When real interest rates rise, the value of TIPS will decline, and when real interest rates fall, the value of TIPS will rise.

The Consumer Price Index (CPI) measures the price changes for each item in a predetermined basket of goods and services, and the inputs are weighted according to their importance to consumers.

Correlation is a statistical measure that describes the strength of the relationship between two variables. It can vary from 1.0 to -1.0.

Duration is a measure of the sensitivity of the price of a fixed-income asset to a change in interest rates and is expressed in years.

Exchange Traded Fund (ETF) is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold.

A five-year zero coupon inflation swap enables investors to increase or decrease their exposure to the risk of inflation. An income stream that is tied to the rate of inflation is exchanged for one with a fixed interest rate.

The Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original principal.

The Bloomberg Barclays U.S. Treasury Index is the U.S. Treasury component of the U.S. Government Index. The index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

The Bloomberg Barclays U.S. TIPS Index is an unmanaged index comprised of U.S. Treasury Inflation Protected Securities with at least $1 billion in outstanding face value.

The Bloomberg Inflation Swap USD 5-Year Zero Coupon Index is a tradable index designed to replicate the performance of investing in five-year inflation swaps. The index maintains a constant maturity from month to month. A zero-coupon inflation swap is an exchange of inflation-linked cash flow and a fixed cash flow at maturity.

Indexes are unmanaged, do not reflect the deduction or expenses, and are not available for direct investment.

The Morningstar Inflation-Protected Bond Category encompasses bond portfolios that invest primarily in debt securities that adjust their principal values in line with the rate of inflation. These bonds can be issued by any organization, but the U.S. Treasury is currently the largest issuer for these types of securities.

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