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On the Performance Drivers of U.S. Treasury Inflation-Protected Securities

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Abstract: With the alarming federal deficit and persistent execution of expansionary monetary policy, inflation risk has become a serious concern for U.S. financial market participants. Many investors are confronted with a choice between Nominal Treasuries and Treasury Inflation-Protected Securities (TIPs) in making asset allocation decisions. Using monthly data on the Barclays Capital U.S. TIPs Index and Nominal Treasury Index from March 1997 to November 2008, this paper examines the comparative performances of TIPs and Nominal Treasuries as two asset classes, and uses a structural vector autoregressive (VAR) model to examine the key drivers underlying the return performance on each asset class. Empirical results show that the returns on TIPs and Treasuries are both negatively driven by the changes in the level and term spread of interest rates, but their responses to the change in the quality spread (as measured by the BAA and AAA corporate bond yield spread) and the inflation rate are completely different. A higher quality spread tends to drive up the Treasury return but drive down the TIPs return. A higher inflation rate tends to drive down the return on Nominal Treasuries but has little impact on the TIPs return. Treasuries tend to outperform TIPs during periods dominated by increasing concern for credit and liquidity risks, but TIPs tend to outperform Treasuries during highly inflationary environments.

JEL Classification: D53, E31, G19
Keywords: Inflation Risk, Treasury Inflation-Protected Securities (TIPS).

1. Introduction

With the alarming federal deficit and persistent execution of expansionary monetary policy since the outbreak of the global financial crisis, intermediate-term