TIPS for Inflation

A look at these securities, in light of the Federal Reserve's new outlook.

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This summer, the Federal Reserve made a key policy shift. It announced that it would focus on promoting job creation and tolerate a little more inflation along the way for the near future.

Fed Chairman Jerome Powell stated on August 27 that the central bank plans to now "seek to achieve inflation that averages 2 percent over time," rather than proactively adjust short-term interest rates when inflation approaches that established target. So in the near term, 2% inflation may or may not compel the Fed to hike.[1]

Powell called this a "robust updating" of Fed strategy. Historically speaking, it is. As his predecessor, Janet Yellen, told The New York Times, "most of the Fed's history has revolved around keeping inflation under control. This really does reflect a decisive recognition that we're in a very different environment."[1]

What could this change mean for investors? It may lead some to take a look at Treasury Inflation-Protected Securities (TIPS).

In the past, the Fed has raised short-term interest rates in times of declining unemployment, as a precaution against the possibility of the economy "overheating," which may cause inflation. If the Fed takes the same precaution in this decade, households may seek investments with the potential to react to higher interest rates, and TIPS may be worth consideration.[1]

How do TIPS react to inflation? The principal amounts of TIPS adjust in response to variations in the Consumer Price Index (CPI), which measures inflation changes. When the CPI increases, so do the principal of these securities. If the CPI falls, their principal reduces.[2]

TIPS pay a fixed rate of interest, paid every six months. The fixed interest rate applies to the adjusted principal so that interest payments can vary from one 6-month period to the next.[2]

The relationship between TIPS and the CPI can also affect what the bondholder earns when the securities mature. At that point, the bondholder receives either the adjusted principal or the original principal, whichever is greater.[2]

Just how are TIPS taxed? Interest income from TIPS is currently exempt from state and local taxes but subject to federal income tax. Adjustments in principal are taxed as interest in the year the adjustment occurs, even though the bondholder does not receive the principal adjustment until maturity. Individuals should consider their ability to pay the current taxes before investing.[3]

TIPS can be confusing, so you may want to consult with a financial professional who can guide you on how inflation-protected securities work. Also, remember, this article is for illustrative purposes only. Please contact a tax, legal, or accounting professional if you are concerned about how TIPS may influence your overall tax strategy.

We have seen low inflation recently, but inflation has crept higher during certain times in our history. The Consumer Price Index rose an average of 1.77% annually during the 10-year period ended December 31, 2019. During 1990-1999, however, it averaged 3.01% annually. Many remember the Seventies and Eighties when inflation was much higher than that.[4]

If you are concerned about inflation picking up and feel that short-term interest rates may increase, TIPS may be worth considering.

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Citations

1. New York Times, August 27, 2020
2. The Balance, February 1, 2020
3. U.S. Department of the Treasury, August 13, 2019
4. Statista, September 11, 2020