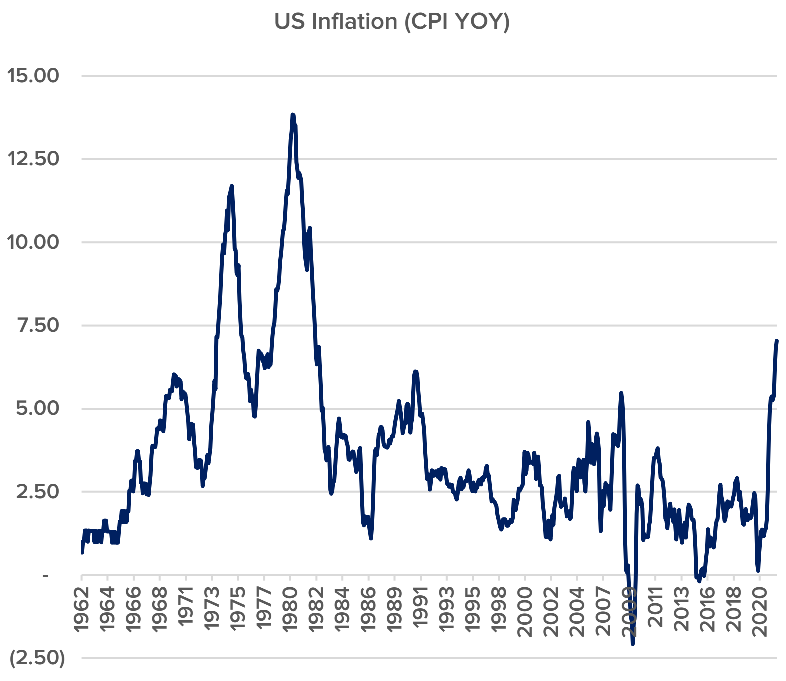
Inflation has been in the news a lot lately. No doubt you've likely experienced it firsthand as well. The latest inflation readings are over 7%, the highest since the early 1980s.



Source: Bloomberg

Inflation can damage investment portfolios in two ways:

1.) Inflation causes cash and fixed return streams to lose purchasing power

2.) Unexpected inflation causes the correlation between bonds and equities, traditionally assumed to be negative, to be positive thereby reducing fixed income's ability to act as a hedge to equities, and vice versa.

Unfortunately, there is no one silver bullet for protecting an investment portfolio against rising inflation. Those who read our newsletters or have seen our Macro Strategist Mimi Duff on CNBC and/or Bloomberg TV recently know that we at GenTrust have been sounding the alarm that inflation is far more likely to be sustained than the market has been pricing in. We were doubters of the "Inflation is transitory" narrative from the start for a host of reasons. We won't restate them here. For those interested, you can read about our reasoning in our 2022 outlook here:

https://www.gentrustwm.com/news#newsletter_download

Or listen to Mimi Duff provide our views here:

https://www.linkedin.com/feed/update/urn:li:activity:6863965991001554944/

We continue to believe that the potential for high sustained inflation is underpriced in the market. Currently the market is forecasting approximately 3.5% inflation for 2022, 3% for 2023 and 2.5% or below for 2024 and beyond despite current levels being above 7%. While we agree inflation is likely to come off its high levels in the coming months to revert back to the trend of the last few decades so quickly seems overly optimistic to us.

For those who believe the potential for future inflation is underpriced, a natural reaction would be buy Treasury Inflation Protected Securities or "TIPS". We too are big believers in TIPS and own them across many of our portfolios. That said, they are not a panacea and investors should be wary about overly relying on TIPS as a means of protecting portfolios against inflation. To understand this, you need to understand how TIPS work.

TIPS are bonds where the principal and interest payments are adjusted by the Consumer Price Index ("CPI," a standard gauge of inflation). If inflation increases, so does the principal and interest payments. At maturity, the TIP holder receives back the adjusted principal (if inflation was positive over the life of the bond) or the original principal (if inflation was negative over the life of the bond) so that the bond holder will never receive less than the originally invested principal.

Standard or "Nominal" Treasuries pay a fixed coupon regardless of inflation. Pretend the Treasury issued a $1,000 one-year nominal bond with a 2% coupon. At the end of a year the owner would receive $20 in interest and $1,000 in principal back. Obviously if inflation is high during the year, it is bad for the bond owner as the fixed $20 payments and the $1,000 of face value returned at the end of the period will have reduced purchasing power. Simply put, whatever you wanted to purchase with the money you receive from the bond has likely gone up in price, perhaps even faster than the bond's interest rate. You'd likely have been better off foregoing the investment and purchasing the good at the start of the year instead.

Now consider a $1,000 one-year TIPS bond with a 1% coupon. If inflation were high, say CPI of 5% in that year, the principal would be adjusted up to $1,050 and the 1% coupon would be paid on the larger $1,050 notional. The investor would receive $10.50 instead of $10 if there were no inflation, and the investor would also receive back $1,050 in principal as it too would be adjusted higher by the CPI-rate. In this way, the inflation-protected bond has offered the investor protection against the high rate of inflation during the year.

By comparing a Nominal Treasury Bond and a Treasury Inflation-Protected Security, one can calculate a "breakeven" inflation rate at any point in time. If inflation over the course of the period the bond is owned is greater than this breakeven number, an investor would have been better off owning the TIPS vs nominal bond. If inflation is lower than the breakeven rate, the nominal bond would have been the better choice. When we discussed above the market expectations for inflation of 3.5% in 2022, 3% in 2023 and 2.5% in 2024+, we calculated this information from looking at the TIPS market and comparing it to the Nominal Treasury Bond market.

Of course, a key question for investors is *"will you always make money owning TIPS if inflation is high?"* Unfortunately, the answer is *"not always."* Whether you make money also depends on the bond's "real yield." The real yield is calculated by subtracting inflation from the yield on a nominal bond and it varies in part based on the supply and demand for money. In a period of strong demand driven inflation and/or a period in which the Fed is raising interest rates, there is a reasonably high likelihood that the real yield goes up. This would be a natural outcome if the demand to borrow money is high, but the Fed is reducing the money supply. In this circumstance you would likely be better off owning TIPS than Nominal Treasuries, but you may also lose money in both investments as bond prices, by definition, go down when yields rise.

While for those who have spent their careers in the bond market, like several members of our investment team, this dynamic is as ingrained as breathing, in our experience, it catches many market participants by surprise. After all, we've been reading recommendations for investors to buy TIPS to protect against runaway inflation and hearing of retail investor demand for TIPS. Yet even as money has flowed into the TIPS market, as real rates have moved higher recently (becoming less negative), TIPS prices have fallen

10-Year Real Rates (In % Left Axis)

Source: Bloomberg

PRICE of TIP - AN INDEX ETF for the TIPS Market

Source: Bloomberg

This does not mean everyone should sell their TIPS. As mentioned earlier, we still own them and as the example shows, in the scenario where real rates stay anchored or move lower but inflation moves higher, they provide substantial portfolio protection. That said, we use a diverse basket of real assets which we'll be outlining in detail in an upcoming paper to insulate client portfolios against rising inflation. As we likely enter an economic environment unlike any most investors have experienced in their lifetimes, uncertainty is high, diversification has value, and there is no silver bullet.

There is no assurance that any trends depicted or described will continue. Please refer to [important disclosures](#) at the end

Important Disclosures

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