Investors Snap Up TIPS, Expecting Inflation to Rebound

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An auction of five-year Treasury inflation-protected securities sold at a negative yield for the first time on Monday, a major sign that investors expect the Federal Reserve will be successful at reviving the economy-and re-igniting inflation.

The $10 billion auction received such strong demand that the resulting yield was negative 0.55 percent. That means investors paid more for the securities, which carried a coupon-or interest rate-of 0.5 percent, than they are currently worth.

While five-year TIPS, as the inflation-adjusted securities are known, have been trading at a negative yield since late September, this was the first time a negative yield was realized at auction, said Ken Volpert, head of taxable fixed income at Vanguard.

But the negative yield on the securities doesn't mean investors will ultimately receive a negative return, Volpert said. That's because the principal of TIPS rises along with the Consumer Price Index, which increases the total return of the security.

So if the Fed is successful in stimulating the economy with the latest round of asset buying, inflation will start rising again, making these TIPS more valuable.

Currently, the break-even inflation rate for TIPS is 1.6 percent, meaning if inflation is 1.6 percent or higher, investors are better off owning an inflation-protected security than a standard Treasury note.

The Fed's target for inflation is two percent. If that's realized through the Fed's latest asset buying, investors in Monday's auction would receive a two percent increase in principal for each of the next five years, or a total return of 10 percent (not including compounding), Volpert said.

"Investors now believe inflation will run higher than Treasury yield," said Jack Ablin, chief investment officer at Harris Private Bank.