

US Rate Strategy Notes

Alert: Buy 5y TIPS on breakeven basis

We like buying 2y to 5y TIPS at current levels. Valuations are attractive with breakevens ranging from 1.60 for the Jan 15s, 2.04 for the July 16s and 2.10 for the April 17s. We think that the breakevens in this sector should move higher based on the FOMC statement today for the following reasons:

1. The near term threshold for the Fed to exit monetary easing from an inflation standpoint is a projection rate of 2.5%. Combined with the corresponding threshold for the unemployment rate at 6.5%, it is likely that inflation expectations would go higher as the Fed persists with its asset purchase program.
2. With breakevens in the 10y sector and beyond already close to the 2.5% level, there is limited room for breakevens to rise if the Fed's threshold of 2.5% is credible (even if is only a threshold and not a trigger for tightening). While it is possible that an increase in inflation risk premium could cause some increase in longer end breakevens, we think that the 2y to 5y sector has the most room to run in the current environment.
3. The Fed's maturity distribution for purchases of TIPS is the 4y to 30y sector, which is closer to QE2 than operation twist. We think that this move down in the maturity spectrum will have a positive impact at the margin, on 4y and 5y TIPS.

We have found the front end of the TIPS curve attractive for some time now and we already have a long position in the 2y sector (July 14s) as a breakeven curve flattener trade vs. 10s (see [US Rate Strategy Notes - Rebalancing the BE curve flattener trade](#) and [US Rate Strategy Notes - Entering a 2s10s breakeven curve flattener](#)). We therefore buy 50MM of the April 17s on a breakeven basis at 2.10%. The SOMA holds only 1.4% of this note, giving some room for buildup in the portfolio. Note that there is an auction of this issue next week. We expect a size of 14bn in the announcement tomorrow. We plan to add to the position if there is any cheapening into the auction.

The risk to our trade is if we get significant fiscal contraction in 2013 as a negative outcome of the current political negotiations, which would suppress consumer demand and decrease inflation expectations. However, we think that the current breakeven levels in front end TIPS already reflect this fear to some extent, and therefore the downside in breakevens is limited.

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Appendix A-1

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