

TIPS or nominal Treasurys? Navigating rates near fair value

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With real and nominal Treasury rates near fair value and the outlook unusually uncertain, investors may find less value in making a broad directional rate call. Instead, the relative appeal of Treasury Inflation-Protected Securities (TIPS) and nominal Treasurys may depend on what drives the next change in yields and whether inflation ultimately exceeds current market expectations.

TIPS, nominal Treasurys, and breakeven inflation: A primer

TIPS and nominal Treasurys are both backed by the US government, but they offer different exposures to inflation. Nominal Treasury yields combine real yields with expected inflation. As a result, an increase in nominal yields can carry very different implications depending on whether it's driven by higher real rates, higher inflation expectations, or both. Meanwhile, TIPS principal adjusts with realized inflation, protecting principal from changes in the inflation level while offering a yield expressed in real terms. This relationship is the basis for breakeven inflation, which is the difference between the yield on a nominal Treasury and a TIPS security of the same maturity. It represents the implied inflation rate at which an investor would be indifferent between holding the nominal bond or the inflation-linked bond. Separating the 10-year nominal Treasury yield into its real-yield and breakeven inflation components helps identify whether changes in Treasury yields are being driven primarily by real rates, inflation expectations, or both (Figure 1).

Understanding TIPS performance

If inflation over the relevant holding period exceeds the breakeven rate, TIPS would generally be expected to outperform comparable nominal Treasurys; if inflation falls below the breakeven rate, nominal Treasurys would generally be expected to outperform, before accounting for liquidity and other market effects. As investors weigh various market dynamics that can influence inflation, such as volatile oil prices or a higher terminal policy rate, inflation expectations are key to TIPS performance. Breakevens can widen due to rising inflation expectations, creating a tailwind for the relative value of TIPS versus nominals.

What drove Treasury yields and returns this year

The 10-year US Treasury yield has increased by approximately 60 basis points year to date through September, with higher real yields accounting for most of that move. Real yields rose approximately 50 basis points, while 10-year breakeven inflation increased by about 10 basis points.¹ For more details, see Navigating a Higher-for-Longer World.

Despite the increase in real yields, the inflation adjustment to TIPS principal helped TIPS outperform comparable nominal Treasurys over the period (Figure 2).

Outlook: Risks pull in both directions

Risks to the rate outlook remain two-sided. Deficit concerns, stronger-than-expected growth, renewed inflationary pressure, or a more price-sensitive Treasury investor base could push rates higher. Investors may also demand higher yields to hold longer-term bonds as they assess uncertainty over Fed policy, increased borrowing to fund AI infrastructure and a less reliable stock-bond diversification relationship.

Conversely, a sharp economic slowdown, further disinflation, or a broad risk-off environment could drive rates lower. These crosscurrents are compounded by uncertainty surrounding the neutral rate that neither stimulates nor restricts economic growth.

Against this backdrop, we remain neutral on both real and nominal rates, and believe the relative opportunity may depend less on a broad directional rate call and more on the investor's inflation outlook—especially with TIPS currently attractive by historical standards.

What this means for TIPS and nominal Treasuries

The recent performance of TIPS and nominal Treasuries reflects a rise in yields driven more by higher real rates than by higher inflation expectations. The Fed's response to this environment, particularly amid a leadership transition, introduces additional policy uncertainty. Over time, AI-related productivity gains could prove disinflationary; in the near term, however, the associated demand for capital and infrastructure investment may place upward pressure on rates.

With rates near fair value, investors who believe inflation will exceed the level embedded in breakevens may find TIPS more compelling, while those who expect inflation to fall short of market pricing may prefer nominal Treasuries. Portfolio objectives, liquidity, and the desired level of inflation protection should also inform that choice.

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