TIPS for Inflation

In February 2018, Jerome Powell was appointed as Chair of the Board of Governors of the Federal Reserve System. He became the 16th chair to take over the helm of the world's most influential central bank. Among other duties, he and the Fed governors are tasked with adjusting short-term interest rates to help control inflation in an effort to promote overall economic growth.[1]

Until 2021, inflation had remained relatively low, which had allowed the Fed to maintain an accommodative monetary policy. After the COVID-19 pandemic, the Fed increased short-term interest rates to combat high levels of inflation. More recently, the Fed has indicated that it will be keeping its eye on inflation to inform its monetary policy.

A Few TIPS

Unlike conventional U.S. Treasury bonds, the principal amount of Treasury Inflation-Protected Securities, or "TIPS," is adjusted when there are changes in the Consumer Price Index (CPI), which measures changes in inflation. When the CPI increases, a TIPS's principal increases. If the CPI falls, the principal is reduced.

The relationship between TIPS and the CPI can affect the amount of interest you are paid every six months, as well as the amount you are paid when your TIPS matures.[2]

Remember, TIPS pay a fixed rate of interest. Since the fixed rate is applied to the adjusted principal, interest payments can vary from one period to the next. TIPS help manage inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index— while providing a real rate of return guaranteed by the U.S. Government.

When TIPS mature, the bondholder will receive either the adjusted principal or the original principal, whichever is greater.[2,3]

If you are concerned about inflation – and expect short-term interest rates may increase – TIPS are an investment that may be worth considering. A close review of your overall strategy might also reveal other investment choices that may be appropriate in an environment of changing interest rates.

Inflation in Perspective

For the 20-year period ended 2023, the Consumer Price Index averaged a 2.56% inflation rate per year. While inflation peaked at 8% for 2022, it cooled to a 4.1% average for 2023.

Source: USInflationCalculator.com, 2024

1. Investopedia.com, January 25, 2024
2. The interest income from a Treasury Inflation-Protected Security (TIPS) is exempt from state and local taxes. However, according to current tax law, it is subjected to federal income tax. Adjustments in principal are taxed as interest in the year the adjustment occurs even though the principal adjustment is not received by the bondholder until maturity. Individuals should consider their ability to pay the current taxes before investing.
3. Investopedia.com, February 20, 2023