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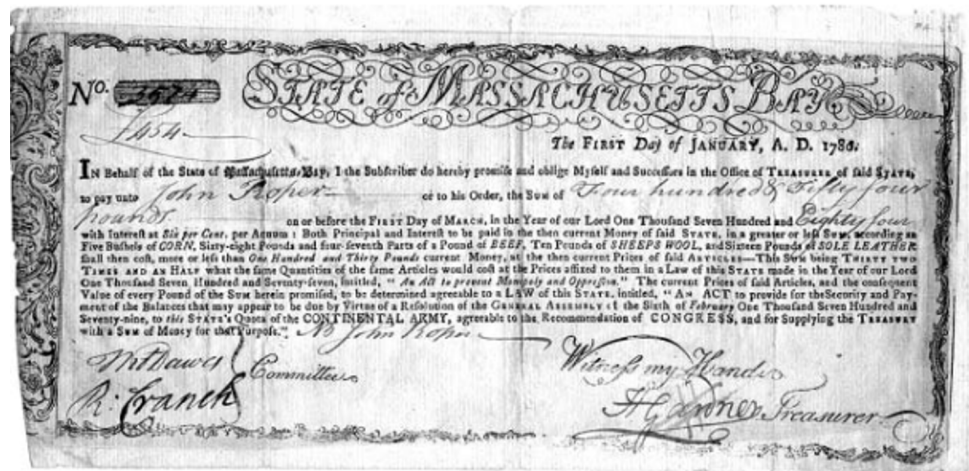
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Do you own enough TIPS (Treasury Inflation-Protected Securities)?

The great enemy of bonds is unexpected inflation. Month after month, those fixed bond payments buy fewer Big Macs, pay fewer medical bills and cover less rent. People can plan for an expected annual inflation of 2%, but a year or two of 8% inflation can ruin the best-laid plans. Only the very shortest of those well-known “risk-free” US Treasuries protect against unexpected inflation.

The first known attempt to solve this inflation problem was the issuance of inflation-indexed bonds by the Commonwealth of Massachusetts in 1780 during the Revolutionary War. The payments on the bonds were adjusted based on the then-current value of specified amounts of corn, beef, wool and leather. The first known Cost of Living Adjustment soon followed. The President of Harvard College had his 1780 salary adjusted to compensate for the inflation that had occurred since 1775.¹

For those of us immersed in US fixed income markets, the Bloomberg US Aggregate Index is the center of our universe. “The Agg” only includes fixed-rate bonds, it contains no inflation-indexed bonds. Including inflation-indexed bonds in a portfolio benchmarked against the Agg can provide protection against higher than expected inflation. Including them does add downside risk from lower than expected inflation and from that rarely seen creature: deflation. The last calendar year that the US CPI showed deflation was 1954. On a fine detail, if there is net cumulative deflation from the date of issuance, holders receive the original principal.



From Schiller, a 1780 inflation-indexed bond maturing in 1784

To understand the peculiar current state of the TIPS market, it helps to understand the finer details of how the principal is adjusted for inflation. The US CPI announcements that make headlines across the world are seasonally adjusted and only carried out to one decimal place. The number that is actually used to calculate the TIPS principal adjustment is an index that is carried out to three decimal places and is not seasonally adjusted. It uses 1982-1984 as the 100.000 base for the index. For May 2026, the index increased from April 2026's 333.020 to 335.123. That is actually an increase of 0.6315%, the headline number that the market seized on was an increase of 0.5%.

In an added twist, there is a lag between when the CPI is reported and when it is used in calculating an adjusted principal amount. The adjusted principal amount is essentially past inflation. We already know the adjustment for every day in July, because it is 1/31 of that 0.6315% May 2026 inflation number (ignoring rounding). The next reporting date, for June CPI, is July 14, 2026. On that date, you will be able to calculate the principal adjustment for each day in August 2026.

One last detail: TIPS bonds also have a fixed coupon, so a portion of the return that holders will receive is actually known when the bond is issued. The yield on a TIPS has two components, there is a known rate, the “real yield”, based on the past CPI indexes since the bond was issued, the fixed rate coupon and the price of the bond. Just a normal, slightly more complicated, bond yield calculation. And then there is the unknown future inflation. Based on those known components, we can calculate the market’s estimate of the unknown part. That market-calculated, but actually unknown part, is called the “breakeven” rate. If actual inflation to maturity comes in at exactly the breakeven rate, you have earned the same yield as the fixed rate US Treasury. If inflation actually ends up being higher than the breakeven rate, you made the right decision to buy a TIPS rather than a fixed-rate US treasury bond.

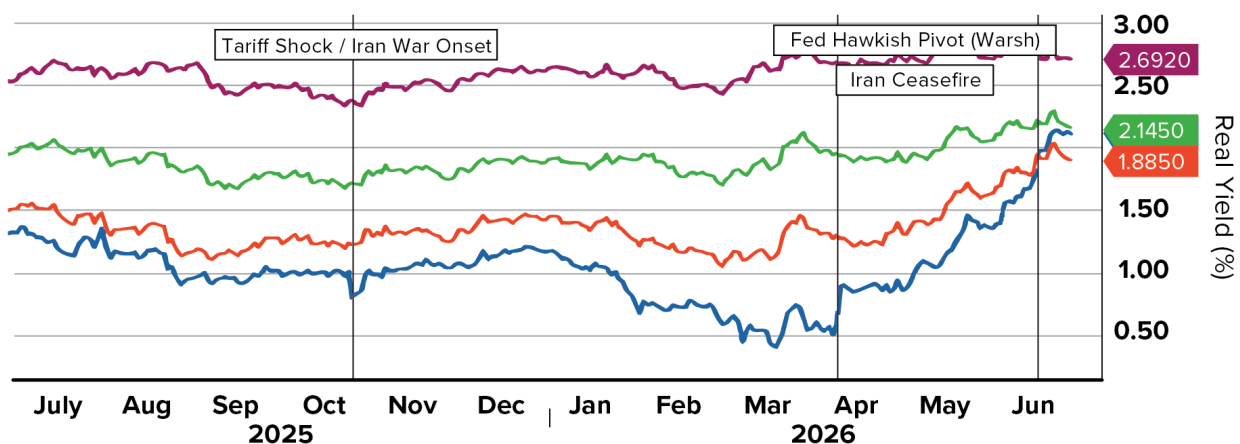
Now, back to the peculiar current state of the TIPS market: market commentators often use the breakeven calculation as short-hand for the market consensus of inflation expectations. But it’s not really that. Maybe there is a little bit of premium in there for buying a slightly less liquid bond that isn’t in the Agg. There won’t be any demand from passive Agg investors, but maybe there will be extra demand if people are buying passive TIPS funds. There’s a little bit of a TIPS universe supply/demand issue that probably vary between a premium or discount. And maybe some other stuff that the market often ignores.

The point is that market commentators right now are treating the low breakevens as evidence that inflation is under control. Somehow magically, the market seems to now know that the Fed and the US Treasury Department will soon have solved the long-standing inflation issue. We don’t think they have.

Why Are Real Yields Rising?

When you buy a regular government bond, the stated yield is the nominal yield. Take out inflation, and what’s left, your actual gain or loss in buying power, is the real yield. Compare a nominal Treasury (an ordinary, fixed-rate bond) with an inflation-protected one. When nominal yields climb faster than the breakeven rate, real yields are rising.

■ 2Y Real Yield 2.0980 ■ 5Y Real Yield 1.8850 ■ 10Y Real Yield 2.1450
 ■ 30Y Real Yield 2.6920



Over the past year, real yields rose for every length of bond while breakevens actually slipped lower. That implies investors aren’t demanding more because they fear inflation but instead they want a bigger real reward to lend to the government at all. The jump has been uneven across the curve, landing hardest on short-term bonds — the 2-year real yield climbed from about 1.3% to 2.1%, while the 30-year real yields have barely edged higher.

Market commentators say that four things are driving real yields higher:

- 1. Increased government borrowing.** Washington is running large deficits and adding debt fast. To get investors to buy all the new bonds, it has to offer higher yields, and that pressure falls mostly on longer-term bonds.
- 2. A Fed that stopped cutting.** Inflation stayed stubborn and then rose to 4.25% by May, so the Fed put rate cuts on hold and may even raise rates. Short-term bonds react most to the Fed, which is why the 2-year real rates have moved the most over last 3 months.
- 3. The Middle East war.** The conflict with Iran and the threat to oil shipments through the Strait of Hormuz pushed energy prices and inflation fears higher, lifting yields. It also scrambled the signals: swings in oil have been moving these yields around for reasons that have little to do with where inflation settles long term.
- 4. Uncertainty about the Fed itself.** A new Fed chair took over in May, and the Fed has been saying less about its plans. When the path is less clear, investors want a bit of extra cushion, which nudges yields up across the board.

Why Short-Term and Long-Term Bonds Moved Differently

Bond	Nominal yield	Real yield (TIPS)	Breakeven	Real yield, 1-yr change
2-year	4.11%	2.10%	2.00%	+0.80%
5-year	4.14%	1.89%	2.25%	+0.41%
10-year	4.38%	2.15%	2.22%	+0.22%
30-year	4.87%	2.69%	2.17%	+0.18%

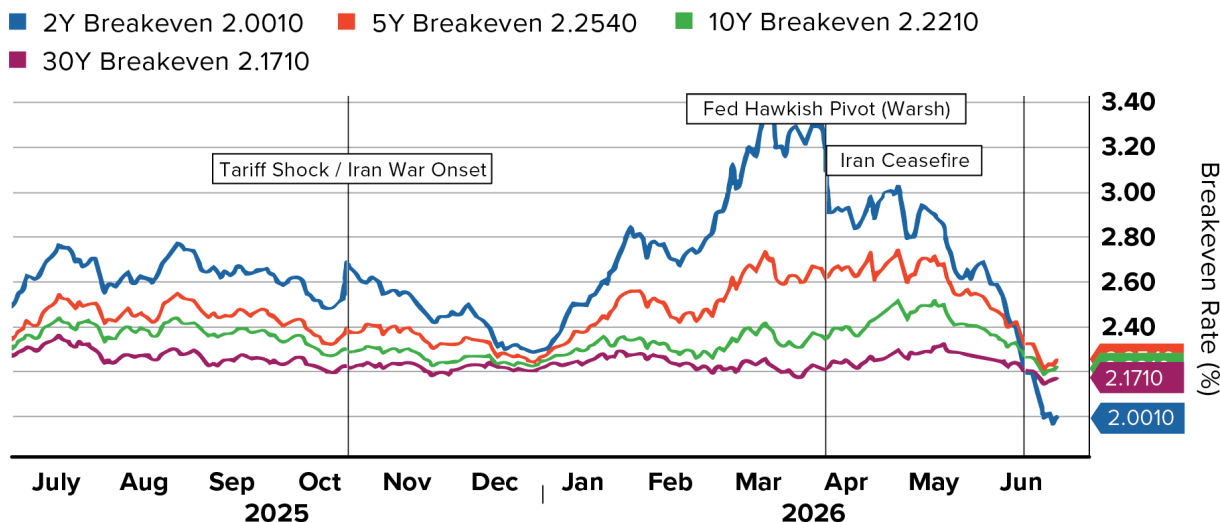
Source: U.S. Treasury market, change over the 12 months to June 29, 2026.

The 2-year. This bond moves with what investors expect the Fed to do. A year ago they were betting on rate cuts; when inflation refused to fall, those bets were torn up and the real yield shot up. At 2.1%, it has changed more than the other points on the curve. This is interpreted as the market’s way of saying the Fed will stay tough for a while.

The 5-year. The middle of the curve, and the lowest real yield of the group. Its breakeven hardly changed, so almost the entire move was a real-yield move.

The 10- and 30-year. This is interpreted as investors caring less about the Fed and more about whether the government can manage its debt. The 30-year reached its highest real yield since the 2008 financial crisis before easing back.

Although the nominal curve remains upward sloping, the real yield curve dips in the belly due to the highest point of breakeven rate at the 5 year part of the curve.



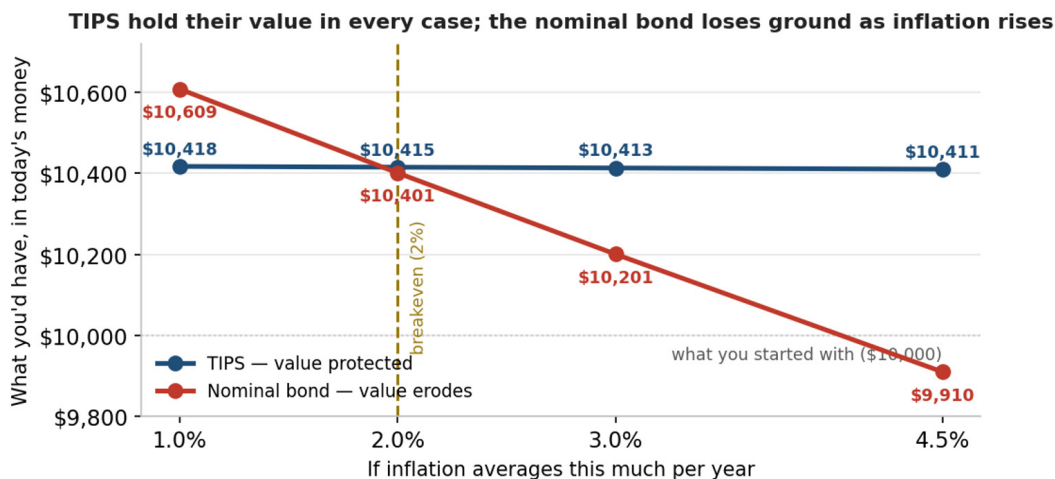
How does it work — TIPS vs. a Nominal Bond, in Real Dollars

TIPS pay interest on a principal amount that rises with inflation. As prices go up, both the bond's value and its interest payments grow with them, and you get the inflation-adjusted amount back at the end (never less than you put in). A nominal bond just pays fixed dollars, whatever inflation does.

Example: Put \$10,000 into a 2-year bond. The nominal bond yields 4.11% and hands back a fixed \$10,821.80 no matter what. The TIPS yields 2.098% above inflation, so what you end up with depends on how high inflation runs. The two tie if inflation averages about 2% (current breakeven rate). Here's what we receive at the maturity of these 2 year bonds.

If inflation averages	Nominal bond Payout – At Maturity	Nominal bond – Real Value*	TIPS Payout – At Maturity	TIPS – Real Value*
1.0% (low)	\$10,822	\$10,609	\$10,627	\$10,418
2.0% (the tie point)	\$10,822	\$10,401	\$10,836	\$10,415
3.0% (sticky)	\$10,822	\$10,201	\$11,048	\$10,413
4.5% (oil shock)	\$10,822	\$9,910	\$11,369	\$10,411

* **Real value**" = At maturity values expressed in today's purchasing power. Real value = what those dollars are actually worth after inflation. Real Value = Total at maturity / (1+ inflation) ^ (no of years). Year Interest and no reinvesting assumed.



The math, in the worst case (4.5% inflation). The TIPS payments grow with prices: about \$219 in year one, \$229 in year two, and \$10,920 back at the end — \$11,369 in total, versus the nominal bond's fixed \$10,822. That is \$547 more. And because the nominal bond's dollars never grow, they buy less over time: that \$10,822 is worth only \$9,910 in today's money, an actual loss of buying power (assuming an inflation rate of 4.5%).

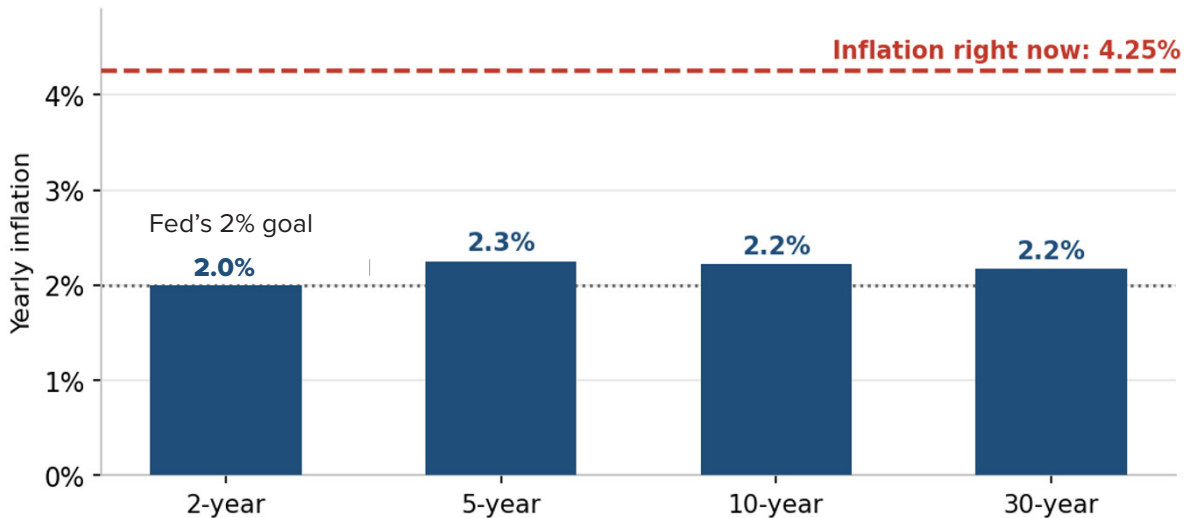
The bottom line. Look at the two "real value" columns. The TIPS holder keeps about the same buying power, roughly \$10,415, no matter what inflation does. The nominal-bond holder swings from \$10,609 if inflation stays low to just \$9,910 if it runs high, where they actually go backwards. The nominal bond only wins if inflation stays under about 2% — the breakeven. With inflation at 4.25% today, that is a low bar, and the odds favor TIPS.

Why Choose TIPS over Nominal Treasuries:

Here is the choice every bond buyer faces: a nominal Treasury (an ordinary, fixed-rate bond), or an inflation-protected one (a TIPS). They are almost twins, with one difference. A TIPS automatically grows with inflation, while a nominal bond pays a fixed amount no matter what prices do. So the whole decision comes down to one question: will inflation turn out higher than the market expects? If it does, TIPS win.

Right now the bar is low. The breakeven (inflation rate the market is pricing in) sits at about 2.0–2.25% across the curve, very close to Fed’s 2% goal, even though the U.S. has not actually seen inflation that low in more than five years. The bars below show each maturity’s breakeven against inflation today.

Inflation only has to beat the breakeven (blue bars) for TIPS to win — and it already does



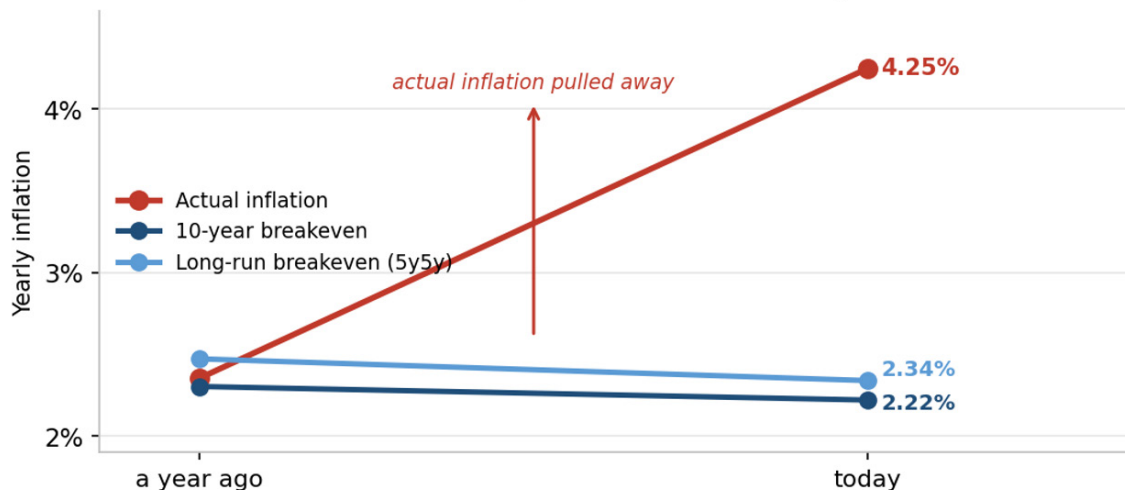
Breakeven Rates can be expressed as:

$$\text{Breakeven} = \text{Expected inflation} + \text{Inflation risk premium} - \text{TIPS liquidity premium}$$

Breakeven rate also reflects things that have nothing to do with inflation, and right now some of these factors are pushing breakeven rates lower. So, the real bar for TIPS to win is even lower than it looks.

The gap is hard to miss. Inflation was running at 4.25% in May, yet the 10-year breakeven sits at just 2.2%. Over the past year actual inflation jumped while the breakeven slipped.

Inflation took off, but breakevens barely moved



Most of the gap comes down to oil, not a real change in the inflation outlook:

- Short-term breakevens move with the oil price. Because these bonds track the headline inflation number, when oil falls the breakeven falls too, even if the bigger inflation picture has not changed. That makes the predictive power of short term breakeven rates very low..
- TIPS demand driving breakeven lowers: When oil spiked in the spring, investors rushed into these bonds and pushed the breakeven down for technical reasons. So both rising and falling oil have recently dragged the breakeven rates lower.

With a hurdle rate (i.e breakeven rates) as low as they are today, the probability of TIPS outperforming their nominal counterparts is as high as it has been in recent times.

1. https://www.nber.org/system/files/working_papers/w10183/w10183.pdf, THE INVENTION OF INFLATION-INDEXED BONDS IN EARLY AMERICA. Robert J. Shiller, Working Paper 10183 <http://www.nber.org/papers/w10183>



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