

Inflation Hedging On Main Street? Evidence From Retail Tips Fund Flows

Based on BFI Working Paper 2022-159, [*"Inflation Hedging On Main Street? Evidence From Retail Tips Fund Flows,"*](#)
by Stefan Nagel, Chicago Booth; and Zhen Yan, Arrowstreet Capital

Households participating in financial markets pay attention to inflation news when making investment decisions, even in an environment of mostly low and stable inflation.

Do households pay attention to inflation when making investment decisions? That question has risen in prominence as inflation has recently soared to heights not seen in decades. Central bankers care about the answer because managing inflation expectations is key to effective monetary policymaking. Are households' expectations aligned with policy? If not, will households' actions generate higher future inflation? Further, and importantly, how strongly and how fast do consumers adjust their choices in response to changing inflation expectations?

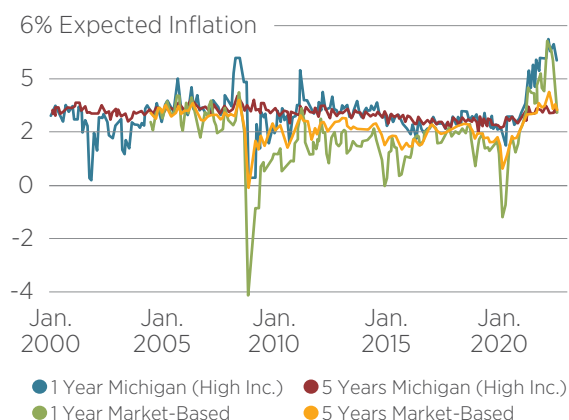
To examine these and related questions, the authors seek alternatives to the conventional, and often unreliable, technique of survey-taking

to study household investment decisions, focusing on aggregate flows into funds that hold inflation-protected Treasury securities (TIPS), considered attractive assets for risk-averse sectors. The authors' working hypothesis is that a rise in realized inflation, inflation expectations, or inflation uncertainty could make inflation risks more salient to retail investors, leading to an increase in households' aggregate demand for TIPS relative to other market participants and, hence, a positive net flow into TIPS.

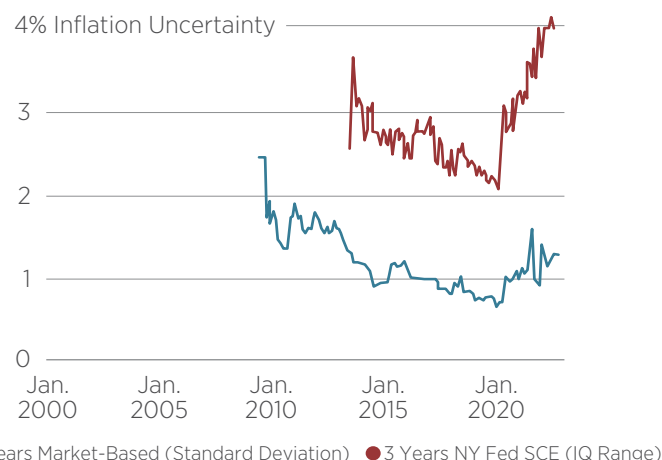
Please see the working paper for details on methodology but, in part and in brief, the authors study retail flows into exchange-traded funds (ETF), supplemented with additional tests

Figure 1 • Time-Series of Inflation Expectations and Inflation Uncertainty Measures

A) Inflation Expectations



B) Inflation Uncertainty



Notes: In their work, the authors measure risk-neutral, market-based expectations of future inflation with daily rates of 1-year and 5-year inflation swaps from Bloomberg. They supplement these market-based measures with survey-based inflation expectations from the Michigan Surveys of Consumers. Since higher-income survey respondents are more likely to be financial market participants, they focus on median inflation expectations of the upper tercile by household income. In this Figure, Panel A plots the time series of these inflation expectations measures. Sensibly, the long-horizon measures are less volatile than the short-horizon measures. It is also apparent that market-based expectations measures are more volatile than the survey-based measures. Panel B plots the time series of select inflation uncertainty measures (please see working paper for more details).

using open-ended mutual fund (MF) flow data (of which little is currently known), along with survey-based expectations from the Michigan Survey of Consumers and the Federal Reserve Bank of New York, to find the following:

- Broadly, households participating in financial markets pay attention to inflation news when making investment decisions, even in an environment of mostly low and stable inflation.
- When market-based long-horizon inflation expectations rise, aggregate household inflows into inflation-protected ETF increase, while nominal Treasury ETF experience outflows.
- Relatedly, potentially inflation-relevant events like the taper tantrum in 2013 and the 2016 presidential election are also associated with substantial retail TIPS fund inflows.¹
- Regarding such inflation-related events, and somewhat surprisingly, changes in market-based measures of inflation expectations extracted from inflation swap rates are likely the best proxy for whether those events induce households to change their allocation to inflation-protected investments. (Inflation swap rates are an inflation protection strategy whereby investors transfer inflation risk to a counterparty in exchange for a fixed payment.)

¹ On May 22, 2013, the Federal Reserve announced it would start tapering its asset purchases at some future date, igniting huge retail outflows from TIPS ETFs in the following weeks. These outflows coincide with the "Taper Tantrum" in bond markets that saw a sharp rise in Treasury bond yields and that was widely covered in the media. Similarly, there was strong net retail buying of TIPS ETFs following the election of Donald Trump as US president in November 2016.

- Household survey-based measures have little incremental explanatory power for retail TIPS fund flows over and above market-based measures.
- Changes in market-based inflation expectations, especially the first movements of upward inflation, dominate changes in inflation uncertainty in explaining retail TIPS fund inflows.

Bottom line: For policymakers interested in understanding inflation concerns of households, this research suggests that market-based expectation measures should not be dismissed. Indeed, such expectations are closely linked to households' investment decisions, and movements in market-based expectations provide a good summary of the inflation news that reaches households. Further, and pertinent to current events, households' investing behavior may provide additional early cues on whether the central bank is losing credibility, and whether inflation expectations are becoming unanchored.

READ THE WORKING PAPER

NO. 2022-159 · NOVEMBER 2022

Inflation Hedging on Main Street? Evidence from Retail TIPS Fund Flows

bfi.uchicago.edu/working-paper/2022-159

ABOUT OUR SCHOLAR



Stefan Nagel

*Fama Family Distinguished Service Professor,
Chicago Booth*

[chicagobooth.edu/faculty/directory/n/
stefan-nagel](https://chicagobooth.edu/faculty/directory/n/stefan-nagel)

CHICAGO BOOTH