Asset Class Investment Strategies

Inflation-Linked Bonds

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

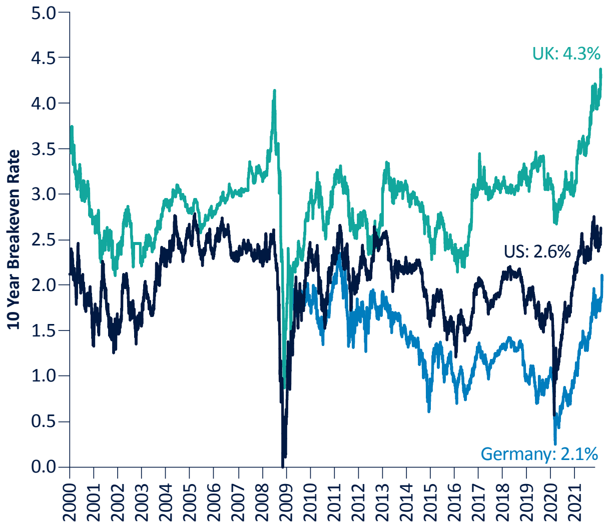
Major Trends

Long-term inflation expectations remain anchored: The difference between the yield on a nominal fixed-rate bond and the real yield on an inflation-linked bond of the same maturity provides the breakeven inflation rate, a measure of investors' inflation expectations over the life of the bond. As of 24 February, the 10-year breakeven rate was 2.4% in the US, 2.1% in Germany and 4.4% in the UK.

UK's Inflation-Linked Gilts are an anomaly: The US and Germany both index to the Consumer Price Index (CPI), whereas UK ILBs are indexed to the Retail Price Index (RPI). RPI includes the cost of housing and can deviate substantially from CPI. In 2021, UK RPI was 7.6% while CPI was 5.4%. The UK is expected to align RPI and CPI in 2030[1].

Exhibit 1

Long-term inflation expectations moderately higher than average



Source: *Bloomberg*

Golden Rules

- Inflation-Linked Bonds are a highly efficient source of inflation protection, interest rate duration, portfolio diversification and liquidity.
- The asset class beta should be accessed at the lowest possible cost, typically via a market duration ETF.
- Investors should hold the bonds that are indexed to the basket that best matches their consumption, which will typically be their home currency bond.

2022 Strategic Priorities

We continue to actively monitor the optimal source of portfolio duration and may rotate out of ILBs into nominal bonds for USD and GBP investors if the yield on the 10-year US Treasury and UK Gilt rises to c. 2.5%, or for EUR denominated investors if the German Bund yield rises to 1.5%. Alternatively, we will look to reduce ILB exposure if inflation fears cause breakeven inflation rates to rise to levels that we believe to be disconnected from the economic reality.

The 10-year breakeven rate of 4.2% in the UK appears high, but this reflects a scarcity premium, with demand for inflation-linked assets from UK pension funds outstripping supply. Analysis from pension provider L&G estimates that liability-driven investing will generate £56 billion in demand for UK ILGs in 2022, nearly double the expected net issuance of £27 billion, suggesting this premium will persist in the near term.

Expected 12-Month Returns

Exhibit 2[1]

Expected returns by scenario

	Recovery Falters (10%)	Stagflation (10%)	Gradual Normalisation (60%)	Reflation 2.0 (20%)	Expected Value
Inflation Linked Bonds	2.4%	6.4%	-2.5%	-3.9%	**-1.4%**
Notes	Real yields are assumed to remain at the 31 Jan level of -0.5% in both slow down and stagflation, as the breakeven rate moves in line with nominal yields. In the base case and reflation scenario, nominal yields rise faster than breakeven rate, causing real yields to rise to +0.3% and +0.5% respectively.				

[1]Return assumptions are for the 12 months from 31 January 2022. Estimates of performance returns are based upon certain assumptions which should not be construed to be indicative of actual events that will occur. There is no assurance that the performance presented will be achieved. Please see important Disclaimers at the end of this material.

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