Asset Class Investment Strategies

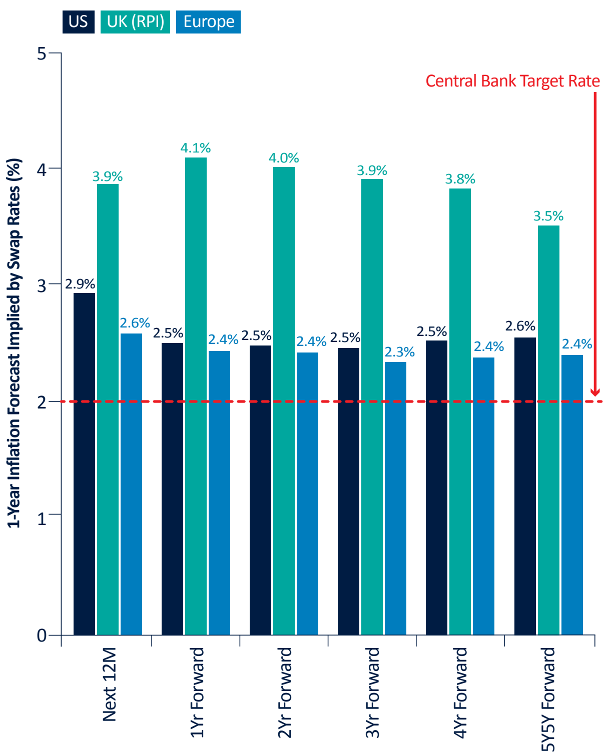
Inflation-Linked Bonds

Major Trends

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. In the US and Europe, as of mid-February, these expectations remained modestly above the central bank target rate of 2% across almost all time periods, including the next 12 months. This suggests that the inflation-linked bond market has 'priced in' a rapid and permanent fall in inflation to a level that is structurally 40-60bps higher than inflation has been over the last decade. UK inflation is expected to remain close to 4%, but this reflects RPI rather than CPI. RPI is being phased out for multiple reasons, e.g., it does not account for the possible substitution of goods, and so typically runs roughly 1% above CPI.[1]

Exhibit 1

Inflation expectations remain anchored across all time periods



***Source:** Bloomberg*

Shorter-duration ILBs/TIPS provide better protection against near-term inflation surprises: Inflation-linked bonds are an efficient asset in that they provide both inflation protection and interest rate duration. However, in periods where near-term inflation increases sharply but long-term inflation expectations remain anchored, the impact of the interest rate duration will far outweigh the benefit of the inflation protection. This is what has happened over the last two years. One means of mitigating this risk, and better hedging near-term inflation risk, is to hold shorter duration inflation-linked bonds, which are less sensitive to changes in interest rate but have greater sensitivity to changes in inflation. This is especially true in the UK, where the market-weighted ILB benchmark has significant exposure to the 30-year breakeven rate, which is largely insensitive to near-term inflation pressures.

Golden Rules

- Inflation-Linked Bonds are a highly efficient source of inflation protection, interest rate duration, portfolio diversification and liquidity.
- Investors should hold the bonds that are indexed to the basket of goods that best matches their consumption, which will typically be their home currency bond.
- The asset class beta should be accessed at the lowest possible cost. For taxpayers, this may be direct ownership of underlying bonds due to potentially favourable capital gains treatment. Alternatively, exposure can be achieved via the swaps market in an overlay structure to further improve cash efficiency.

1 The Retail Price Index (RPI) increased by 8.4% and 15.2% in 2021 and 2022 respectively. In comparison, the Consumer Prices Index including owner occupiers' housing costs (CPIH) was 4.2% and 9.8%, demonstrating the degree to which RPI can overstate inflation. The Office of National Statistics plans to align RPI with CPIH in February 2030.

2023 Strategic Priorities

We actively review optimal sources of portfolio duration on an ongoing basis, including the relative attractiveness of nominal and real yields. The long-term inflation expectations priced into index-linked bonds appear modest relative to the risk of structurally higher inflation. The green energy transition is likely to underpin higher inflation over the next 5-10 years given the scale of investment required to replace (rather than increase) existing carbon-intensive infrastructure, which makes ILBs relatively attractive in our base case and upside scenarios. However, in downside scenario in which growth slows sharply, nominal bonds are likely to provide better portfolio protection. Given these countervailing factors, we continue to favour diversification and recommend a mix of nominal bonds and ILBs/TIPS.

In the middle of 2022, for US investors, we rotated 2.5% out of TIPS and into nominal Treasuries after nominal yields had risen by more than real yields (i.e., after TIPS had provided a degree of shelter from the impact of rising yields). We did not do this for EUR and GBP investors, as the risks of stagflation in Europe was greater due to the sharp rise in energy prices following the war in Ukraine. However, as the risk of an energy crisis and protracted stagflation have lessened, we recommend that EUR and GBP denominated portfolios rotate some exposure from ILBs into nominal bonds to improve protection against a recession. The capital weighting to government bonds and ILBs does not change, but the allocation ratio should be adjusted to match that of the SAA benchmark.

Long-Term Expected Return

Exhibit 3

Based on our 10 year forecasts, we target the following long-term expected returns for Inflation-Linked

	Inflation Linked Bonds
Risk-free Rate	3.5%
Risk Premium	—
Illiquidity Premium	—
Manager Alpha	—
Total Return	**3.5%**

Inflation-Linked Bonds expected return assumes actual inflation equals breakeven rate on average, making the return equal to the equivalent nominal bond return.

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

Your capital is at risk and you may not get back the full amount invested.

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