Inflation-Linked Bonds

Major Trends

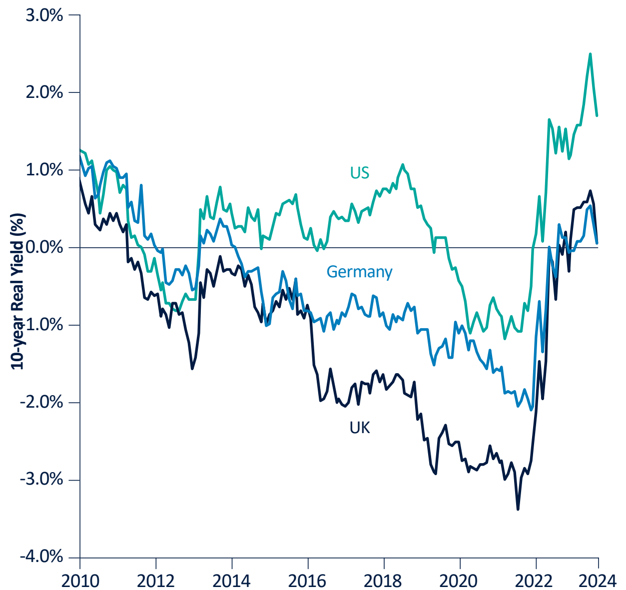
Long-term inflation expectations remain anchored: The difference between the yield on a nominal fixed-rate bond and the real yield on an inflation-linked bond ("ILB") of the same maturity provides the breakeven inflation rate, a measure of investors' inflation expectations over the life of the bond. In the US and Europe, these expectations remained only modestly above the central bank target rate in 2023. At the end of 2023 the 10-year breakeven rates in the US, Germany and UK were 2.2%, 2.0% and 3.5% respectively (Exhibit 1) (note US and German ILBs are indexed to CPI whereas UK ILBs are indexed to RPI, which is typically 1% higher than CPI[1]).

Exhibit 1
Market inflation expectations are above pre-COVID levels, but have remained anchored

Source: *Bloomberg*

Rising real yields: With inflation expectations anchored even as nominal yields increased, the real yield on ILBs rose to the highest level in a decade in 2023 (Exhibit 2). Investors in the US are now able to "lock in" a return of roughly inflation +2% p.a. over the next decade, irrespective of how inflation changes over the period.

Exhibit 2
The real yield on TIPS is close to the highest in a decade



Source: *Bloomberg*

Shorter-duration ILBs provide better protection against near-term inflation surprises: Inflation-linked bonds 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. We believe that one way to mitigate the duration risk, and therefore more effectively hedge near-term inflation risk,

1 The Retail Price Index (RPI) is a statistically poor inflation index that typically overstates inflation. For example, it does not account for the possible substitution of goods in the basket as prices rise. The calculation of the RPI will be aligned with Consumer Prices Index (CPI) including owner occupiers' housing costs (CPIH) in 2030. For reference, CPIH increased by 4.2% in 2023 while RPI rose by 5.2%.

Inflation-Linked Bonds
continued

is to hold shorter maturity inflation-linked bonds which are less sensitive to changes in interest rates but are more exposed to near-term inflation shifts. 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

- We believe that Inflation-Linked Bonds provide a degree of inflation protection, interest rate duration, portfolio diversification and liquidity.
- We would recommend investors hold 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.

Partners Capital are not tax advisors. Tax treatment will depend on the individual circumstances of each client and is subject to change. You should consult your own tax advisor to understand the tax treatment of a product or investment.

2024 Strategic Priorities

We continue to actively monitor the optimal source of portfolio duration, and the relative attractiveness of nominal and real yields. Current long-term inflation expectations priced into ILBs appear modest relative to the risks of structurally higher inflation. We believe that 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 may make ILBs relatively attractive over the longer-term. However, as inflation expectations would likely fall in a recession, we believe that exposure to nominal duration is likely to provide better protection in a protracted downturn. Given these countervailing factors, we continue to favour diversification and recommend an even mix of nominal bonds and ILBs.

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.

Long-Term Expected Return

Exhibit 3

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

	Inflation Linked Bonds
Risk-free Rate	4.0%
Risk Premium	0.3%
Illiquidity Premium	—
Manager Alpha	—
Total Return	**4.3%**

Long-term forecast for Inflation-Linked Bonds assumes that the starting breakeven rate is a good predictor of inflation over the period. As such, ILBs and Nominal Bonds expected to produce the same return over the period.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are tnot a reliable indicator of future performance.