The best inflation approach? Keep calm and diversify

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In July last year we looked at the potential for inflation to be the 'hidden risk', as governments around the world put in place extraordinary support measures to combat the effects of the Covid-19 outbreak. We thought that while inflation was likely to remain benign, the risks to that view had increased, but that hedging those risks was relatively cheap.

Since then, we've seen a host of changes that have had an impact on government bond markets. The election of Joe Biden as US President obviously had an impact, but this was magnified when the Democrats were able to take control of the Senate. We expected this to lead to a large fiscal stimulus package and this was duly passed. In the UK, a Brexit deal was agreed before Christmas, avoiding the cliff-edge no-deal outcome that markets had feared. And most importantly, the approval of several vaccines and efforts to get these rolled out, led to hopes that 2021 could see the start of a global economic recovery.

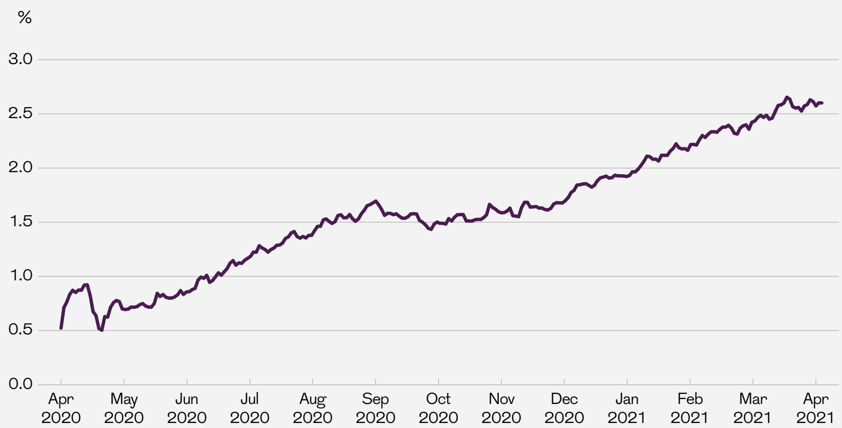
The world looks very different now

As a result, global inflation expectations have moved materially higher (see figure 1). In one sense this is obvious – just six months ago, lockdowns and restrictions were causing a massive drop in global GDP and the recovery route was unclear. That is no longer the case. Global reflation is now seen as a distinct possibility, causing a sell-off in global bond markets, led by long maturities. We have seen breakeven rates increase everywhere, with the UK underperforming thanks to a sterling rebound in the wake of the Brexit deal and the resolution on RPI reform.

Do recent moves mean that inflation is now fully reflected in bond markets? We don't think so. Inflation figures can be expected to edge higher this year simply due to the year on year comparison with a very subdued 2020. But we see this more as a technical short-term factor.

Is the inflation increase likely to be a sustained one? We know that this year, inflation figures will look higher just because of the base effect – the comparisons with the more subdued data from last year. Whether or not that increase is sustained depends on a variety of factors, and is something we are still debating: the impact of higher commodity prices (oil in particular) and as a local issue, supply chain issues in the UK due to Brexit would all point to higher inflation both in the UK and further afield. However, a leading indicator for higher inflation is usually rising wages: but with public sector wages constrained by high levels of government debt, and the private sector under pressure after a year of lower revenues, how much scope is there for widespread wage increases? If wages are constrained, the potential for producers to pass through price rises looks limited.

Figure 1: US 5yr implied inflation



Source: RLAM, Bloomberg as at end March 2021.

Past performance is not a reliable indicator of future returns.

The mindset of central banks also needs to be considered here. Rising inflation typically prompts monetary policy tightening from central banks. Not so long ago, central banks made their reputations on their eagerness to slay the 'inflation monster'. Since the global financial crisis, central banks have been much more circumspect: with developed economy growth rates lower, they have tried to avoid squashing any recovery before it gets established – and we believe that this will remain the mindset as we come out of the pandemic. Better to let inflation run hot and then act, than an early hike in rates which kills growth and inflation.

Separating the UK from global trends

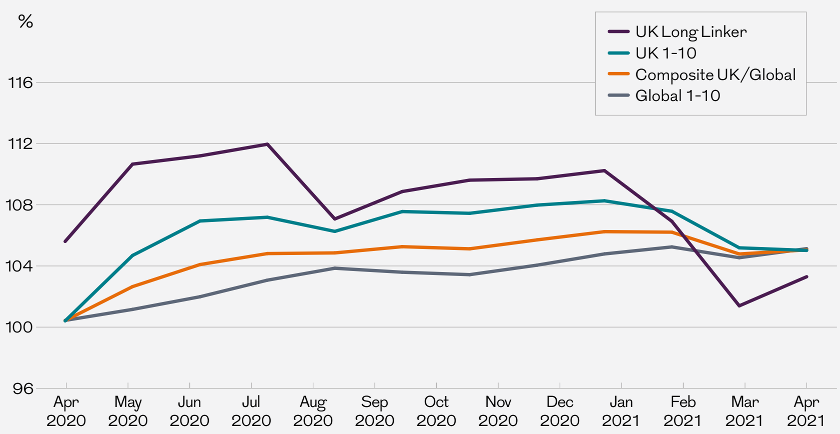
The inflation picture in the UK is similar to the global outlook but has a number of specific factors that merit consideration. First, since the Brexit deal, sterling's trade-weighted value has risen by approximately 10%. This is inherently deflationary. Second, inflation expectations in the UK are different. A look at 10-year breakevens suggests the market is pricing in inflation of around 3.6% per annum for each of the next ten years, yet the Bank of England has an explicit target of 2%. There are technical factors that have historically pushed UK breakevens higher – primarily the purchase of inflation protection as part of defined benefit LDI hedging strategies. This is still a factor today, but with the DB market moving towards run-off, this effect is already fading. We wonder if the market is still not fully pricing in the move from RPI to CPI.

Implications for investment decisions

We are living in an extended period of very low inflation. While it is tempting to think on inflation as yesterday's problem, even 2% inflation per annum has a material impact on long-term purchasing power.

We believe that inflation positioning depends on your outlook and objectives. Traditionally, UK investors looking for a degree of inflation protection would buy a UK index-linked fund. However, as detailed above, UK inflation may be

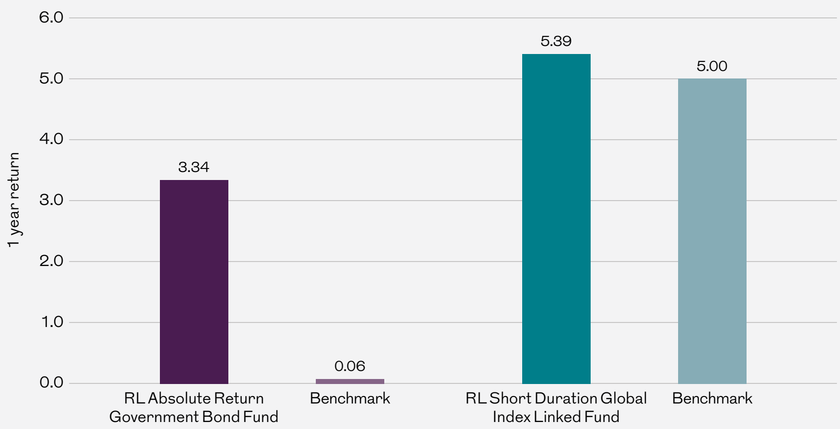
Figure 2: Inflation-linked returns sharply lower in 2021



Source: RLAM, Bloomberg as at end March 2021.

Past performance is not a reliable indicator of future returns.

Figure 3: Shorter duration fund performance



	1 year (%)	3 years (% ann)	5 years (% ann)
Royal London Absolute Return Government Bond Fund	3.34	0.88	0.54
Benchmark: Overnight Cash Rate (SONIA)	0.06	0.45	0.39
Royal London Short Duration Global Index Linked Fund	5.39	2.99	2.32
Composite Benchmark*	5.00	2.78	2.39

* 30% Bloomberg Barclays UK Government Inflation Linked Bond 1-10 year Total Return GBP Index, 70% Bloomberg Barclays World Government Inflation Linked Bond (ex UK) 1-10 year Total Return GBP Index

Source: RLAM as at 31 March 2021.

Performance of funds based on M Acc share classes, net of fees. Past performance is not a reliable indicator of future returns. Benchmark performance is shown gross of fees and taxes.

mis-priced. Moreover, the duration of a normal UK index-linked index is around 21 years. Any inflation protection is vastly outweighed by substantial interest rate risk. As an example, in the first two months of 2021, where inflation fears really started to take hold, index-linked gilts returned -8% (figure 2).

We believe that a more globally focused, short duration option may be more appropriate in this environment (figure 3). Our discussions with clients recently have centred on the RL Short Duration Global Index Linked Fund helping to diversify risk away from an overvalued UK market and with an index considerably shorter than a UK long maturity index linked fund. Absolute return strategies that can provide a positive real return may also be useful additions to a diversified portfolio. The RL Absolute Return Government Bond fund can take explicit inflation positions with little or no duration exposure, helping to protect against rising yields.

Inflated views

There is no precedent for the situation we are in today. The measures taken thus far, and the desire by policy makers to avoid cutting off any recovery could combine to create a powerful inflationary mix. Or the deflationary impact of the past year could utterly swamp any such effect. As such, pinning portfolios on one scenario over the other may not be wise. Investors may want to consider ways to mitigate the impact of a more inflationary world without taking material interest rate risk, maintain their liquidity and minimise drawdowns and volatility, whilst still benefitting from active management.

Investment risks

The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Charges from capital risk (Short Duration Global Index Linked Fund only): Charges are taken from the capital of the fund. Whilst this increases the yield, it also has the effect of reducing the potential for capital growth.

Counterparty risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the fund to financial loss.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the fund could lose significantly more than the amount invested in derivatives.

EPM techniques: The fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the fund to increased price volatility.

Exchange rate risk: Changes in currency exchange rates may affect the value of your investment.

Government and Public Securities risk (Short Duration Global Index Linked Fund only): The Fund can invest more than 35% of net assets in different Transferable Securities and Money Market Instruments issued or guaranteed by any EEA State, its local authorities, a third country or public international bodies of which one or more EEA States are members.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Contact us

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Issued in April 2021 by Royal London Asset Management Limited, 55 Gracechurch Street, London, EC3V 0RL. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

Ref: AL RLAM PD 0091

83438 04 2021