ASSET MANAGEMENT

REVIEW AND OUTLOOK FOR INDEX LINKED BONDS

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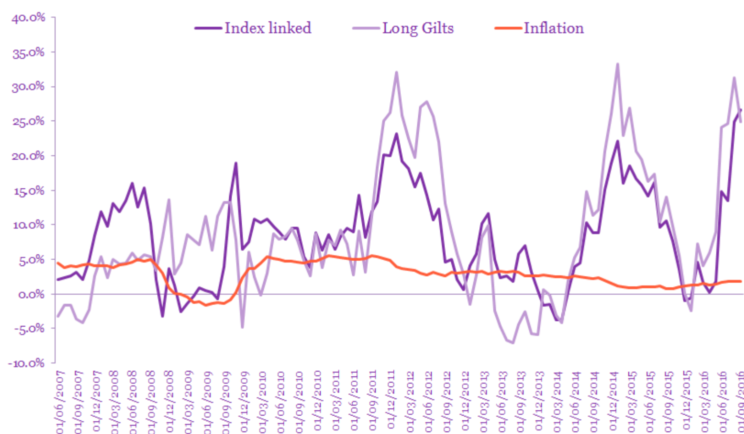
Conventional and inflation-linked gilts have generated strong returns over the last year

Over the last year, both conventional and inflation-linked gilts have generated returns in excess of 25%. Meanwhile, inflation has only risen by between 1% and 1.5%.

Inflation-linked gilts have attracted inflows as sterling's depreciation pushed up inflation expectations. However, inflation has not been a driver of returns from longer-dated bonds.



Falling real yields have driven index-linked gilts

In the wake of the Brexit vote, we've seen renewed quantitative easing (QE) and a rate cut from the Bank of England (BoE). The fall in long-dated yields to record lows increased defined benefit scheme deficits, in turn sparking renewed hedging activity – typically through buying long-dated conventional and inflation linked gilts. But with the BoE also buying these bonds as part of its QE programme, the fall in yields has been exaggerated. In other words, it is the fall in real yields, not rising inflation expectations, that has been the main driver of index-linked gilt (ILG) returns.

Historically, at higher levels of inflation, real yields have been significantly higher than current levels.

There has historically been a reasonably significant positive correlation between real yields and inflation, based on the retail prices index (RPI). Current ILG yields are now far lower than we would expect for current inflation levels.

There has been speculation that inflation will rise largely because of the recent moves in sterling and the recovery in oil prices to above $50 a barrel (having been as low as $25 a barrel at the beginning of 2016). Some commentators expect RPI inflation to rise to as high as 4% by next year. RLAM expects UK

inflation based on the consumer prices index (CPI) to rise to around 2% by the end of next year. The difference between RPI inflation and CPI inflation has usually been 0.7-0.8%. We therefore expect RPI inflation to rise to around 3% next year.

Historically, when RPI inflation has been between 3% and 4%, real yields have been closer to 0% than current levels of -2%. This demonstrates the potential vulnerability of the ILG market to an increase in inflation.

As inflation rises, real yields may also follow suit. This may hurt longer-dated bonds.

Rising inflation will push real yields higher, although we would expect further pension fund purchases to slow or dampen this effect. Rising inflation is likely to be positive for short-dated inflation-linked bonds, their longer-term counterparts are more vulnerable as inflation-induced gains will be wiped out by the rise in real yields.

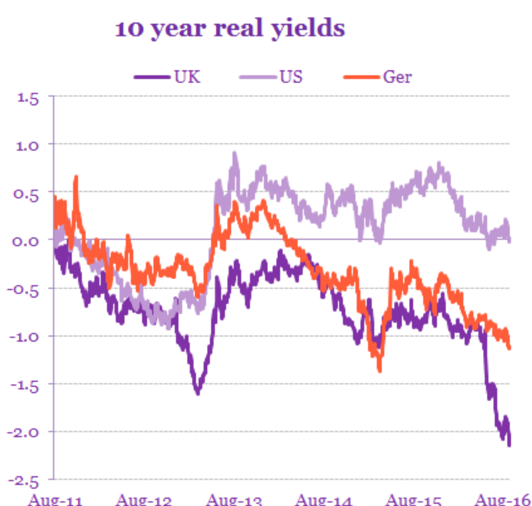
Our sensitivity analysis shows that a 1% move in inflation has a lower impact on the prices of longer-dated bonds than an equivalent move in real yields. In fact, our analysis shows that even on a more conservative basis, where inflation rises to 3% and real yields rise by 0.5%, we would expect the 1-year projected return from 5-year inflation-linked bonds to be -2.0% while the returns from 50-year bonds could be as weak as -22.5%. This shows the risk of holding very long-dated ILGs: the benefit of the inflation protection is wiped out in the event of a rise in real yields.

Index linked gilt duration	1 % move in inflation	1 % move in yield
5 Years	-1.4	-7.1
10 Years	-1.1	-10.2
30 Years	-0.8	-27.5
50 Years	-0.8	-44.9

Source: Bloomberg based in ILG

UK inflation-linked bonds have outperformed their global peers.

The combined impact of purchases from pension funds, Brexit and the BoE's monetary policy has meant that UK inflation-linked bonds have vastly outperformed overseas bonds. Real yields in the UK have declined more than those in the US and Europe.



Source: RLAM as at 29 September 2016.

10-year breakeven rates (the difference between nominal and real yields, and hence a measure of the market's inflation expectations) suggest the UK market is pricing in higher domestic inflation to a greater extent than the US and European markets. In the US and Europe, inflation expectations have risen more gradually. This difference in performance is particularly marked when looking at real yields – since the Brexit vote, UK real yields have fallen much more sharply.

Look beyond the UK, and bias towards shorter-dated ILGs

This provides an opportunity. Although US index-linked Treasuries (known as TIPS) are expensive in absolute terms, with real yields of around zero, these are cheap relative to the UK. Holding US TIPS instead of UK ILGs provides investors with the dual benefits of higher yields and protection against rising UK yields. Where we are buying overseas exposure, this is on a hedged basis to remove currency risk.

A diversified portfolio that comprises more shorter-dated inflation-linked bonds may offer better relative value than longer-dated bonds. Such a portfolio would benefit from higher inflation and simultaneously offer protection from a broad-based rise in yields.

In conclusion, index linked bonds undoubtedly have a role to play within portfolios, and regional exposures can offer relative value. However, investors should be cognisant of the drivers behind recent strong performance and remain vigilant of the risks associated with falling real yields, particularly at the longer dated end of the spectrum.

The webinar is available here to listen in full

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