FOR PROFESSIONAL AND QUALIFIED INVESTORS ONLY

Expert's view

Cherry pick your exposure to inflation

It's almost one year since the Covid-19 crisis started and dramatically upset the global economy. Economic activity has started to normalise since the summer of 2020. This along with hopes that a mass vaccine campaigns will allow further normalisation have supported a rebound in inflation expectations. The Fed's new stance on inflation – with its shift towards an average inflation figure – suggests more flexibility if inflation rises past the previous 2% target. In this report, we examine the factors that could drive moves in inflation and the performance of inflation-linked bonds (ILB).

Facts and overview

- **The global recovery is taking shape**: The US leads the developed world here. US inflation prints recovered over H2 2020, progressively pushing real rates into positive territory in January 2021. The repricing of the US recovery also triggered a progressive bear steepening of the US Treasury curve and a contagion effect to other markets.
- **Flows into inflation-linked exposures have accelerated since H2 2020**. ETPs have been clear winners here, compared to active funds.
- **Inflation outlook:** The question remains whether the recent upside will last over time. Higher wages are still a necessary condition for a sustained recovery in price levels.
- **Central banks will remain accommodative:** With the Fed's new approach, the PCE would need to overshoot at 2.3% for some time for the average inflation to range around 2%. Current market expectations are for tapering to start late 2021/ early 2022, with no rate hike expected before 2023.

Our key takeaways

- **Constrain duration risk in a global inflation-linked bond allocation:** Every 1 basis point rise in the interest rate will knock 1 basis point off the capital value of a bond per year of duration. Such a risk is particularly relevant for markets with higher duration such as the UK inflation-linked bond market.
- **ILB vs inflation expectations:** The choice depends on one's outlook for inflation. Inflation-linked bonds are the conventional choice, but inflation-expectations strategies may perform better if markets are underestimating how high inflation could go.
- **Sensitivity of inflation expectations strategies:** A US inflation expectations strategy will move by approximately 8bps for a 1bp absolute change in the underlying breakeven inflation rate. This sensitivity is closer to a 4% change for a strategy sensitive to EUR inflation expectations.

Summary

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On the path to normalisation

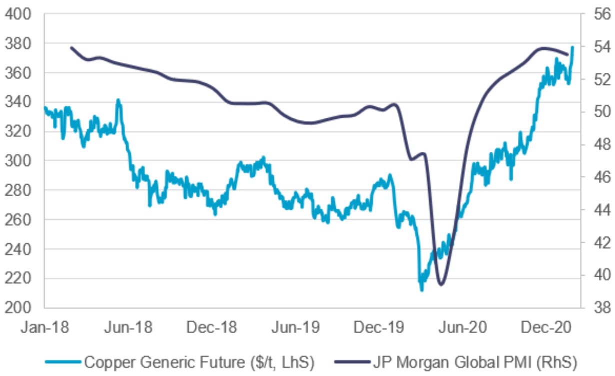
The global recovery is taking shape, as emphasised by the sharp rebound in Global PMIs (see chart 1). Price levels are normalising. The US economic recovery leads the way in developed markets, and inflation prints have gained momentum since H2 2020.

Headline inflation prints were heavily distorted at the height of the Covid-19 crisis. Not only did demand collapse (due to lockdown restrictions) but oil prices also suffered an unprecendented market rout. Heightened uncertainty about the inflation outlook unsettled many forecasters. This heated up the market debate, as activity started to recover.

Higher inflation prints over recent months also pushed real rates up along with a progressive steepening of the USD Treasury curve.

Chart 1: Reflation supported by the global recovery

Copper's price recovery & global business activity survey



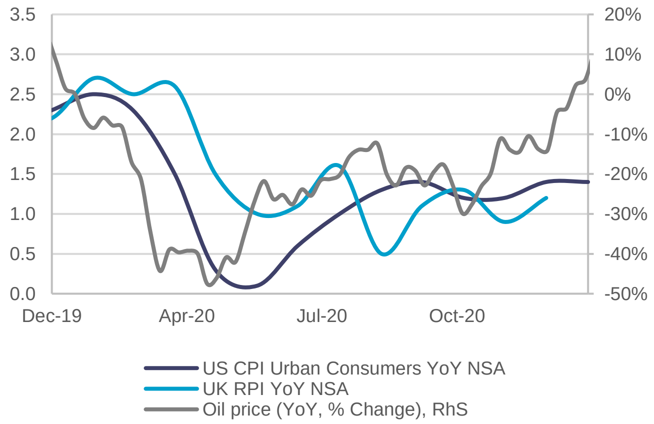
Source: Bloomberg, Lyxor International Asset Management. Data as at 09/02/2021. Past performance is not a reliable indicator of future returns.

The recovery in inflation expectations has not just materialised in the US but also in Europe.

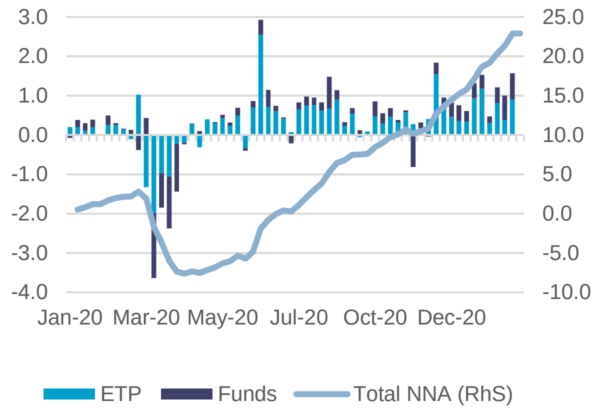
The severe activity restrictions that many economies have endured over the past year have certainly left economic scars, and the path of recovery remains uncertain. Higher price pressure from the oil price and other raw materials has led a recovery in headline inflation prints over recent months (see chart 2). Other components in the inflation baskets in many countries have also started to show signs of revival.

Chart 2: The inflation recovery has been accompanied by strong inflows into inflation-linked bonds

Oil price, US & UK CPI (YoY, % change)



Cumulated flows in funds and ETFs with inflation-linked exposure (EUR, USD, Global). (US or EU domiciled, in EUR)



Sources: Bloomberg, Lyxor International Asset Management. Data collection as at 09/02/2021. Fund flow data as at 12/02/2021 – source Morningstar. Past performance is not a reliable indicator of future performance.

The inflation conundrum

Higher price levels caused by a recovery in demand eventually result in positive corporate activity and then margin expansion. Positive corporate activity and higher demand leads to increased hiring, which pushes unemployment lower and feeds through higher pressures on wages. The Phillips curve tells us that there is an inverse relationship between price levels and unemployment. Wage inflation is therefore the last step before higher inflation and a necessary condition for a sustained recovery in price levels. Once inflation starts overshooting for a prolonged period, central banks start tightening target policy rates again in order to regain control of inflation.

Whether the ongoing normalisation in prices can be sustained in the longer term remains a source of heated debate. For now, inflation expectations have built up and the US yield curve has steepened (see charts 3 & 4). Ultimately, a sustained pick-up in inflation will have to be supported by higher income levels. As for Fed policy, it remains likely to keep an accommodative bias and wait for substantial progress before taking action. Current market expectations, as priced in the OIS market, indicate tapering is likely to start late 2021/early 2022, with no rate hike expected before 2023.

In previous cycles, when inflation was near 2.0%, markets would start anticipating hikes in the policy rate which would dampen inflation expectations. Market participants would consider a 2% inflation rate as a ceiling on inflation without expecting that previous shortfalls would be made up for. While the new guidance is not rule-based (and it remains to be seen how the FOMC will monitor inflation) a soft band of 1.5% to 2.5% around the inflation target seems reasonable. With the Fed's new approach, the PCE would need to overshoot at 2.3% for some time for average inflation to range around 2%.

Chart 3: Run-up in US inflation breakeven

US 10yr inflation breakeven (in %)

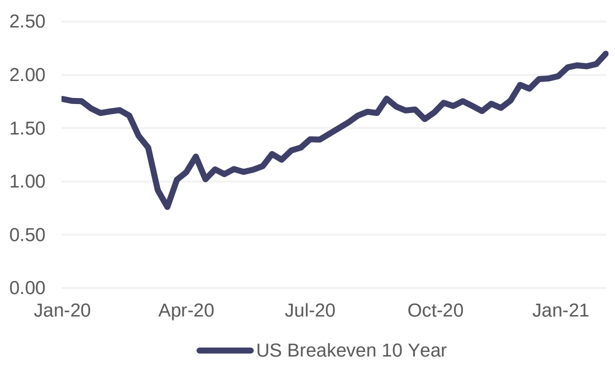
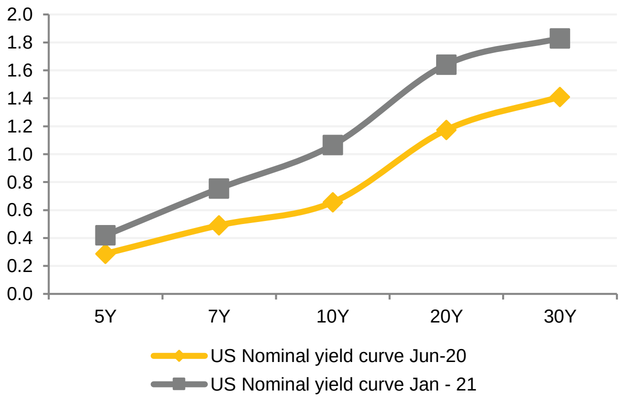


Chart 4: Bear steepening of the US yield curve

Slope of the US Yield curve (in %)



Sources: Bloomberg, Lyxor International Asset Management. Data collection as at 09/02/2021.
Past performance is not a reliable indicator of future performance

Ultimately, it remains extremely difficult to predict the inflation rate over the quarters ahead, as the coronavirus crisis has dramatically changed the outlook for developed countries, in ways that are still only just becoming clear. The question remains whether recent upside will last over time. The inflation outlook will also rely on governments' capability to help local economic activity. Expansive fiscal policies will play a major role in the rate of net credit growth per capita and help determine a new inflation baseline.

In the short term, the recovery in energy prices and global activity should support inflation. However, domestic underlying price pressures are likely to be contained for now, particularly in sectors such as airlines and hospitality, where prices remain depressed due to ongoing activity restrictions.

Longer term, inflation could also come from increasing budget deficits and escalating debt-to-GDP ratios, which could weaken currencies. It could also be driven by a continuation of the trend toward deglobalisation that started with the US-China trade war. Companies may now have another reason to bring supply chains back 'onshore': potential future waves of the virus.

Cherry pick your inflation exposure

Several factors should be assessed in an allocation to inflation-linked bonds:

- The pace of activity (business surveys)
- Inflation expectations (inflation breakeven rate levels)
- Headline inflation drivers (oil price)
- The outlook to central banks (yield curve slope)

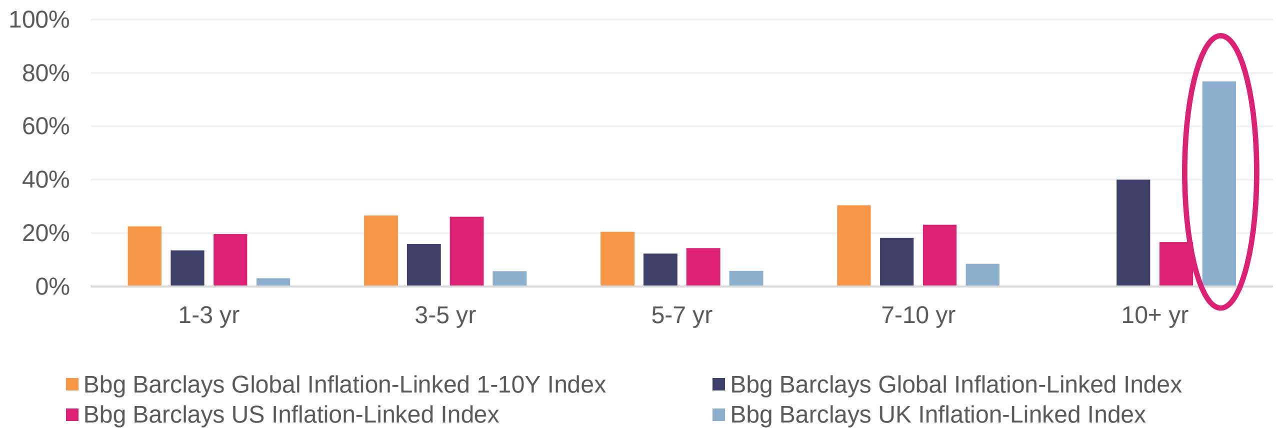
These factors will help in assessing countries specifics in a global portfolio along with duration risk exposure (sensitivity of a bond's price to changes in interest rates).

Country exposure and duration risk

The structure of inflation-linked bond markets can vary a lot from one country to another:

- In the US inflation-linked bond market, the largest ILB market, TIPS hold a duration of 8.2 years, slightly below the average duration of 6.9 years for Treasuries.
- In the eurozone a similar outcome is also observed, with 8.5 years average duration for inflation-linked bonds vs. 8.6 years for nominal bonds.
- Conversely, in the UK, the average duration of inflation-linked bonds is much higher – close to 21.1 years, while those of Gilts are around 12.6 *(Source: Bloomberg, as at 17/02/2021)*. 50% of the UK inflation-linked bond market also has a maturity above 20 years (almost 80% are above 10 years - see chart 6). Such high duration levels are due to the structure of the UK inflation-linked bond market. It has been specifically created to meet pension funds' and insurers' needs as the bonds pay out regular income, which rises in line with inflation, therefore meeting their liabilities – mainly income payments to pensioners. Those bonds hold very long maturities to match these liabilities.

Chart 5: The UK inflation market is structurally different
Index breakdown by maturity buckets (%)



Sources: Bloomberg, Lyxor International Asset Management. Data collection as at 31/01/2021.
Past performance is not a reliable indicator of future performance

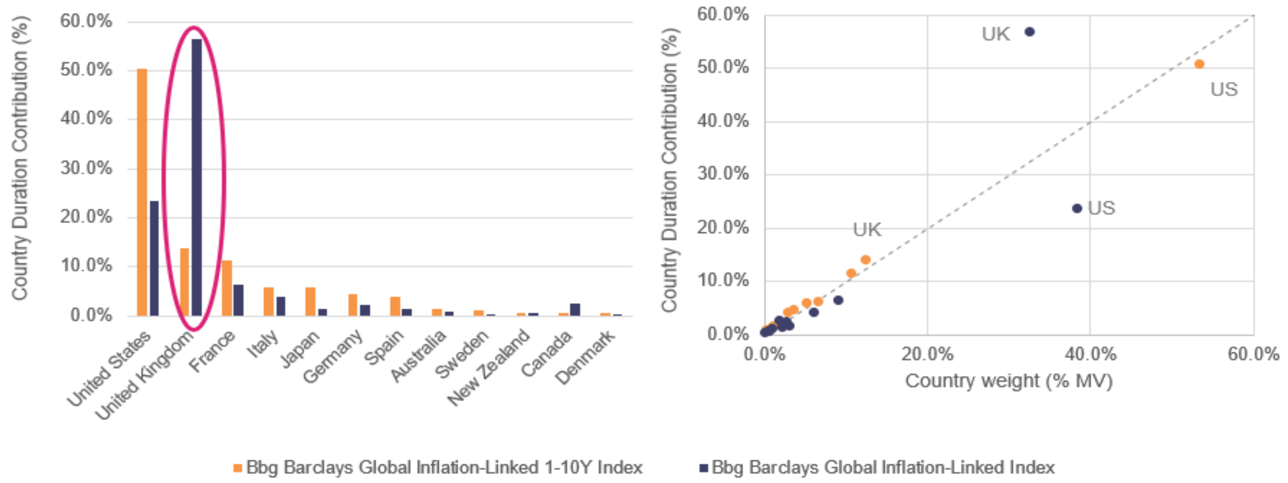
However, the longer a bond has until it matures, the higher the duration and amplification of the fall when real bond yields rise. Indeed, when inflation is on the rise, or deflationary pressures are easing, the rise in real bond yields eventually offsets the beneficial effect of the additional income that comes from an inflation-protected security. As a rule of thumb, every 1 basis point rise in the interest rate will knock 1 basis point off the capital value of a bond per year of duration. This risk is particularly relevant for markets exposed to higher duration, such as the UK.

The long duration of the UK ILB market means that its contribution in terms of duration risk will be higher than its market value weight in a global all-maturity exposure. Indeed, as shown in chart 6 below, while the UK represents only around 35% of the global all-maturity index, its contribution to duration is well above 50%.

One way to limit the impact of this risk in an allocation to global inflation-linked bonds is to constrain exposure to a narrower set of maturities (1-10 years) compared to an all-maturity exposure. Such an approach will considerably reduce the contribution to duration risk from markets with higher duration patterns, such as the UK, and align market value weight with contribution to duration risk.

Chart 6: Limiting duration risk in a global inflation-linked bond exposure

Contribution to duration *A more balanced approach vs the all maturity index*



Sources: Bloomberg, Lyxor International Asset Management. Data as at 31/01/2021. Past performance is not a reliable indicator of future performance

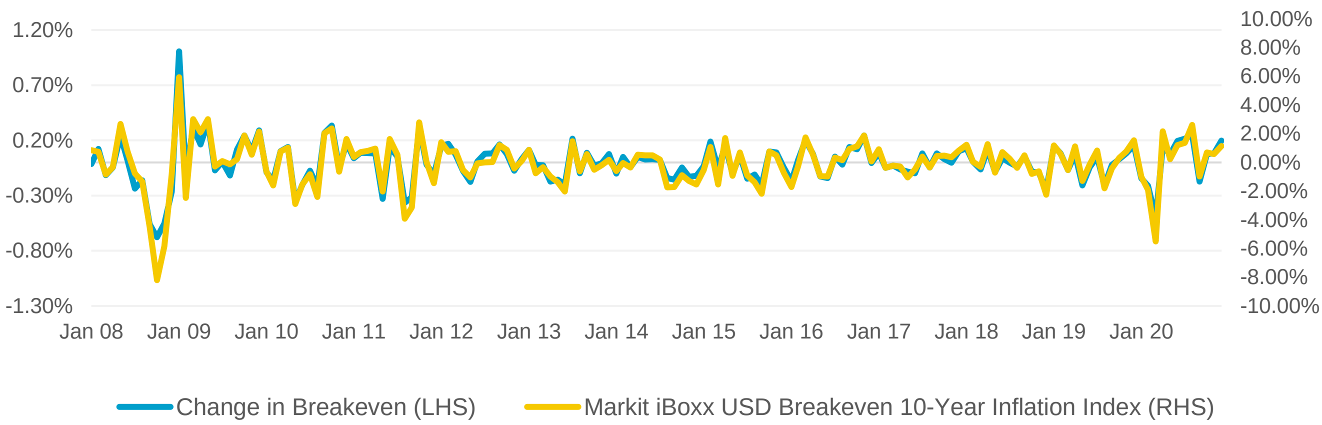
Inflation expectations strategies

Allocating inflation-linked bonds remains the conventional choice. However, inflation-expectations strategies may perform better, thanks to their close-to-neutral duration, at times when markets are underestimating just how high inflation might recover. The choice between inflation-linked bonds or inflation-expectations strategies depends on one's view of where inflation goes next.

Inflation expectations indices are designed to capture changes in the breakeven inflation rate. Due to the non-linear relationship between changes in yield, return, and fluctuations in market supply and demand, the magnitude of index movements compared to changes in breakeven inflation can vary. Therefore, the comparison between the index level and the breakeven rate can only be directional. The relationship between the changes in the two series is clearly visible, however (chart 7).

Chart 7: A 1bp change in USD breakeven corresponds to a ~8bps change in USD inflation expectations

*Markit iBoxx USD breakeven 10-year inflation vs changes in average breakeven**



Sources: Bloomberg, Lyxor International Asset Management. Data as at 31/01/2021. Past performance is not a reliable indicator of future performance.

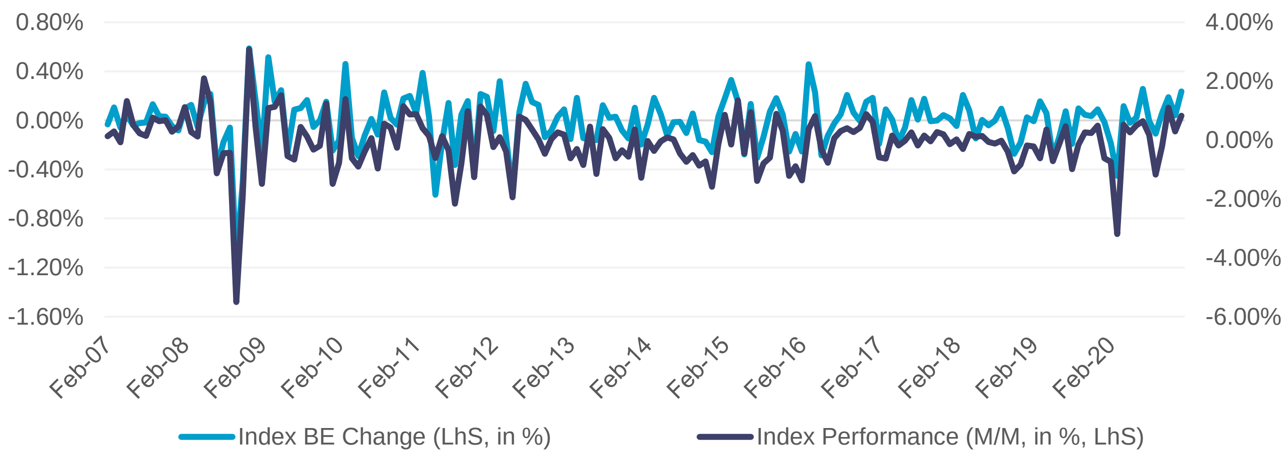
For US inflation expectations strategies, we find that a 1bp absolute change in the breakeven inflation rate historically corresponded to an approximately 8bps change in the index level. This multiplier effect reflects the duration exposure of the long TIPS basket in the structure.

In the eurozone, the structure of the inflation-linked bond market is more complex. It relies on the inflation patterns in each respective member's domestic economy, for example the end of the VAT rebate in Germany at the turn of the year. The market's size is also much smaller compared to the US and the UK. Therefore, to construct a strategy sensitive to EUR inflation expectations, you need to be exposed to a combination of countries along with a set of different bond maturities. In the case of the Markit iBoxx EUR Breakeven Euro-Inflation France & Germany Index, the index is exposed to both France and Germany with a greater emphasis on French bonds (58%) compared to German ones. *(Source: Bloomberg, as at 16/02/2021)*

The Markit iBoxx EUR Breakeven Euro-Inflation France & Germany Index is exposed to bond maturities ranging from 2 to 10 years on in the French OATi and German Schatz market. This more complex structure also influences the index's sensitivity to a change in a EUR inflation breakeven rate. The index's sensitivity will vary a lot over time compared to a similar strategy exposed to the US. The higher turnover in the inflation-linked bond basket will affect the duration of that basket. The strategy will also be exposed to a broader range of inflation breakeven points at different maturities from 2 to 10 years compared to a US strategy focusing on a range closer to the 10-year point.

The duration of the index's EUR ILB basket is currently around 6.3 years but can vary a lot over time. However, a linear regression analysis based on historical data suggests that, over the longer term, the multiplier effect for a 1% absolute change in inflation rate tends to be closer to 4% change in the index level.

Chart 8: A 1% change in EUR breakeven corresponds to a ~4% change in EUR inflation expectations
*Markit iBoxx EUR breakeven Euro – inflation France & Germany vs changes in average breakeven**



*based on monthly observation. Sources: Lyxor International Asset Management, Markit. Data as at 31/12/2020.
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Have a look at our Inflation & Rates Explorer for more of the performance of USD and EUR inflation-linked bonds and inflation expectations strategies.

Related indices for an exposure to Inflation-linked bonds

Index Exposure	Index name	Bloomberg ticker
Inflation Linked bonds		
Global Inflation-linked bonds	Bloomberg Barclays Global Inflation-Linked 1-10 Year Index Unhedged USD	LR10TRUU Index
	The index is representative of the government local currency inflation-linked debt from developed market countries	Duration: 5.13
US Inflation-Linked bonds	Bloomberg Barclays US Govt Inflation-Linked All Maturities TR Index	BCIT1T Index
	The index offers an exposure to the US Treasury Inflation Protect Securities (TIPS Market)	Duration: 8.4
EUR Inflation-Linked bonds	Bloomberg Barclays Euro Inflation Linked - All CPI Index	LF96TREU Index
	The Index includes euro-denominated inflation-linked government bonds within the euro zone with maturities greater than one year.	Duration: 8.36
UK Inflation-linked bonds	FTSE Actuaries Govt Securities UK Index Linked TR All Stocks	FTRFILA Index
	The index provides exposure to Sterling denominated inflation-linked bonds issued by the UK Governments, which cover the main inflation-linked sovereign and sub-sovereign issues.	Duration: 21.22
Inflation expectations		
US 10-Year Inflation Expectations	Markit iBoxx USD Breakeven 10-Year Inflation Index	IBXXUBF1 Index
	The index is representative of the performance of a long position in the 6 last issuances of U.S. 10-year Treasury Inflation-Protected securities and a short position in U.S. Treasury bonds with adjacent durations. The difference in yield between these bonds is commonly referred to as a "breakeven rate of inflation" and is considered to be a measure of the market's expectations for inflation over a specified period of time.	
USD 2-10 Year Inverse Inflation expectations	Markit iBoxx USD Inverse Breakeven 10-Year Inflation Index	IBXXUIBE Index
	The index is representative of the performance of a short position in the 6 last issuances of U.S. 10-year Treasury Inflation Protected securities and a long position in U.S. Treasury bonds with adjacent durations.	
EUR 2-10 Year Inflation expectations	Markit iBoxx EUR Breakeven Euro-Inflation France & Germany Index	IBXXEBF1 Index
	The index is designed to provide exposure to breakeven inflation by entering into a long position in inflation-linked bonds issued by France and Germany and a short position in France and Germany sovereign bonds with adjacent durations.	
EUR 2-10 Year Inverse Inflation expectations	iBoxx EUR Inverse Breakeven Euro-Inflation France & Germany	IBXXEIBE Index
	The index is representative of a short position in inflation-linked bonds issued by France and Germany and a long position in France and Germany sovereign bonds with adjacent durations.	

Source: Lyxor International Asset Management, data as at 12/02/2021

For more information on Lyxor ETF's Inflation range please contact your Lyxor ETF sales representative.

Knowing your risk

It is important for potential investors to evaluate the risks described below and in the fund prospectus on our website www.lyxoretf.com

Capital at risk
ETFs are tracking instruments: Their risk profile is similar to a direct investment in the Underlying index. Investors' capital is fully at risk and investors may not get back the amount originally invested.

Replication risk
The fund objectives might not be reached due to unexpected events on the underlying markets which will impact the index calculation and the efficient fund replication.

Counterparty risk
With synthetic ETFs, investors are exposed to risks resulting from the use of an OTC swap with Societe Generale. In-line with UCITS guidelines, the exposure to Société Générale cannot exceed 10% of the total fund assets. Physically replicated ETFs may have counterparty risk if they use a securities lending programme

Underlying risk
The Underlying index of a Lyxor ETF may be complex and volatile. For example, when investing in commodities, the Underlying index is calculated with reference to commodity futures contracts exposing the investor to a liquidity risk linked to costs such as cost of carry and transportation. ETFs exposed to Emerging Markets carry a greater risk of potential loss than investment in Developed Markets as they are exposed to a wide range of unpredictable Emerging Market risks.

Currency risk
ETFs may be exposed to currency risk if the ETF is denominated in a currency different to that of the Underlying index they are tracking. This means that exchange rate fluctuations could have a negative or positive effect on returns.

Liquidity risk

Liquidity is provided by registered market-makers on the respective stock exchange where the ETF is listed, including Societe Generale. On exchange, liquidity may be limited as a result of a suspension in the underlying market represented by the Underlying index tracked by the ETF; a failure in the systems of one of the relevant stock exchanges, or other market-maker systems; or an abnormal trading situation or event.

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