Fixed income in a rising inflation environment

M&G Public Fixed Income

March 2021

- The prospect of higher inflation has become a key area of focus for investors amid unprecedented levels of fiscal and monetary stimulus and the reopening of economies around the world.
- While inflation is traditionally seen as negative for bonds, we look at a number of fixed income strategies that we believe could offer protection or potentially even benefit during a period of rising inflation.
- Alongside traditional inflation-linked bonds, we outline several other fixed income assets which we feel could offset the negative impact of rising inflation.

Is inflation finally coming back?

The prospect of higher inflation and what this means for financial markets has become a key area of focus for investors in recent months. Some factors could indeed push inflation higher, in our view, in particular the unprecedented levels of fiscal and monetary stimulus, combined with the release of pent-up demand as the global economy reopens. Against this, we believe that some longer-term factors such as the potential long-term economic damage caused by the pandemic could see inflationary pressures subside as stimulus packages unwind.

While inflation is traditionally seen as negative for bonds, we outline a number of fixed income strategies and instruments that we believe could offer protection or potentially even benefit during a period of rising inflation.

The case for inflation

- **Unprecedented levels of stimulus from governments and central banks around the world**. Importantly, we are now seeing combined monetary and fiscal stimulus. This is in contrast to the decade following the financial crisis, when we saw expansionary monetary policy, but restrictive fiscal policy as governments pursued policies of austerity.
- **The likelihood of a strong economic rebound as COVID lockdown measures are withdrawn**. The recovery could be further fuelled by the release of pent-up demand, with household savings standing at record levels in many parts of the world. The possibility of bottlenecks in the global supply chain as producers struggle to meet demand could be another source of inflationary pressure.
- **In the shorter-term, there are several other factors that could push inflation higher**, such as base effects from low commodity prices in 2020 and higher shipping costs due to container shortages (see Figure 1). Looking ahead, we would also highlight the prospect of increases in the US minimum wage and a further rise in global food prices.
- **On a longer-term view, the need to tackle the huge levels of government debt** may incentivise central banks to allow inflation to run slightly hot without tightening interest rate policy in the way we are used to. We have already seen the Federal Reserve move from targeting 2% inflation to targeting a long-run average, giving it the freedom to allow inflation to run a little high following a period of lower inflation.

The case against inflation

- **The powerful forces that have kept inflation low for the past few decades – such as globalisation, ageing populations and technology -- are unlikely to reverse overnight**. You would therefore have to be pretty confident that something has fundamentally changed in the way the global economy functions before becoming too concerned about a sustained rise in inflation.
- **The potential long-term economic damage caused by the pandemic could also have a deflationary impact.** It is far from certain that unemployed and

furloughed workers will walk straight back into their jobs, while certain sectors (most obviously high street retail) may never fully recover. Meanwhile, if the shift to working more from home becomes permanent, we could see significant downward pressure on city centre rental markets.

With so many inflationary and deflationary forces to consider, the future path of inflation will remain as unpredictable as ever. Nevertheless, we must acknowledge that this is the first time for many years that we have seen the emergence of several forces that are likely to put upward pressure on inflation, at least in the near term. Given these uncertainties, we think it would be prudent to include at least some inflation-linked protection within a well-balanced portfolio.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

Figure 1. Shipping costs have more than tripled from a year ago

Source: Bloomberg, shipping cost data 10 February 2021

Fixed income investing in a rising inflation environment

Inflation is usually seen as negative for bonds as the real value of their fixed payments is eroded, with longer-dated bonds especially exposed to a prolonged period of high inflation. In an inflationary environment, bonds may also be negatively affected by rising interest rates as central banks start to tighten monetary policy.

However, there are a number of fixed income instruments and strategies that we believe could help to offset the negative impact of inflation, or potentially even benefit from a period of higher inflation. The following are some of the key strategies we may implement across our fixed income funds in a reflationary environment.

Inflation-linked government bonds

Inflation-linked bonds provide the most conventional means of inflation protection, since their payments are automatically adjusted in line with an official measure of inflation. The inflation-linked government bond market covers a wide range of sovereign issuers across different maturities. When investing in these assets, we assess the level of inflation that is being priced into a particular instrument, and compare this to our own inflation expectations. Based on this analysis, we will seek to gain inflation protection in what we consider to be the most attractively valued part of the market.

Inflation-linked corporate bonds

While this is a much smaller market than the government linkers market, there are also a number of companies that issue inflation-linked bonds. Corporate linkers can offer an attractive source of additional yield compared to what is available on index-linked government bonds. To expand this universe, it is also possible to use derivatives to create synthetic inflation-linked corporate bonds. This would typically be done by selling protection on a credit default swap (CDS) contract to gain exposure to the corporate bond, and pairing this with inflation-linked government bonds to obtain the inflation-linked element.

Duration hedging

Inflation-linked bonds can contain high levels of interest rate risk and can therefore be vulnerable to rising interest rates. This is especially the case for index-linked gilts, which are typically very long-dated. Since interest rates often rise in a rising inflation environment, it may therefore be desirable to hedge some or all of a bond's interest rate exposure using derivatives, such as futures or interest rate swaps.

FRNs and short-dated credit

Steady inflation alongside economic growth is often supportive for credit, so in these periods we may look to invest in corporate issues with a low sensitivity to movements in interest rates. For instance, floating rate notes (FRNs) pay a coupon that is regularly adjusted in line with short-term interest rates and can therefore benefit from a higher coupon if interest rates rise. Short-dated corporate bonds should also prove relatively resilient in a rising yield environment given their naturally short duration.

Sector and currency positioning

Allocating to sectors that would be expected to perform well in an inflationary environment may offer another way of benefiting from rising inflation. One option could be to invest in bonds issued by companies that stand to benefit from rising commodity prices, such as those in the basic industry or energy sectors. Banks and other financials also tend to perform well in a more reflationary environment. Alternatively, some of our flexible fixed income strategies may be able to invest in currencies that tend to be positively correlated to commodity prices.

What our fund managers are doing

Wolfgang Bauer, manager of the M&G (Lux) European Inflation Linked Corporate Bond Fund

"If and when COVID-lockdowns are eventually withdrawn across Europe, there is reason to believe that the economic rebound will put upward pressure on inflation. Base effects and rising commodity prices are also likely to have a near-term inflationary impact (see Figure 2). While European breakeven rates have increased in recent months, I believe they still offer reasonably cheap protection against the risk of rising inflation. Within the M&G (Lux) European Inflation Linked Corporate Bond Fund, I remain focused on inflation-linked government bonds and high quality credit, while maintaining a short duration stance to help limit the negative impact of any future rise in interest rates."

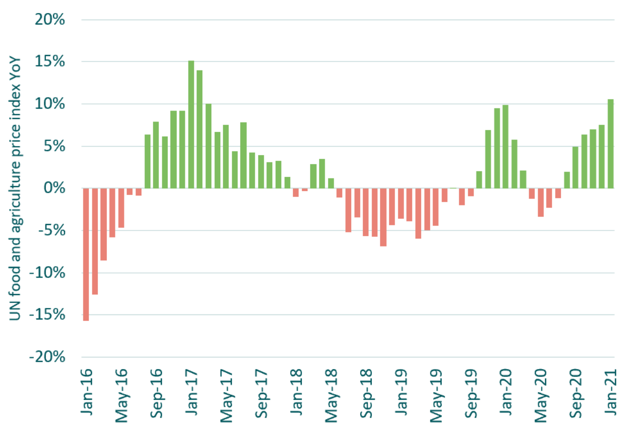
The fund may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the fund will incur a loss. The fund's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the fund.

Jim Leaviss, manager of the M&G (Lux) Global Macro Bond Fund

"I currently see good value in US Treasury Inflation Protected Securities (TIPS), which I believe continue to offer cheap insurance against the risk of a rise in US inflation. Within the M&G (Lux) Global Macro Bond Fund I also have exposure to a number of currencies that I would expect to benefit from the recent strength in commodity prices, such as the Norwegian krone or the Australian dollar."

The fund is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.

Figure 2. Rising commodity prices to pose short-term inflationary pressures



Source: Bloomberg, 28 February 2021

Past performance is not a guide to future performance

Matthew Russell, manager of the M&G (Lux) Short Dated Corporate Bond Fund

"The M&G (Lux) Short Dated Corporate Bond Fund is mainly focused on short duration corporate bonds and FRNs, instruments which I would expect to hold up well in an inflationary environment while offering an attractive source of yield. I see FRNs, in particular, as offering skewed upside potential in the current low interest rate environment. This is because the coupon of an FRN can't fall below zero no matter how negative interest rates become, but there is potentially no limit to how far the coupon could increase if rates rise".

James Tomlins, manager of the M&G (Lux) Global Floating Rate High Yield Fund

"I believe high yield FRNs provide an attractive way to play the reflation theme and to protect against rising interest rates. This was demonstrated in February as concerns over rising inflation triggered a sharp sell-off in global government bonds. In contrast to many fixed income assets, high yield FRNs proved resilient during this period, with their floating rate nature helping to offset the negative impact of rising bond yields".

Further key risks associated with the funds mentioned above can be found in the relevant fund's Key Investor Information Document (KIID).

The funds allow for the extensive use of derivatives.

For M&G (Lux) European Inflation Linked Corporate Bond Fund, please note:

The fund may invest more than 35% in securities issued by any one or more of the governments listed in the fund prospectus. Such exposure may be combined with the use of derivatives in pursuit of the fund objective. It is currently envisaged that the fund's exposure to such securities may exceed 35% in the German government, although this may vary subject only to those listed in the prospectus.

For M&G (Lux) Global Macro Bond Fund, please note:

The fund may invest more than 35% in securities issued by any one or more of the governments listed in the fund prospectus. Such exposure may be combined with the use of derivatives in pursuit of the fund objective. It is currently envisaged that the fund's exposure to such securities may exceed 35% in the governments of Germany, Japan, UK, USA although these may vary subject only to those listed in the prospectus.

UCITS HAVE NO GUARANTEED RETURN, AND PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE

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