Fixed income investing in an inflationary environment

M&G Public Fixed Income

February 2022

- With inflationary pressures continuing to build, central banks have sent out a clear message: monetary policy is too loose and will need to be reined in over the coming months.
- To help navigate a period of more persistent inflation, we believe fixed income investors will need to maintain a flexible and active approach, while carefully managing interest rate risk.
- We highlight two of M&G's more defensive fixed income strategies, which are specifically designed to withstand an environment of higher inflation and rising interest rates.

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested. Where any performance is mentioned, please note that past performance is not a guide to future performance.

Inflation becoming more persistent

Inflation was undoubtedly the main story of 2021 as surging energy prices and supply-chain bottlenecks saw consumer prices rise at their fastest pace for nearly 40 years. For much of the year, central banks held to the narrative that inflation would be transitory and that pressures would gradually ease. However, by the latter stages of 2021 it became clear that inflation was becoming more ingrained. US inflation (Consumer Prices Index) remained above 5% throughout the second half of the year and by December had reached 7%, its highest level since 1982.

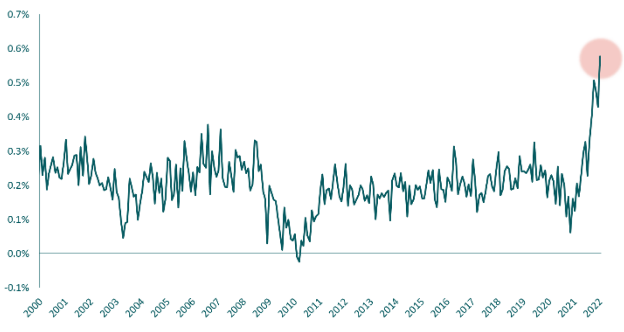
With inflation gathering momentum, central banks have shifted to a much more hawkish stance over the past couple of months. In November, the US Federal Reserve announced that it would start to taper its bond-buying programme, with the pace of tapering subsequently doubled at the December meeting. The Fed policymakers have since indicated that they expect to implement a series of rate hikes over the coming months, with futures markets currently pricing in around five hikes in 2022.

Looking ahead, we see increasing evidence that inflation is likely to remain elevated for some time. In particular, inflation is becoming more broad-based and is no longer confined to a few specific items, such as fuel prices or used cars. The best way to measure this is by looking at median inflation (see Figure 1), as this excludes any big distortions that can skew mean inflation calculations. Median inflation shows that the majority of items are now seeing significant price increases.

Recent employment data points to a further strengthening of the US labour market and we think this will lead to upward pressure on wages. To prevent inflation becoming too entrenched, we think the Fed may be forced to tighten policy more quickly than previously anticipated, with many commentators now expecting the first rate hike to occur in March. This would follow on from the Bank of England, which already started raising interest rates at the end of 2021. While inflationary pressures remain more subdued in Europe, we think the European Central Bank (ECB) could also start to tighten policy at some point in 2022.

Please note that 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. Inflation is everywhere – median US CPI (month-on-month



Source: M&G, Bloomberg, 31 January 2022

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Fixed income strategies to mitigate rising inflation

With the prospect of rising inflation and central bank rate hikes, clients may be questioning whether now is the right time to be holding bonds. Inflation is usually negative for bonds as the real value of their fixed payments is eroded, while rising interest rates may also negatively affect the value of conventional fixed income assets.

However, we believe there are a number of strategies that can be used to help mitigate the negative impact of rising inflation or higher interest rates. Firstly, interest rate risk or duration (the sensitivity to interest rate changes) should be carefully managed. Longer-dated fixed income assets are most susceptible to rising interest rates, so a strategy which focuses on shorter-dated bonds may offer greater resilience in a rising rate environment.

Secondly, it is worth keeping in mind that an inflationary environment can often be quite supportive for credit valuations. This makes sense, since inflation is often seen during periods of economic expansion, when companies would normally be well-placed to grow their earnings and reduce their levels of debt. Therefore keeping an exposure to high quality credit, while limiting interest rate risk, may offer a sensible strategy for those worried about higher inflation.

Finally, we would stress the importance of maintaining a flexible and active approach, as this allows the manager to adjust positioning in response to a changing economic backdrop and to focus on the areas of the market that look best placed to withstand a more inflationary environment.

Short duration	High quality credit	Active approach
Protect against rising rates	*Retain upside potential*	*Navigate the evolving environment ahead*

For investors concerned about the negative impact of rising inflation, we highlight two defensive, fixed income strategies that are specifically designed to withstand an environment of higher inflation and rising interest rates.

M&G (Lux) European Inflation Linked Corporate Bond Fund

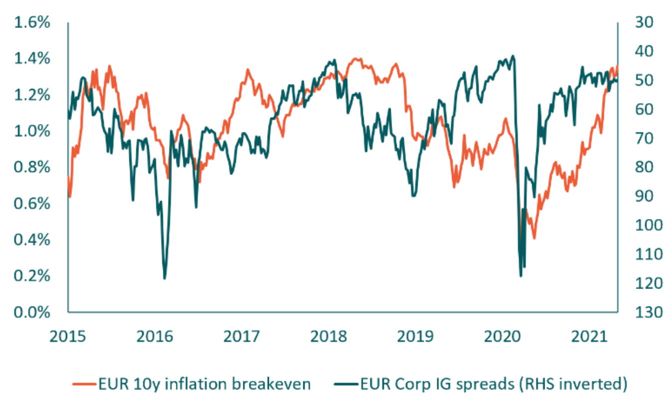
The **M&G (Lux) European Inflation Linked Corporate Bond Fund** offers a distinctive solution for investors looking to include an element of inflation protection in their portfolios. The fund combines inflation-linked protection with the attractive yields that can be found on high-quality corporate bonds. The fund also offers a distinctive short duration profile, meaning a low sensitivity to interest rate changes. The fund is actively managed and performance is measured against a comparator benchmark – the Eurostat Eurozone Harmonised Index of Consumer Prices – although portfolio construction is not constrained by it.

Inflation-linked exposure – the fund will typically hold a significant allocation to inflation-linked bonds. These instruments provide the most direct form of inflation protection since their payments are automatically adjusted in line with an official measure of inflation. The fund seeks to capture the most attractively valued opportunities across global inflation-linked bond markets (a minimum 90% of the fund is in euro or hedged back to euro). A key part of this assessment is to consider the level of inflation that is being priced into a particular instrument, and to compare this with our own inflation expectations.

Short duration profile – the fund has a distinctive duration profile that is significantly shorter than that of a traditional index-linked government or corporate bond fund. This is designed to reduce volatility and mitigate the negative impact of rising bond yields, which are common in an inflationary environment. Duration is typically maintained between 0-2 years, although the fund manager has the flexibility to position the fund outside this range if considered appropriate.

High quality credit – the fund's allocation to inflation-linked bonds issued by companies, provides an additional source of yield compared to what can be obtained on index-linked government bonds. As well as helping the fund achieve its long-term inflation-linked goal, investing in credit also allows us to benefit from the strong correlation between credit and inflation dynamics. Companies typically perform well during period of economic growth and modest inflation, and this is reflected in the fact that credit valuations and inflation valuations have historically moved in line with each other (see Figure 2).

Figure 2. Strong correlation between credit and inflation dynamics.



Breakeven rates indicate inflation expectations. IG = investment grade

Past performance is not a guide to future performance

Source: M&G, Bloomberg, 31 December 2021

Active, flexible approach – the manager can freely adjust the fund's duration, credit and inflation exposure based on his macro outlook and assessment of valuations. As well as investing in inflation-linked government and corporate bonds, the fund can also invest in a broad range of other instruments that would be expected to perform well in an inflationary environments, such as floating rate notes (FRNs).

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.

M&G (Lux) Short Dated Corporate Bond Fund

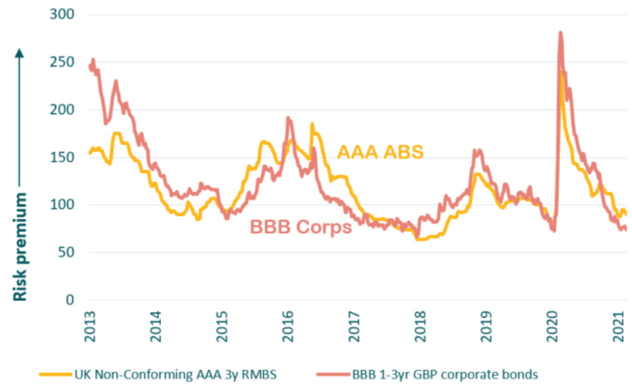
The **M&G (Lux) Short Dated Corporate Bond Fund** offers investors a clear, defensive proposition that seeks to mitigate the negative impact of rising interest rates. The fund has a duration profile duration between 0-3 years, while providing exposure to predominantly investment grade credit (high quality bonds issued by companies) from anywhere in the world. The fund is actively managed and performance is measured against a comparator benchmark – the Markit iBoxx EUR Corporates 1-3 year Index – but the benchmark does not constrain portfolio construction. There are three key ways in which the fund seeks to add value.

Active credit selection – the fund has a highly active approach which is able to draw on the expertise of M&G's in-house credit research team as we seek to identify the most compelling opportunities across global credit markets. In a more volatile market environment, with increasing dispersion between individual credit valuations, we believe the current backdrop can provide a rich source of opportunities for active managers.

ABS complexity premium – the fund is able to invest in asset-backed securities (ABS), an area where M&G has long-running experience. The complexity of researching ABS is a key reason, in our view, why this asset class offers investors a risk premium well in excess of regular corporate bonds. For instance, investing in AAA rated ABS offers a similar level of credit spread to BBB rated corporate bonds (see Figure 3).

Floating rate exposure – the fund can also take exposure to floating rate notes (FRNs) which pay coupons that are adjusted in line with short-term interest rates. In this way, FRNs provide not only protection, but a way of potentially benefiting from any future increase in interest rates.

Figure 3. ABS complexity premium. AAA-rated ABS offers a similar risk premium to BBB corporates.



Past performance is not a guide to future performance

Source: ICE BofA indices, JP Morgan, 31 December 2021

Navigating a more inflationary environment

As inflationary pressure continue to build, central banks have sent out a clear message: monetary policy is too loose and will need to be reined in over the coming months. Government bond yields have already increased sharply since the beginning of 2022 as markets have started to price in a much more aggressive pace of interest rate hikes.

While such an environment is normally seen as being negative for bonds, as we hope to have outlined here we believe there are a number of strategies that can be followed to help offset these headwinds. In particular, we think that an active approach, a short duration stance and a focus on high quality credit will be key to navigating a period of more persistent inflation.

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The funds allow for the extensive use of derivatives.

The funds 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 and the US, although these may vary subject only to those listed in the prospectus.

Investing in these funds means acquiring units or shares in a fund, and not in a given underlying asset such as a building or shares of a company, as these are only the underlying assets owned by the funds.

Further risks associated with the funds can be found in the fund's Key Investor Information Document.

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