5th March 2021

Inflation-linked gilts don't provide short-term inflation protection

- We look at the YTD performance of "inflation-hedge" asset classes in GBP terms, with reference to US and UK 5Y BEIR
- Commodities & Industrial metals have provided best defence, Gold and Inflation-Linked Gilts have provided least protection
- A layered approach to portfolio protection makes sense with Liquid Real Asset ETFs for the near- and medium-term, and inflation-linked bonds and equity income for the long-term

Focus on inflation

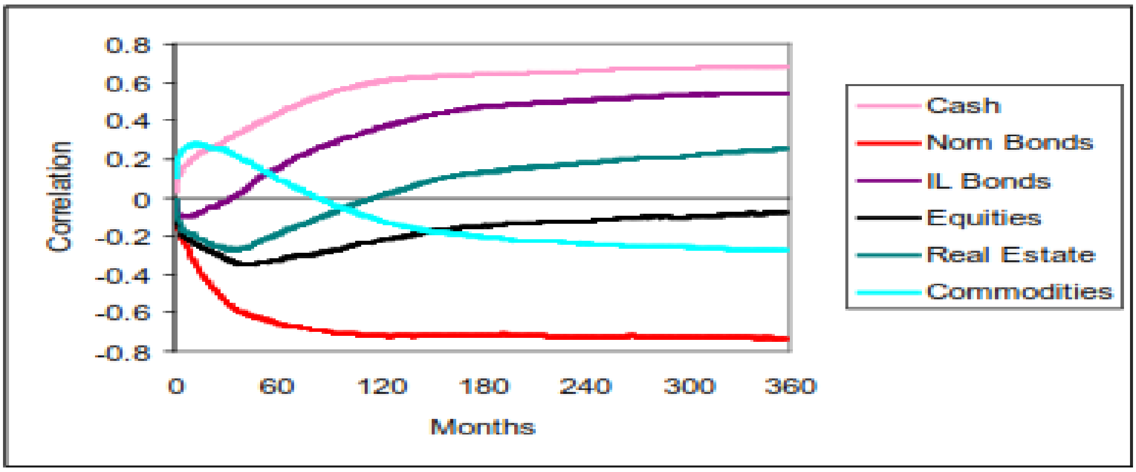
In our recent Focus on Inflation webinar we cited the study by Briere & Signori (2011) looking at the long run correlations between asset returns and inflation over time.

We highlighted the "layered" effect of different inflation protection strategies (1973-1990) with cash (assuming interest rate rises), and commodities providing best near-term protection, inflation linked bonds and real estate providing medium-term protection, and equities providing long-term protections. Nominal bonds were impacted most negatively by inflation.

Figure 1

Correlations between asset returns and inflation depending on the investment horizon

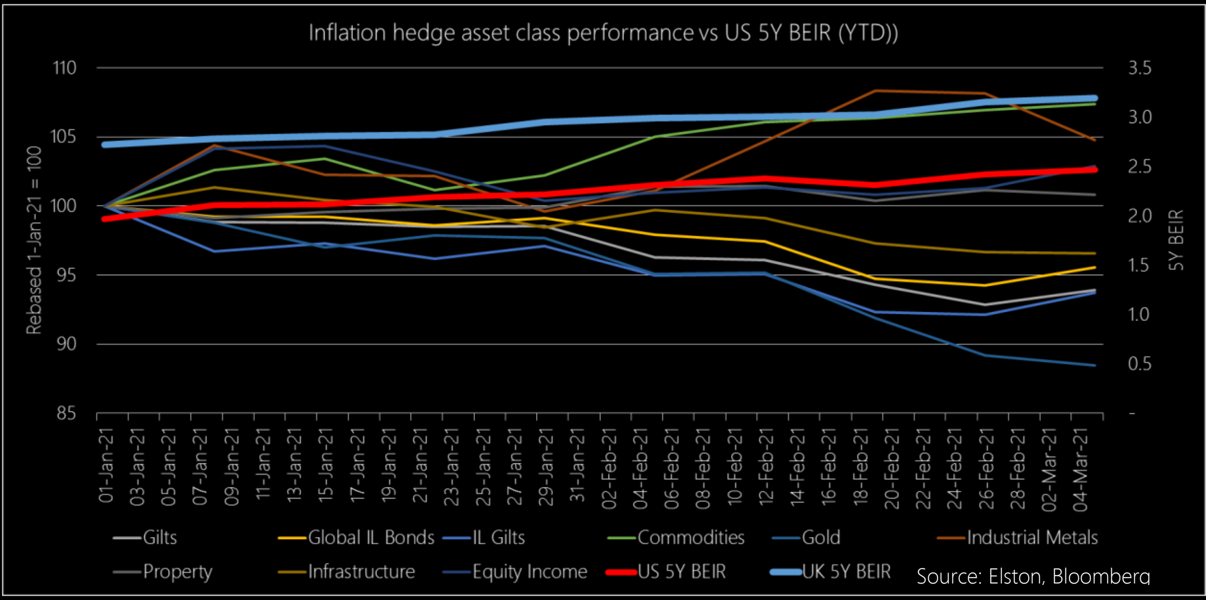
January 1973—December 1990



Source: Briere & Signori (2011), BIS Research Papers

Given the growing fears of inflation breaking out, we plotted the YTD returns of those "inflation-hedge" asset classes, in GBP terms for UK investors, with reference to the US and UK 5 Year Breakeven Inflation Rates (BEIR).

Figure 2: Inflation-hedge asset class performance (GBP, YTD) vs US & UK 5Y BEIR



Source: Elston research, Bloomberg data, as at 5th March 2021

Winners and Losers so far

We looked at the YTD performance in GBP of the following broad "inflation hedge" asset classes, each represented by a selected ETF: Gilts, Inflation Linked Gilts, Commodities, Gold, Industrial Metals, Global Property, Multi-Asset Infrastructure and Equity Income.

Looking at price performance year to date in GBP terms:

- The best protections thus far have been Broad Commodities +7.4% and Industrial Metals +4.8%
- The worst protections thus far have been Gold -11.5% and Inflation Linked Gilts -6.3%.

So Inflation-Linked Gilts don't provide inflation protection?

Not in the short run, no.

UK inflation linked gilts have an effective duration of 22 years, so are highly interest rate sensitive. Fears that inflation pick up could lead to a rise in interest rates therefore reduces the capital value of those bond (offset by greater level of income payments, if held to maturity).

So whilst they provide medium- to long-term inflation protection, they are poor protection against a near-term inflation shock.

Conclusion

In conclusion, we observe:

- To integrate an inflation-protection strategy within a portfolio, a layered approach to inflation-hedge assets makes sense to mitigate inflation risk over different time frames.
- Inflation-linked gilts, owing to their long duration, will not respond well near-term to fears of potential interest rate increases and or interest rate volatility.
- Each inflation-hedging asset class is available through liquid, transparent and cost-efficient ETFs, or as a portfolio of Liquid Real Assets ETFs.

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