11th March 2022

Living with inflation, holding real assets

- Nominal bonds suffer in an inflationary regime
- Real assets provide resilience, but are more volatile
- Market-implied rates suggest inflation is here to stay for the medium-term

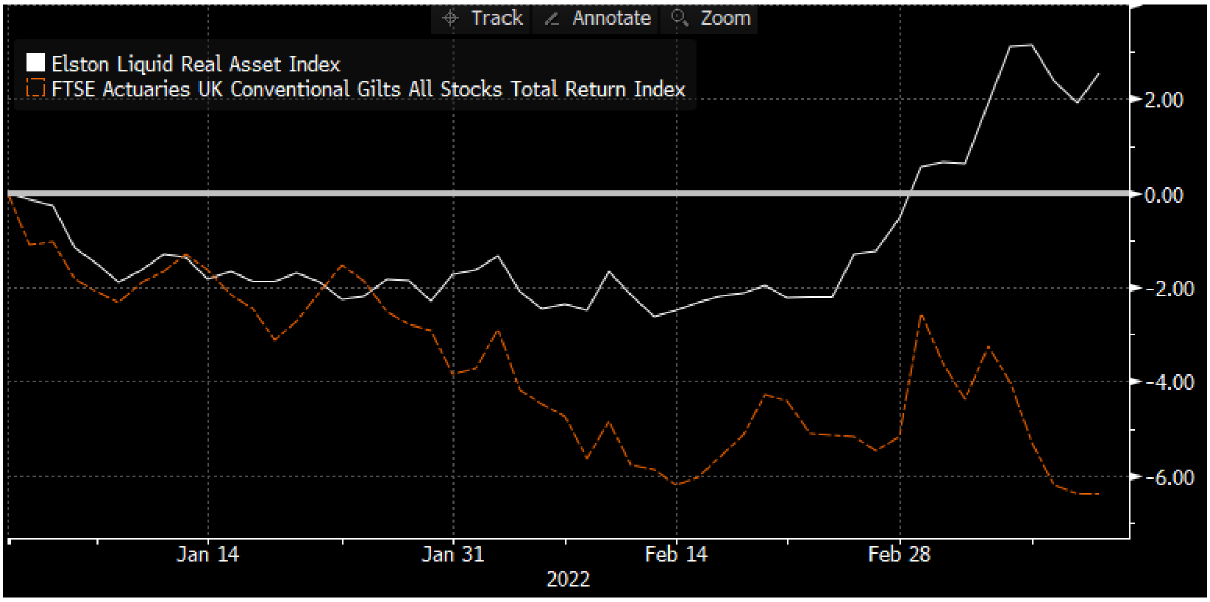
Nominal bonds suffer in an inflationary regime. Real assets provide resilience in an inflationary regime, but have higher volatility. Our Liquid Real Assets index combines rate-sensitive assets and inflation-sensitive assets to capture real asset return patterns, with bond-like volatility.

Underlying exposures to Gold, Energy, Precious Metals, Agriculture and Industrial Metals have all driven performance of the index year-to-date.

The index has outperformed gilts by 8.91ppt with similar risk characteristics.

Portfolio managers and advisers who are looking to 1) reduce or remove nominal bond exposure, 2) want real asset exposure for inflation protection, and 3) want to maintain volatility budget can consider a lower-risk real assets strategy as an alternative.

Fig.1. Liquid Real Assets Index performance



Source: Bloomberg data, as at 11th March 2022

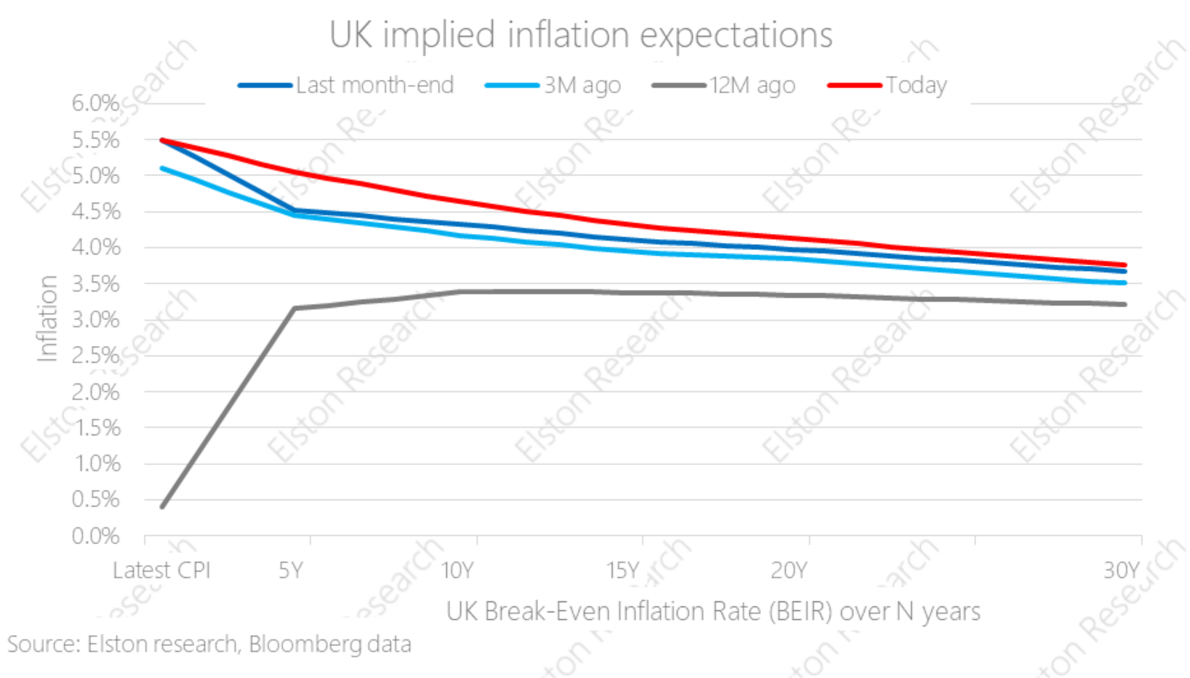
Living with inflation

Rather than relying on forecasts that become rapidly out of date, we look at market-implied inflation expectations as represented by the Break-Even Inflation Rate "BEIR" over different time horizons. To understand BEIRs, please refer to our [Focus on Inflation CPD webinar].

Similar to a "yield curve", comparing how this implied inflation rate curve has changed over time, gives an indication of who inflation expectations have changed.

The chart below compares the current BEIR curve currently, and how it looked 3 months ago and 12 months ago. The change is staggering. It shows that market implied inflation rate is 5%pa for 5 years (from ~3% a year a go), and over 4.5%pa for next 10 years (from ~3.5% a year ago). The 30 year changes are less pronounced.

Fig.2. UK inflation-rate expectations "BEIR curve"

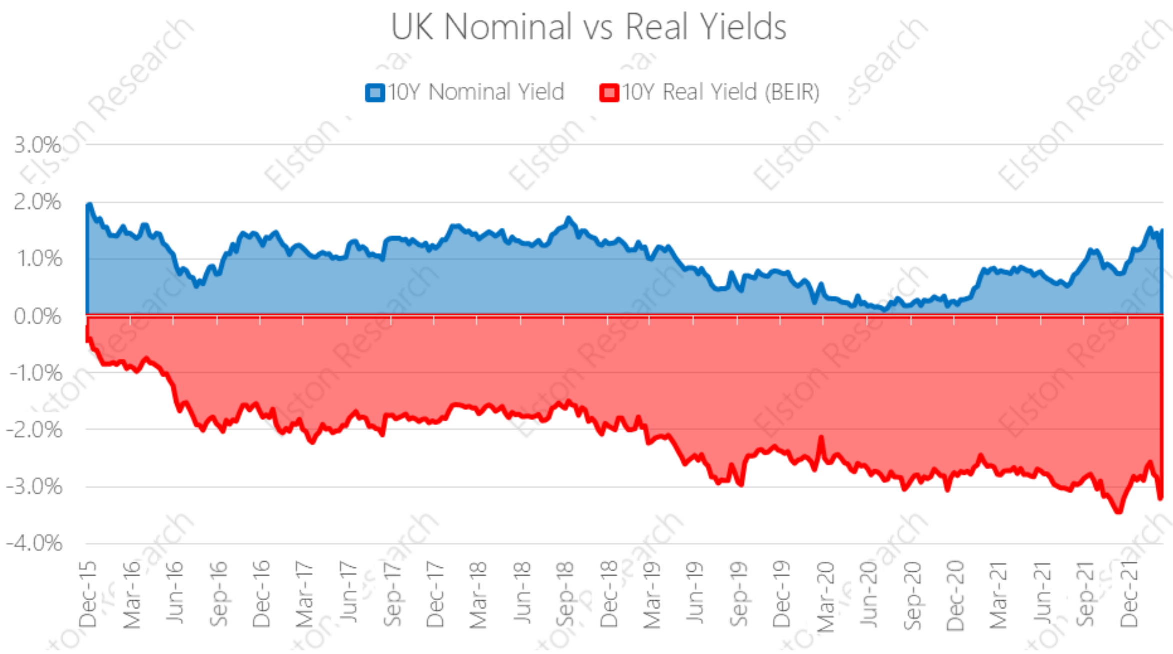


Source: Elston research, Bloomberg data, as at 9th March 2022

The pressure on nominal bonds

Although bonds are traditionally a defensive asset, focusing on nominal bond yields does not capture changing inflation expectations. By adjusting nominal 10 year government bond yields by the 10 year BEIR, we get a picture of "real yields". Whilst real yields remain persistently negative, bonds remain unattractive, relative to risk assets.

Fig.3. Real UK gilt yields remain negative



Source: Elston research, Bloomberg data, as at 9th March 2022

Summary

Inflation is here to stay for the medium-term, and negative real yields keep nominal bond under pressure. [Adapting portfolios for inflation] is key.

Research Team

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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