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ASSET MANAGEMENT

TIP OF THE ICEBERG

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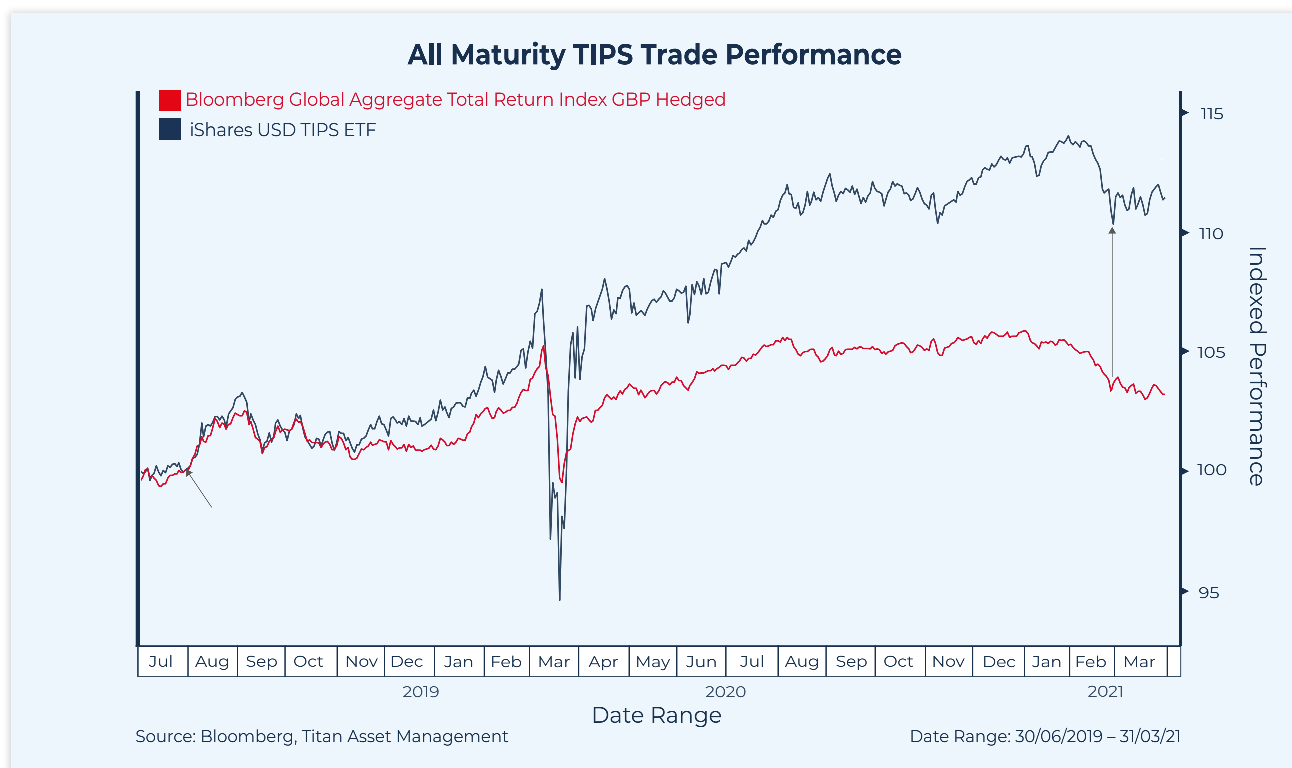
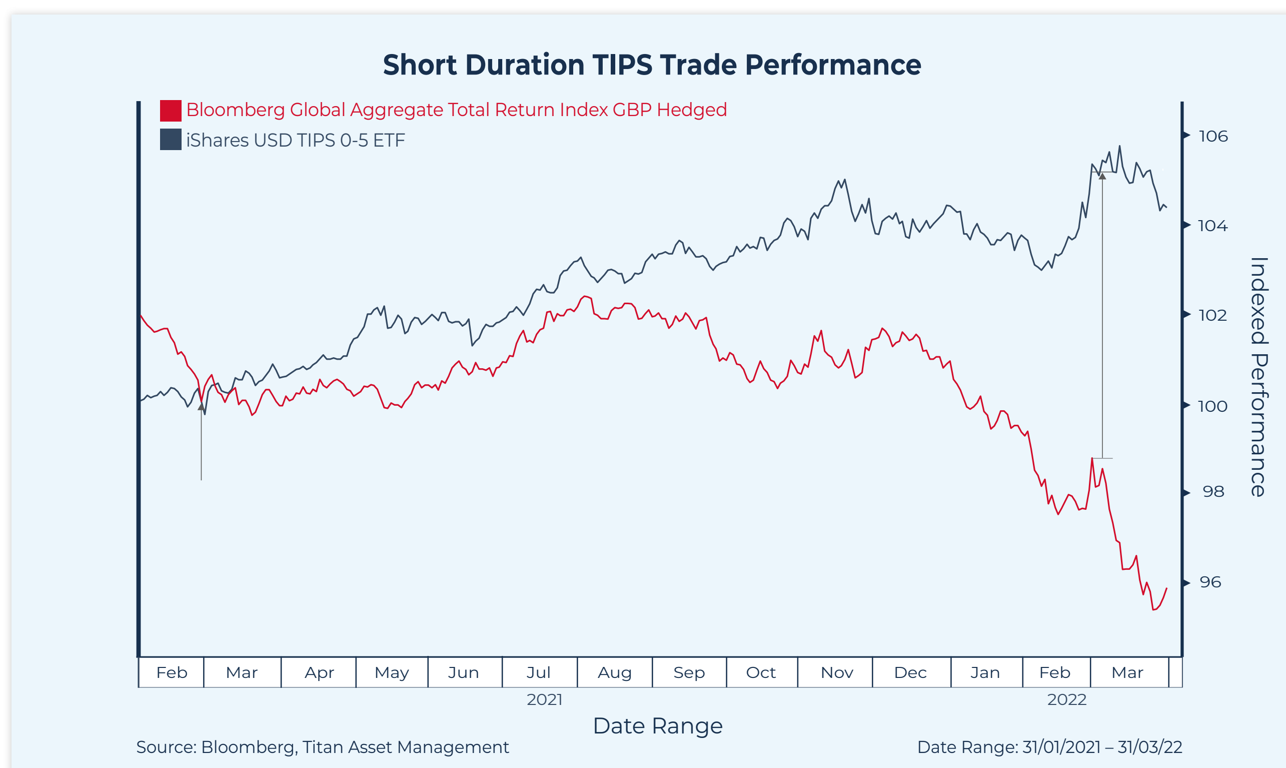
In July 2019 we initiated a position in treasury inflation protected securities (TIPS). These securities generate positive returns from two drivers:

- A fall in the nominal yield of the US government bonds
- A rise in the markets expectations of future inflation as derived from the 'breakeven rate'

In early 2021 we reduced the duration of this position, in anticipation or rising rates. As shown in the chart below, these positions have performed exceptionally well, both in absolute and relative terms versus a generic global aggregate bond index.





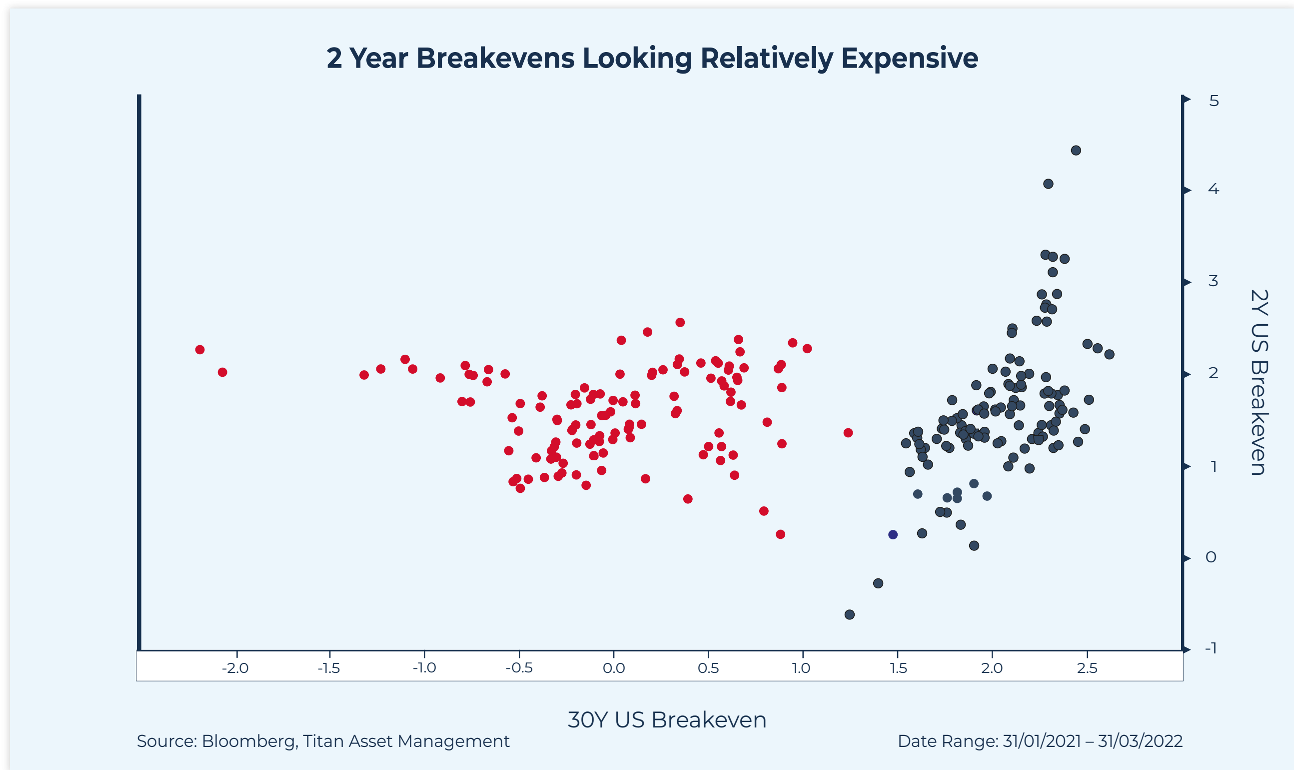
Recently, we have seen short dated yields pick up in anticipation of a rate hiking cycle to combat rising inflation. We think this trends has several key drivers:

1. The Russia-Ukraine war will, in time, take productive resources away from their most efficient use. Governments will look to increase resource security, firms will reroute their supply chains and consumers will boycott cheaper materials from politically undesirable producers. We see this as part of a broader transition from peak globalisation towards a less global world.

2. The rapid rise in ESG mandates has resulted in a structural underinvestment in energy-related firms given their "dirty" credentials. This has led to under-resourced supply dynamics that, when pressured by lockdowns, sanctions and breakdowns in international diplomacy, cause significant upward volatility across commodity prices. A prime example is energy prices. Although energy now only holds a ~7.5% weight in the US CPI basket, it has large second-order effects as rising energy prices impact manufacturers, transportation and service costs. In the past, when US inflation has risen for a sustained period above 5%, it has led to significant fall in energy prices, a slowdown in economic growth, or both. With the current undersupply of energy and energy-related commodities we do not see the former happening in the near-term and markets are now starting to price the latter.

3. Inflation can either (a) be passed onto consumers if firms have pricing power or (b) reduce profit margins for firms whose product demand is elastic enough that they cannot pass costs through. In reality we have seen a mix of both of these outcomes. Lower margins weaken firms' earnings, which, when widespread and sustained, slows economic growth, putting downward pressure on longer-dated yields. Passing through costs reduces disposable incomes while putting upward pressure on market expectations of inflation.

We recently took profit on this short duration theme, and have extended our duration because we believe there is scope for longer duration break-evens to outperform going forward.



This is evident from the chart which shows the year-to-date repricing in the US TIPS market has been focused on the front end. The red dot in the chart shows that, given the current pricing of long term inflation expectations, short dated market priced inflation expectations look expensive. The historic trend can be seen in the red regression line which demonstrates the historic trade-off between the two. The further the red dot moves above the line the cheaper longer dated breakeven rates look in relation to short dated breakeven rates. As such we have extended the duration within our TIPS exposure to a long duration position.

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