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Inflation Licked Bonds

Global Matters Weekly

11 July 2022

– **Alex Harvey, CFA**

Before the 4th of April this year, it cost 85 pence to send a letter first class in the UK. After that date you have needed to stick another 10 pence stamp onto your letter to maintain its first-class status. But if you had a '1st' class stamp knocking about in a drawer, it effectively increased in value by an inflation busting 11.7% this year (and 11.8% the year before that). That's because, as I recently learned, in the UK a postage stamp with '1st' or '2nd' class on it holds its 'class' value through time, even after the annual increase in the price of sending post. Luck runs out for wannabe stamp arbitrageurs at the end of January 2023 however, as Royal Mail looks to introduce barcoding on these stamps, but there will be a two month 'stampnesty' when old stamps can be swapped for new.

50 years ago, it cost 3 pence and 2.5 pence respectively to send a letter by first- or second-class post in the UK[1]. At 95 pence and 68 pence today, that equates to an annualised increase of 7.2% and 6.8% respectively for first and second-class stamps. Over the last 25 years, a period of lower inflation (until this year), their prices have increased by an annualised 5.3% and 5% - more than twice the UK's Consumer Price Index (CPI) rate of 2.1% annualised over the same period. In fact, they almost match the 1-10 year UK Inflation Linked bond index's annualised return of 4.9%. That's pretty good inflation protection, if an unexciting one (apologies to the philatelists out there). And since 2001, Christmas hasn't tasted the same after the arrival of the first self-adhesive stamps.

When it comes to inflation though, postage costs are probably not front and centre of people's minds. Utility bills, food and petrol prices have all been rising sharply in recent months, with the last data release showing that consumer prices in the UK rose by 9.1% year-on-year through May, up slightly on the prior month's 9%. In the US, the equivalent number is 8.6% with the numbers for June out on Wednesday 13 July, expected to show another increase to 8.8%. Core inflation there is expected to fall again, as it did last month, in both the US and the UK but it remains at around 40-year highs.

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One way to protect against inflation is by owning inflation linked bonds whose coupon and principal (the amount to be repaid) is linked to an underlying inflation index, CPI in the US and Retail Price Index (RPI) in the UK. They also embed the market's expectation for future inflation and can be a useful bellwether for inflation pricing. Back in March 2020 – what was arguably 'peak Covid' for financial assets – expectations for future inflation, as measured by the inflation 'breakeven', fell off a cliff such that US 5-year inflation expectations dropped as low as an annualised 0.11%. The US 10 year breakeven rate fell to 0.47%. This provided a significant relative value opportunity for our funds which held Treasury bonds, and which could switch into Treasury Inflation Protected Securities (TIPS). The 175bps increase in 10 year breakevens from mid-March 2020 to the end of June 2022 resulted in a whopping 20% outperformance of TIPS over nominal Treasuries.

As with most insurance though, you need to buy it before the event, and this trade was largely exhausted by the start of the year. Much of this inflation risk has since been recycled into strategies that benefit more directly from inflation once it is going up, rather than from future inflation expectations. Over the course of the last year, we have increased our exposure to real assets – those which have an intrinsic value, such as real estate and infrastructure – much of which generates an income that is directly or closely linked to inflation. As outcome based multi asset investors these strategies, along with equities, are some of the most effective at capturing this inflation 'pass through', and arguably their best returns remain ahead of them. A must have for any investment collector's album.

Sources: [1] https://channelx.world/2019/03/historic-royal-mail-stamp-prices-1971-2019. Unless stated all other sources Bloomberg Finance L.P.

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The **Marketplace**

- Global equities returned 1.7% last week
- Slightly improving labour and production data saw most equity markets rise
- Brent crude fell by 6.3% to $104.7 a barrel
- Gold fell by 3.8% to $1742.7 per ounce

Market **Focus**

US

- US equities returned 2.0% last week on optimism that the Federal Reserve will be able to curb inflation without tipping the economy into a recession
- Nonfarm payrolls for June came in at 372,00, well above the consensus expectation of 270,000, allaying some of the fear of an impending recession
- Average hourly earnings increased 0.3% in June, in line with expectations. In the last year, earnings grew by 5.1%
- President Joe Biden discussed possible reductions in U.S. tariffs on Chinese goods in a meeting with his advisers last week as his administration nears a closely-watched decision on trade with China.

Europe

- European equities returned 1.8% last week
- German industrial production grew by 0.2% in May (vs. 0.4% expected), although the previous month's growth was revised up to 1.3% (vs. 0.7% previously)
- European gas prices rose by 14.4 % last week to EUR175 per megawatt-hour
- The minutes of the European Central Bank's (ECB) June meeting showed most members agreeing to a 25-basis-point increase to the deposit rate in July and leaning toward a 50-basis-point move in September
- Eurozone producer prices surged by an annual 36.3% in May. Excluding energy, prices rose 16.0%
- German economy minister Habeck appealed to Canada's government to release a turbine for Nord Stream that's been affected by sanctions, amidst fears that Russia could use the missing turbine as a reason to stop the flow of gas, drawing opposition from Ukraine.

UK

- UK equities returned 0.3% last week
- Prime Minister Boris Johnson announced his resignation following a raft of ministerial departures, it's unclear if he will remain in post as caretaker PM
- Britain's job market grew at the slowest pace in 16 months, suggesting the rapid hiring spree following the pandemic is starting to give way to more normal trends.

Asia/Rest of The World

- Japanese equities returned 2.0% last week
- Chinese equities fell 0.1% last week
- Japan's household spending fell 0.5% year-on year in May (vs. 2.1% expected), declining for the third straight month
- Japan's longest serving PM Shinzo Abe was shot and killed while delivering a speech for the parliamentary elections for the parliamentary upper house
- China's factory gate inflation came in at 6.1% year on year cooled to a 15-month low in June (vs. 6.0% expected) compared to a 6.4% rise in May. Additionally, consumer prices rose 2.5% y/y in June (vs. 2.4% expected), widening from a 2.1% gain in May and to the highest in 23 months.

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Asset Class/Region	Currency	Currency returns			
		Week ending 8 July 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	2.0%	3.1%	-17.7%	-8.8%
United Kingdom	GBP	0.3%	0.3%	2.0%	9.4%
Continental Europe	EUR	1.8%	2.0%	-15.8%	-8.7%
Japan	JPY	2.0%	0.6%	-4.2%	0.4%
Asia Pacific (ex Japan)	USD	0.8%	-0.1%	-15.8%	-20.5%
Australia	AUD	1.7%	1.2%	-8.8%	-5.7%
Global	USD	1.7%	2.2%	-18.7%	-12.6%
Emerging markets equities					
Emerging Europe	USD	-2.5%	-3.7%	-77.9%	-77.7%
Emerging Asia	USD	0.5%	-0.3%	-17.5%	-22.7%
Emerging Latin America	USD	0.3%	-0.6%	-1.2%	-12.3%
BRICs	USD	0.6%	0.5%	-16.6%	-25.3%
China	USD	-0.1%	-0.1%	-11.4%	-26.0%
MENA countries	USD	-1.1%	-1.3%	-2.5%	5.7%
South Africa	USD	2.5%	1.8%	-5.7%	-9.3%
India	USD	2.5%	2.4%	-11.4%	-1.5%
Global emerging markets	USD	0.4%	-0.4%	-17.9%	-22.4%
Bonds					
US Treasuries	USD	-0.7%	0.0%	-8.9%	-9.7%
US Treasuries (inflation protected)	USD	-0.8%	0.3%	-9.4%	-6.0%
US Corporate (investment grade)	USD	-0.2%	0.3%	-14.1%	-14.7%
US High Yield	USD	1.1%	1.3%	-13.1%	-12.0%
UK Gilts	GBP	-0.9%	1.0%	-13.8%	-14.6%
UK Corporate (investment grade)	GBP	-0.4%	0.9%	-13.4%	-14.8%
Euro Government Bonds	EUR	-0.6%	0.7%	-11.6%	-12.8%
Euro Corporate (investment grade)	EUR	0.3%	1.1%	-10.9%	-11.8%
Euro High Yield	EUR	0.3%	0.4%	-14.1%	-13.8%
Japanese Government	JPY	-0.1%	0.1%	-3.0%	-3.4%
Australian Government	AUD	0.7%	1.2%	-9.1%	-11.1%
Global Government Bonds	USD	-1.1%	-0.5%	-14.6%	-17.1%
Global Bonds	USD	-1.1%	-0.6%	-14.9%	-17.2%
Global Convertible Bonds	USD	0.3%	0.5%	-20.5%	-24.2%
Emerging Market Bonds	USD	-0.8%	0.3%	-26.4%	-27.8%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 8 July 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-0.3%	1.5%	-19.5%	-7.3%
Australian Property Securities	AUD	3.7%	5.3%	-21.2%	-11.1%
Asia Property Securities	USD	-0.4%	-0.6%	-5.1%	-13.8%
Global Property Securities	USD	0.1%	0.9%	-18.6%	-13.4%
Currencies					
Euro	USD	-2.4%	-3.1%	-10.8%	-14.3%
UK Pound Sterling	USD	-0.3%	-1.4%	-11.3%	-12.8%
Japanese Yen	USD	-0.5%	-0.3%	-15.4%	-19.3%
Australian Dollar	USD	0.8%	-1.1%	-6.1%	-8.1%
South African Rand	USD	-2.1%	-2.8%	-4.8%	-14.6%
Swiss Franc	USD	-1.2%	-2.1%	-6.4%	-6.0%
Chinese Yuan	USD	0.0%	0.0%	-5.1%	-3.1%
Commodities & Alternatives					
Commodities	USD	-2.5%	-2.5%	20.0%	34.2%
Agricultural Commodities	USD	-1.5%	-3.6%	5.1%	23.2%
Oil	USD	-6.3%	-8.8%	34.5%	41.2%
Gold	USD	-3.8%	-3.7%	-4.7%	-3.1%
Hedge funds	USD	-0.5%	-0.5%	-5.5%	-5.3%

Source: Bloomberg. Past performance is not indicative of future returns

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