

## **Multiple benefits to US inflation-protected bonds**

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The consensus in global markets increasingly seems to be that the US Federal Reserve (the Fed) will start cutting interest rates soon. Declining inflation figures and a cooling US labour market makes this scenario increasingly likely. And, since lowering interest rates lowers the cost of short-term debt, doing so would also help to manage the US's growing debt burden. But while market participants have overwhelmingly positioned for a rate cutting outcome, we believe the future path of inflation is not as clear-cut as most would believe.

At [PSG Asset Management](#), independent thinking and thorough research are deeply ingrained as part of our globally integrated [3M process](#). We've outlined our thinking on the topic of inflation extensively in our publications (refer to the reading list at the end of this article) and won't repeat them here. But in short, we believe inflation protection should remain top of mind for investors. If yields don't sufficiently compensate investors for inflation, the result is a loss of income in real terms. In addition, investors face the risk of capital losses if the yields rise in the future to reflect higher inflation. As such, we are always on the look-out for sources of inflation protection to add to our portfolios, at attractive prices.

### **The rebirth of global inflation-linked bonds**

In a world where inflation isn't a concern, inflation-linked bonds have limited appeal. But when inflation is unpredictable with the potential to surprise to the upside, these instruments can play a valuable role in a portfolio. An inflation-linked bond (ILB) is a bond in which both the regular coupon payments and the principal paid at maturity are linked to an inflation index. Conceptually, the value of your investment is guaranteed to grow by at least the rate at which the price of goods and services are increasing (inflation). Or, put differently, ILBs are a type of bond that offers the benefit that you don't have to worry about inflation.

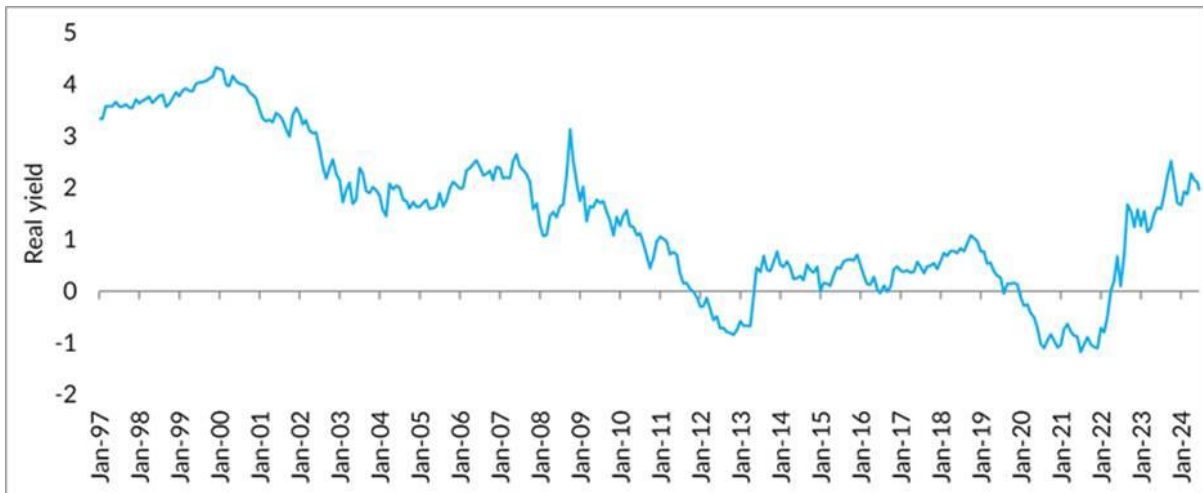
Leveraging off our globally integrated investment process to evaluate both the risks and opportunities, we believe select global ILBs currently offer substantial benefits to investors – in our local as well as global funds. One example of this is the US Treasury Inflation Protected Security (TIPS) market. The US TIPS market is dwarfed by its much larger and older brother – the US Treasury market (fixed rate bonds). US TIPS were first issued in 1997, and currently have a market value of US\$1.77 trillion compared to the US\$10.03 trillion in the Treasury market (i.e. the TIPS market is less than 20% the size of the US Treasury market). These instruments can play a vital role in protecting investors' real income when they are attractively priced, as well as enabling optimal portfolio construction through diversification of risks.

### **Why we are adding TIPS to our local portfolios**

US TIPS are currently trading close to 15-year highs as shown in the graph below, due to a strongly held consensus of falling inflation in the US. While we believe these instruments deserve consideration in global funds, they potentially have a critical role to play in local funds with offshore exposures. TIPS hold numerous benefits:

- The US is expected to issue a significant quantum of bonds to finance their deficits in the years ahead. US TIPS are a smaller portion of the market and will likely be shielded to some degree as typically the majority of issuance is through fixed rate bonds and treasury bills.
- They offer cheap protection from potentially high and more volatile inflation. US 10-year TIPS are currently offering inflation plus 2% per annum in dollar terms.

## 10-year US TIPS



Sources: Bloomberg and PSG Asset Management calculations

- US TIPS offer protection against a stronger dollar, both because they trade in dollars and due to the strong correlation of US inflation to periods of US dollar strength. Simply put, owning these instruments protects rand investors against dollar strength (or rand weakness, a key driver of local inflation).

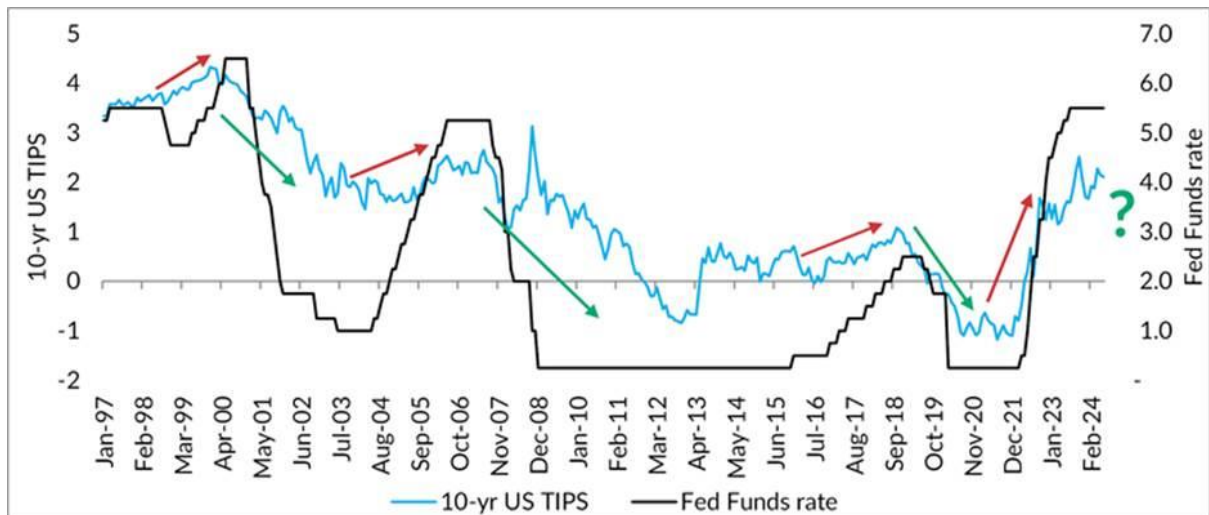
## High CPI and strong dollar periods



Sources: Bloomberg and PSG Asset Management calculations. Blocked areas indicate where periods of dollar strength and increasing US CPI have coincided.

- Despite our views that inflation remains an issue in the US, the Fed does appear likely to cut interest rates. US TIPS offer the additional benefit that they typically trade in line with the Fed Funds rate. These bonds therefore also provide potential for meaningful upside for capital gains should rates begin to fall. Conceptually, if the Fed does cut rates, this should further spur inflation, making the US TIPS more attractive.

## 10-yr US TIPS tighten with Fed Funds rate



Sources: Bloomberg and PSG Asset Management calculations. Green arrows indicate where the Fed has cut rates and the TIPS curve has rallied – i.e. experienced a price increase. Red arrows indicate where the Fed has hiked rates and the TIPS curve has widened – i.e. experienced a price decrease.

**A global perspective helps us to construct robust and well-diversified portfolios**

We believe that [looking at investment opportunities through a global lens](#) improves our understanding of the potential range of outcomes available to investors, both negative and positive. While we believe the local fixed income landscape offers great opportunities for investors at the moment, we think global inflation-linked bonds can add valuable diversification and inflation protection benefits to client portfolios at current prices. Being able to identify opportunities such as US TIPS gives us the ability to enhance risk-adjusted returns and add to portfolio diversification for our clients, with the focus on delivering investment excellence to our clients in the long run.