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The Ukraine conflict: Navigating short-term inflation volatility

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What we know

Inflation hit 6.2% in the UK for February, its highest point for over 30 years, and we expect it to continue rising this year. However, it's impossible to forecast exactly where inflation will peak in the short term. The invasion of Ukraine has stoked aggressive volatility in markets, witnessing a surge in the price of Brent crude oil prices to $139 per barrel, and gas prices to $800 per therm. This was quickly followed by a subsequent cool in prices as markets were soothed by the apparent progress of peace talks (at time of writing).

The potential for further sharp price moves makes it difficult to ignore the short term. But with the unpredictable nature of events in Ukraine, it's more important than ever to look through the uncertainty of near-term volatility and focus on what we know.

At the start of this year, we advised those seeking inflation protection to reduce the duration of their investments and diversify globally. This was against a backdrop of an expensive UK inflation market, and a hawkish shift in global central bank policy seeking to tackle inflation through a cycle of interest rate rises. Today, our view remains broadly unchanged. Let us explain why.

Why reduce interest rate risk

It makes sense to first explore how we arrived at this view at the beginning of the year, following the strongest year on record for index-linked funds in 2021, and one which saw the UK market outperform globally for the most part.

Global central banks were extremely supportive of markets last year, firm in the belief that higher inflation was a transitory phenomenon. Real yields subsequently reached record lows on a global basis and resulted in global linker funds delivering strong absolute returns for the year, while traditional government bond funds provided negative returns in comparison.

However, as inflation data consistently surpassed consensus expectations, global central banks took a more hawkish stance on inflation toward the end of the year. Given additional inflation pressures in the UK, largely driven by the Brexit impact, the Bank of England was the first major central bank to move, raising its interest rate from 0.1% to 0.25% in December. Up until this point, heightened inflation in the UK saw UK linkers significantly outperform their global peers: index-linked gilts delivered 10.26% to the end of November (FTSE Actuaries UK IL Gilts All Maturities) compared to 6.86% for global linkers (Barclays Global IL Global IL).

Understanding hidden risks

Firstly, and we reiterate, it's important to understand what inflation-linked – or 'linker' – funds are *really* offering. In 2021, as the global economy rebounded back into action following a period of lockdown driven dormancy, we saw an influx of investment into inflation-linked funds from investors seeking to protect their capital from losses linked to rising inflation. But we noticed a common misconception when discussing the funds with potential investors – that strong inflation would result in strong returns.

While higher inflation *can* result in stronger returns for linker funds, there are other elements at play, notably the level of nominal yields (the yield of a traditional bond). So, while these assets do offer exposure to and protection from inflation, they are also exposed to the same risk as nominal bonds, mainly interest rate risk. Most index-linked assets are longer in duration than their non-inflation counterparts, meaning they are more exposed to moves in interest rates (the longer the duration of an asset, the greater the capital loss in the event of an interest rate rise).

Therefore an index-linked fund is in fact a '*real yield*' fund rather than an inflation fund, with performance determined by both the change in nominal yields as well as the move in inflation. This can be highlighted this year where inflation is at a 30-year high, which is positive for linker funds, but this has been outweighed by the rise in long-dated nominal yields, which is negative for linker returns. Thus long-dated real yields have risen, and as a result, long-dated index linked funds have returned -7.7% in 2022 (as of end of March).

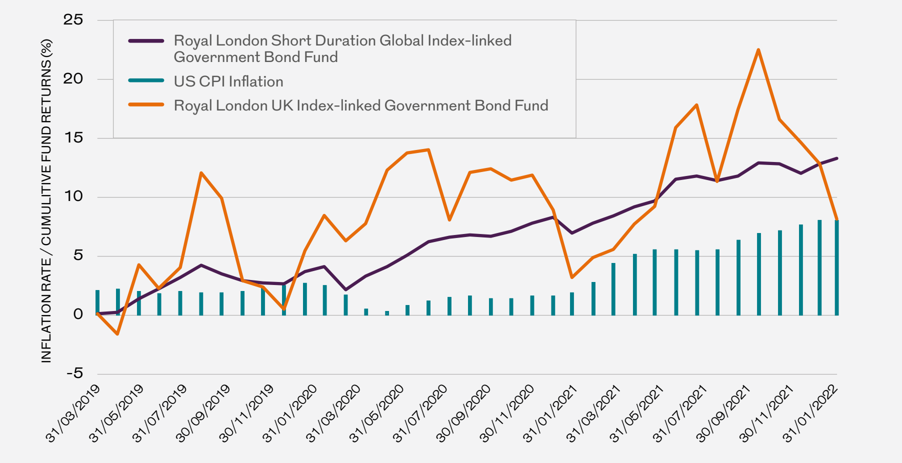
The UK linker index subsequently fell 5.53% following the December rate rise, posting a total return of 4.16% to investors for 2021. This highlights the risks posed to inflation-linked funds from rising interest rates. It also prompts us to remind investors that UK linker indices tend to be longer in duration than their global peers (as well as nominal indices) and as a result interest rate rises tend to translate to greater capital losses for longer duration assets. Hence, switching shorter in duration (either domestically or using global funds) will act to better preserve capital in a rising rate environment, a view we maintain going forward.

Why diversify globally

Despite the UK's first rate rise in December and subsequent rises to 0.75% by March, the UK inflation market remains buoyant relative to other global markets, with inflation expectations rising and real yields falling. The UK 10-year implied inflation rate was 4.4% at the time of writing, reflecting the market's view that inflation will average comfortably over 4% per annum over the next 10 years. These inflation expectations far outstrip those in the US and Germany, where comparative 10-year implied inflation sits at 2.9% and 2.4% respectively. Bearing in mind that central banks set interest rates to achieve 2% inflation, investors need to remember that they are locking into negative real yields. The 10-year UK real yield was -2.9% at the time of writing, compared to -0.75% in the US, and -2.17% in Germany, hence diversifying can not only help reduce interest rate risk but can also increase the yield on an index linked portfolio.

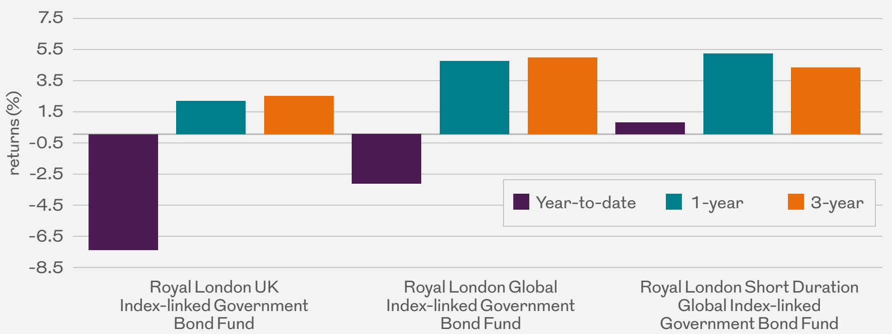
In the UK Retail Price Index (RPI) reform adds a further element as to why we believe linkers are expensive: the revision of RPI inflation by the Office for National Statistics (ONS) will shave close to a full percentage from the current metric in 2030, so in the absence of further energy shocks to the market we believe that UK linkers have limited scope for further upwards movements in price. We believe global markets offer much better opportunities to find value. With inflation in Japan and Australia currently below the targets of their respective central banks, these inflation

Figure 1: Global Inflation Market Overview, January 2019 to March 2022



Source: RLAM, Bloomberg as at 24 March 2022.

Figure 2: Royal London Fund Returns (gross, annualised)



	Annualised fund returns (%)			
	Year-to-date	1-year	3-year	5-year
Royal London UK Index-linked Government Bond Fund	-7.25	2.11	2.2	3.6
Royal London Global Index-linked Government Bond Fund	-2.98	4.77	4.9	4.06
Royal London Short Duration Global Index-linked Government Bond Fund	0.5	5.14	4.29	3.04
Royal London UK Government Bond Fund	-7.75	-6.64	-0.19	0.93
Royal London Short Duration Duration Gilt Fund	-1.25	-1.77	0.05	0.18
Royal London International Government Bond Fund	-3.86	-2.74	1.46	1.71

Source: RLAM as at March 2022.

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

markets may offer greater scope for upside, and even European markets which have moved in recent months may experience further upside due to the inflation spill over from the Ukraine crisis.

What to monitor

There *is* scope for inflation to continue to edge higher through 2022, which means inflation protection and inflation-linked funds are still an option that investors should consider. For now, central banks remain hawkish on inflation, but the extent to this hawkishness may alter as events unfold in Ukraine, and as the impact of global sanctions and energy shortages are felt, the rhetoric may have to soften somewhat. Only recently Bank of England Governor Bailey was softer on inflation than previously, raising concerns about a combination of restricting factors on disposable income for households – rising interest rates *and* rising energy costs. This indicates that the BoE is wary of creating a recessionary environment and has an eye on maintaining growth. In contrast, the Federal Reserve in the US, which is more insulated from energy price spikes, has doubled down on its hawkish stance, preparing markets for a rate rise at every Federal Reserve meeting this year. The European Central Bank sits somewhere between the two.

The stickiness of inflation also remains an uncertainty that we at RLAM and investors should keep a close eye on, and one factor we constantly monitor is wage inflation as this is a key focus for central banks. Bumper pay rises through the first half of 2022 would need to be seen for real average earnings to surpass the rate of inflation, which could lead to a snowball effect of higher wages driving higher prices leading to higher wages.

What to conclude

For now, the persistence and outlook for inflation is hazy at best. However, we remain firm in our advice to investors to act on what you know and look through any short-term volatility. Given this uncertainly, we believe that a strategy of reducing interest rate risk and diversifying globally could help to limit the risk of capital losses.

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

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