AXIOMA Wealth Management AG

How to survive inflation while staying invested in the bond portfolio and to earn at the same time?

According to conventional beliefs, inflation is the bond's biggest enemy. Meaning that if the inflation is 'coming over the hill', one should urgently change the strategy: sell bonds and buy gold or equity. But is it so unequivocally simple?

First quarter of 2021 was under the 'star sign' of inflation fears. Yields of US treasuries rose noticeably, reflecting the forecast of a growing inflationary pressure at the time when statistics did not yet look too scary. Yields of 10-year treasuries practically doubled over the course of the first quarter (from 0.9% to 1.74%) and yields of 30-year treasuries increased by as much (from 1.64% to 2.41%). However, they reached these maximums towards the end of the quarter. Further on, yields kept yo-yoing but within a narrow margin (+/- 10 basis points for 10yr issues) and from June they actually started to go down.

So, what happened?

Firstly, it is unusual that yields had a sharp drop right on the eve of the publication of latest consumer inflation stats (planned at the time for 10/06). Expectations of market players were on par with the actual record inflation of up to 4.7% as of May but went up to 5%. Even April stats (4.2%) represented a maximum of the last 10 years.

Secondly, small, at first glance, price fluctuations happened only in underlying assets. Market consensus was, that the inflation would grow, yields of US treasuries would grow too, implying that, in order to earn anything from those events, one would have had to resort to short selling treasuries. One of the widely used products of short selling long (20yrs and over) treasuries with the use of the 3X leverage, ETF TTT US, showed -15% between 01-18 June. It showed that not all investors were ready for the change in trend in the yield dynamics of US treasuries, and the market, as always, demonstrated that it was ahead of statistics.

Now, let's have a look at the profitability of our bond strategy during the periods of higher inflation.

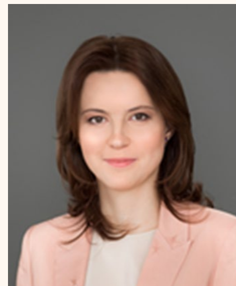
In 2015, the CPI, which reflects the rate of consumer inflation, went from 0% to 0.8%. Our strategy at the time earned us 12% in US$. Inflation continued to grow in the following year and the index reached 2.1% by the end of 2016 with a localized peak of 2.7% at the start of 2017. However, our strategy continued to bring in double-digit returns! Then arrived 2018, and at the end of it, our strategy result was slightly below zero. Was it because of the inflation? No. It was the threat of the economic slowdown because of the attempted scale-back of stimulus programmes by major central banks and the flaring up of the trade war between the US and China that upset the markets. Inflation index reached 3% mid-year and ended 2018 at below 2%.

It may seem that the inflation itself and the expectation of it have nothing to do with bonds. This, of course, is not correct. However, bonds have an inbuilt protection from inflation expectations, and it is called – duration.

Let us go back to the macroeconomic theory, it will help us understand, why inflation has a negative impact on bond strategy returns. Buildup of inflation expectations means, that investor/creditor will raise the premium for the duration; 'longer money' will become more valuable to cover the inflation. Therefore, yield of long bonds (from 10yrs) will be going up and their price will correspondingly fall. At the same time, 'short bonds' (less than 5yrs), to a large extent, are influenced by interest rates, not inflation expectations.

It is worth noting that in 2015-2018 interest rates were also on the up and that begs the question of how it was possible to have not only a positive return but to sustain the return at double digits? EM credit spreads on average shrank three times, which led to the decrease in yields, irrespective of how the US treasuries faired during the same time. With all this in mind, we can only surmise that bonds are a complex instrument and the bond price depends on interest rates and credit spread movement which, when combined, reflect the state of the economy in general and companies in particular. Investment Managers alter composition and duration of portfolios guided by their view of the future market. Inflation expectations play just one of the many roles here, but - if our performance is of any proof – not the key part!

30 June 2021



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We hope you will find this information useful and we will be glad to answer your questions

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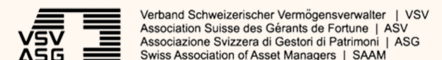

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