

Talking Heads podcast with Elida Rhenals

Chris Iggo: Hello, and welcome to this week's BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis on topics that really matter to investors. In this episode, we'll be discussing inflation and how inflation-linked bond strategies can help investors navigate what is the second inflation shock we're experiencing in the space of just four years.

I'm Chris Iggo, Chief Investment Officer for AXA IM Core, part of BNP Paribas Asset Management, and I'm joined today by Elida Rhenals, who is a senior portfolio manager in the rates and inflation team at AXA IM Core. Welcome Elida, and thank you for joining me today.

Elida Rhenals: Thanks, Chris, for having me today.

CI: So, there's a lot going on as far as inflation is concerned. We've seen oil prices rising steadily over the last two months because of the conflict in the Middle East. On the day that we record this podcast, the price of Brent crude went above \$120 a barrel. We're seeing lots of evidence that inflation is coming through in the official data and expectations that inflation will be elevated for some time. What's your view as a manager of inflation-linked bonds in terms of the outlook for the next few months?

ER: Well it's a tricky one, but our base case is that inflation will remain persistent and volatile rather than returning smoothly to target. Energy prices above \$100 per barrel is a reminder that supply shocks can emerge quickly, especially in this fragile geopolitical environment, and we've seen how sensitive inflation is to energy. Historically, [a] 10% increase in oil prices adds between 2.3% and 2.4% to headline inflation within a year.

So, for next year, we expect inflation to remain elevated – probably gradually decline if the conflict eases, but remain above central bank targets and more volatile than in the past decade. So, in short, the inflation regime has changed.

CI: That's very clear. And we're seeing already the increase in energy components of consumer price indices. But what would be the more persistently nasty scenario over the next few months, if we start to see inflation affecting prices in things other than energy?

ER: Of course, these things unfold in a disorganised way. For now, the energy shock is still contained only to energy, but if this conflict proceeds some second-round effects coming from wage pressures if consumers and households start demanding more wages.

Before that, there are other pockets beyond energy, like fertilizers and other by-products from fossil energy like helium, and that could spill over into other core goods that could lift inflation in 2027 and even in 2028. As long as the conflict continues, it can spill over to any other components of inflation.

CI: And we're seeing inflation rise everywhere. Even before the war, inflation in the US was above the Fed's target and it's moved above the ECB's target now in Europe. Are any countries

or economies particularly at risk, or do you think it's a more general problem for all advanced economies?

ER: [While] trying not to extrapolate past history to current history, we see inflationary pressures, of course, in the short term, in Asia. But history has proven that when inflation rises, it rises everywhere around the globe. The first region is Asia because they are the most vulnerable to supply bottlenecks, supply shocks from the Middle East.

But in other DM economies, we think the UK and the European region are the most vulnerable. And inside the European Union, Italy is one of the countries most exposed to imports from the Middle East.

CI: Okay. Well, let's now turn to inflation-linked bonds. For some of our listeners, inflation-linked bonds may seem as a kind of a niche investment. They can be quite technical. Could you just remind listeners, in simple terms, how they work?

ER: Everything is in the name. Inflation-linked bonds are quite straightforward. They are government bonds where the principal – and therefore the coupons – adjust with inflation. So, when inflation rises, the value of the bond increases automatically.

And of course, when inflation falls, the adjustment slows, but investors still receive a real yield on top that today is positive. What makes them unique is that they deliver real return and not a nominal one. Demand for that protection is real. We've seen, since 2022, global inflation bond funds receive over €200 billion in net inflows – one of the largest re-allocations into the asset class on record.

CI: A number of countries issue inflation-linked bonds. But, as an investor and thinking about liquidity, what are the major markets for you?

ER: Well, there are three key markets globally. The largest is the United States – as we call them, TIPS [Treasury Inflation Protected Securities]. They represent roughly \$2 trillion in market cap today.

Then you have the United Kingdom, which historically has been one of the deepest and most mature inflation-linked markets since the eighties. And finally, we get the EU, which has expanded significantly over the past decade. It now accounts for roughly €1 trillion in linkers issuance.

Together these three markets form the backbone of global inflation-linked investing, with strong liquidity and transparent pricing. But more importantly, and this needs to be stated, is that governments continue to issue these bonds because they diversify funding and attract long-term investors, especially in a situation like today.

CI: And because they're government bonds and they continue to be issued there are no real concerns about liquidity in these markets?

ER: Not at all. They imagine inflation in bonds as government bonds that actually guarantee you inflation at maturity. So, it's pretty simple, pretty straightforward – high liquidity and high quality – it's investment grade for most of them.

CI: And initially I'm coming from the UK, so this was very much the case here, the major investors in these kinds of bonds were pension funds. They used them to hedge their inflation-linked liabilities. But the market has evolved over the years. How would you describe the investor base today?

ER: Yes, it's a very good point. Historically, pension funds and insurers have been the main investors because of their long-term liabilities linked to inflation. But even since Covid, I would say 2020, 2021, the investor base has broadened dramatically and we see asset managers [and] central banks coming to the asset class, [such as] sovereign wealth funds.

Increasingly [there are] more tactical players and retail investors. So that tells you that inflation protection is becoming mainstream as an investment theme.

CI: And of course, there's a derivatives market growing alongside the bond market.

ER: Exactly. It's super liquid now as well.

CI: And within the universe you can manage bonds in different ways. Perhaps you could talk a little bit about some of the different kinds of strategies that you and your team manage for clients.

ER: Since they are bonds, you can imagine every kind of strategy, but we typically see two main approaches to this asset class.

The first is the short duration inflation-linked bond strategy, which is particularly attractive in today's context because [the bonds] offer lower interest-rate sensitivities [and] a short duration. They have more stable performance, and their performance is directly linked to realised inflation.

More importantly, as I mentioned before, they currently offer positive real income. In many markets, short-dated inflation linked bonds are yielding around 1.5% to 2% in real terms, which is historically super attractive.

The second approach that we see today is an active total return strategy or a flexible approach where investors can actively adjust duration and breakeven curve positioning to capture opportunities across the cycle because, again, inflation is a volatile phenomenon. So, you can actually use this not just as a defensive asset class, but also a source of active performance.

CI: Looking at the market today and thinking about what's happening at the macro level, you mentioned you look at real yields and at what the implied inflation rate is in the market – the breakeven inflation rate. What's your view on both of those factors at the moment? Are they at attractive levels? Is the market being reasonable in its expectations of where inflation will go?

ER: Absolutely, yes. The market keeps pricing a relatively benign inflation path in the future. Let's take the example of the Euro area. Long-term inflation expectations are still close to 2%, in the 10-year tenure or even the 5-year tenure, which is broadly in line with [the] central bank target. In our view, these contained inflation expectations do not reflect premia or upside risk to inflation because, again, risks are not just cyclical, they are more structural.

We have a geopolitical fragile environment. We have supply constraints. We have fiscal expansion in basically every DM market. and we also have energy transitions. So, from a valuation perspective, inflation protection still looks reasonably priced, and that is for the breakeven side.

For the rate side, we still think that values are historically attractive. When we think of 2022 real rates, the premia paid on top of inflation was negative. So that means in 2022 you had to pay to get inflation. Today, for example, real rates in the Euro area are 1% and 2% in the US, which means that you're getting real returns on top of inflation.

What we believe is that now we are in a phase where monetary policy is still restrictive. Growth is slowing and inflation remains uncertain. That combination creates a super supportive environment for inflation in bonds because you are paid for both income and inflation protection. So, even with the rally that we have had in recent weeks, it still makes sense in ,an allocation.

CI: So you wouldn't say it was too late to invest in inflation given what's happening in the Middle East and with energy prices?

ER: Not at all. In fact, I think it's the time to reconsider inflation protection.

CI: I agree with you. I think beyond the very short term, there are geopolitical risks that might mean inflation is higher in the future or maybe more volatile. So, should investors think about a structural allocation to inflation-linked bonds within just a fixed-income portfolio, or also within a multi-asset portfolio?

ER: It's the perfect cocktail to get attractive risk-adjusted returns with positive real yields, super-high inflation indexation. And again, inflation, I think the reason history has shown us that inflation is not going to be a temporary shock. It's the underlying risk in any allocation – either multi-asset or only fixed income – you should be protected against that risk. And inflation in bonds is one of the most efficient ways to do it.

CI: Great, thank you, Elida. That's all very clear. Thanks for joining me today.

ER: Thank you very much for having me.

CI: That's it for this week's episode of Talking Heads. If you would like to learn more about our investment insights, please reach out to your BNP Paribas Asset Management contact or check out Viewpoint , our website for investment insights at viewpoint.bnpparibas-am.com.

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You've been listening to the BNP Paribas Asset Management Talking Heads podcast with me, Chris Iggo, and Elida Rhenals from the AXA IM Core fixed income team at BNP Paribas Asset Management.

I hope you've enjoyed the podcast, and please do join us again on Talking Heads next week. Until then, take care.