1
00:00:08,280 --> 00:00:12,800
It’s been quiet a while on the inflation front since the beginning of the year.

The market narrative has shifted
quite significantly over the past few weeks.

2
00:00:12,800 --> 00:00:15,200
Following the agreement
of a Middle East peace deal,

3
00:00:15,200 --> 00:00:19,400
oil prices have fallen sharply,
retracing by more than 25% and inflation

4
00:00:19,400 --> 00:00:22,400
expectations
have moved lower alongside them.

5
00:00:22,400 --> 00:00:25,320
But has the inflation story
really come to an end?

6
00:00:25,320 --> 00:00:27,880
While markets increasingly seem to think so,

7
00:00:27,880 --> 00:00:29,000
we disagree.

8
00:00:29,000 --> 00:00:30,400
Several structural forces

9
00:00:30,400 --> 00:00:33,560
continue to point towards
a more persistent inflation environment.

10
00:00:33,560 --> 00:00:38,560
The first is energy. While markets
are pricing a return to abundant supply,

11
00:00:38,560 --> 00:00:43,200
we believe the normalisation process could
take considerably longer than expected.

12
00:00:43,200 --> 00:00:45,640
Shipping routes still need to normalise,

13
00:00:45,640 --> 00:00:49,280
inventories remain relatively depleted, and oil demand,

14
00:00:49,280 --> 00:00:54,040
which was temporary depressed over
the past few months, is likely to recover.

15
00:00:54,040 --> 00:00:56,360
Although oil prices have corrected,

16
00:00:56,360 --> 00:00:57,440
we're not convinced that

17
00:00:57,440 --> 00:01:01,360
this marks the beginning
of a sustained disinflationary trend.

18
00:01:01,360 --> 00:01:03,360
The second theme is climate.

19
00:01:03,360 --> 00:01:07,040
The recent European heatwave is yet
another reminder

20
00:01:07,040 --> 00:01:10,480
that climate change is not only
an environmental challenge.

21
00:01:10,480 --> 00:01:12,680
It is also an inflationary one.

22
00:01:12,680 --> 00:01:16,760
Climate adaptation requires
significant investment in infrastructure,

23
00:01:16,760 --> 00:01:19,160
while a strong El Niño, expected later

24
00:01:19,160 --> 00:01:23,360
this year, is likely to further
disrupt agricultural production

25
00:01:23,360 --> 00:01:27,080

and in some regions,
hydroelectric power generation.

26
00:01:27,080 --> 00:01:32,000
These are supply-side shocks that
tend to lift inflation further than reduce it.

27
00:01:32,000 --> 00:01:35,840
The third structural
theme is artificial intelligence.

28
00:01:35,840 --> 00:01:38,840
Much has been said about AI's long-term

29
00:01:38,840 --> 00:01:41,760
disinflationary potential
to productivity gains.

30
00:01:41,760 --> 00:01:44,000
We broadly agree with that view.

31
00:01:44,000 --> 00:01:47,840
However, before we can benefit
from those productivity gains,

32
00:01:47,840 --> 00:01:50,880
we first need to build
that infrastructure.

33
00:01:50,880 --> 00:01:55,680
Data centres, electricity grids,
semiconductor capacity, and digital

34
00:01:55,680 --> 00:02:00,360
infrastructure all require unprecedented
levels of capital expenditure.

35
00:02:00,800 --> 00:02:03,680
That investment supports growth, indeed,

36
00:02:03,680 --> 00:02:09,160
but also fuels demand for energy,
industrial materials and skilled labour.

37
00:02:09,160 --> 00:02:13,080

We are already seeing large technology
companies investing heavily

38
00:02:13,080 --> 00:02:17,800
in recruiting electricians, welders,
pipefitters and specialised technicians.

39
00:02:18,520 --> 00:02:23,200
In other words, the investment phase of
AI is likely to be inflationary

40
00:02:23,200 --> 00:02:26,800
before the productivity benefits
eventually materialise.

41
00:02:26,800 --> 00:02:30,040
Taken together,
we believe these structural forces

42
00:02:30,040 --> 00:02:33,440
continue to skew inflation
risks to the upside.

43
00:02:33,440 --> 00:02:37,800
So if our macro view is right,
the next question is simple:

44
00:02:38,600 --> 00:02:40,320
Are markets pricing these risks?

45
00:02:40,320 --> 00:02:42,640
We don't think they are.

46
00:02:42,640 --> 00:02:46,320
And that's where valuations
become particularly compelling.

47
00:02:46,320 --> 00:02:49,840
Inflation breakevens have been driven
almost entirely by the declining

48
00:02:49,840 --> 00:02:53,000
energy prices this year,
and are now looking expensive

49

00:02:53,000 --> 00:02:56,360
relative to other asset
classes, particularly in the US.

50
00:02:57,080 --> 00:03:01,040
What's even more striking is that short-term forward breakevens are pricing

51
00:03:01,040 --> 00:03:05,240
inflation that is in some cases below
central bank targets.

52
00:03:05,240 --> 00:03:10,280
And in our view, markets are assigning
very little probability to any upside

53
00:03:10,280 --> 00:03:12,440
inflation surprise in the short term.

54
00:03:12,440 --> 00:03:17,680
At the same time, depressed breakeven
valuations have pushed real yields to levels

55
00:03:17,680 --> 00:03:22,800
that remain historically attractive,
especially at the front end of the curve.

56
00:03:22,800 --> 00:03:26,520
Real yields are still close to these levels,
through the aggressive

57
00:03:26,520 --> 00:03:30,480
tightening cycle of 2022-2023,

58
00:03:30,480 --> 00:03:34,560
despite a macro economic backdrop
that looks very different today.

59
00:03:34,560 --> 00:03:39,040
We acknowledge the markets are also
pricing a higher neutral real rate,

60
00:03:39,040 --> 00:03:42,840
partly reflecting expectations of stronger
productivity growth.

61

00:03:42,840 --> 00:03:45,800
While that may ultimately prove justified,

62
00:03:45,800 --> 00:03:50,200
we believe markets are pricing
those productivity gains far too early.

63
00:03:50,200 --> 00:03:53,760
And as a result,
we see limited room for a material further

64
00:03:53,760 --> 00:03:56,960
increase in front-end real yields from the current level.

65
00:03:56,960 --> 00:03:59,720
So when we put everything together,

66
00:03:59,720 --> 00:04:03,800
we believe the potential opportunity
remains very attractive.

67
00:04:03,800 --> 00:04:07,600
Inflation risks continue
to be skewed to the upside

68
00:04:07,600 --> 00:04:12,400
while current market pricing reflects
a relatively benign inflation outlook.

69
00:04:12,400 --> 00:04:15,400
Ultimately, we think markets are paying

70
00:04:15,400 --> 00:04:19,080
a very small premium
for inflation protection at a time

71
00:04:19,080 --> 00:04:23,880
when the structural risk of inflation
remains firmly in place.

72
00:04:23,880 --> 00:04:27,160
And that is why we continue
to see potentially

73
00:04:27,160 --> 00:04:30,560

compelling value
in front-end inflation-linked bonds.