

# Inflation protection in a rising rate environment

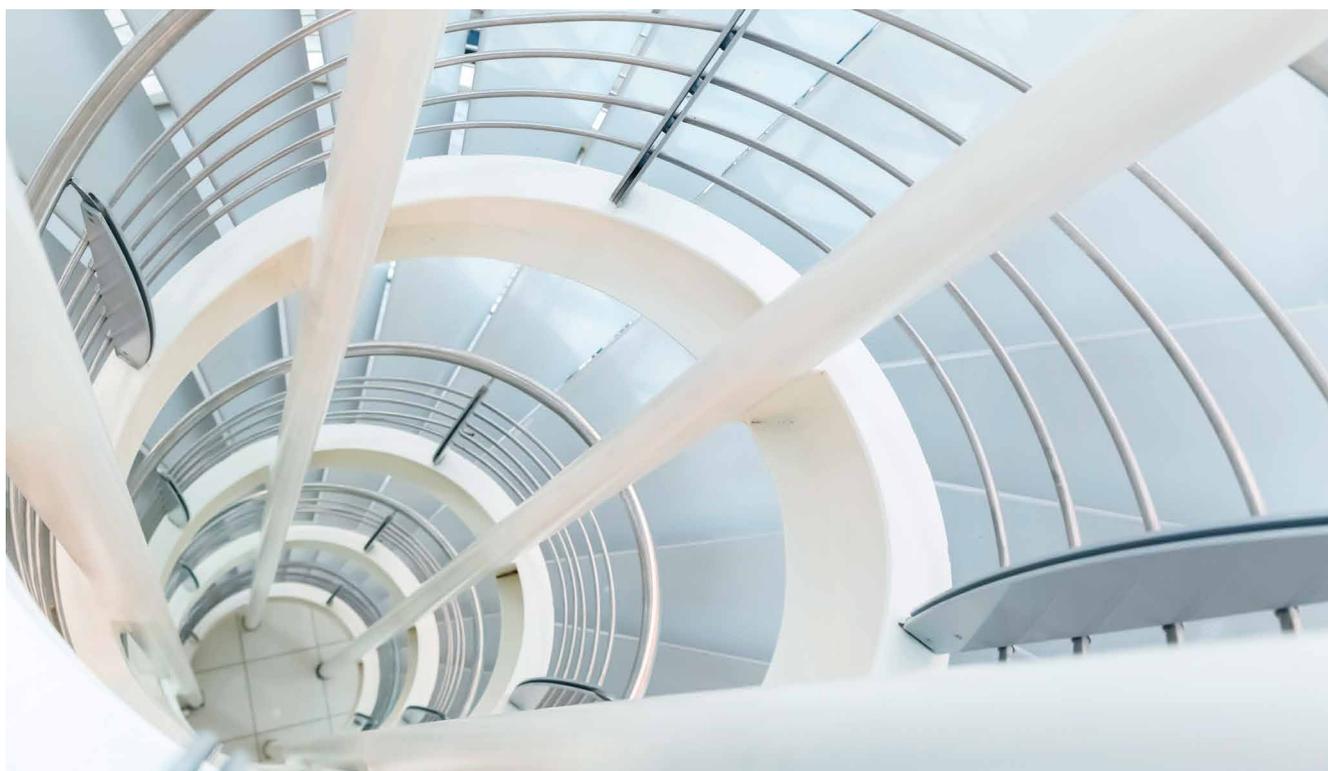
## UBS ETF **Market Matters**

↗ Inflation-linked securities explicitly compensate their holders for realized inflation, making them attractive during times of higher than expected inflation.

↗ In addition to realized inflation, inflation-linked bonds pay real yield. Hence they are subject to real interest rate risk, just like other bonds. Rising real interest rates will generally affect longer-dated securities to a greater extent, making their valuations more volatile.

↗ Investors holding a view that future inflation will be higher than currently expected should favor Treasury inflation-protected securities (TIPS) over nominal Treasuries, and vice versa. The choice between shorter-term maturity (1-10 year) vs longer-term (10+ year) is driven by expectations regarding development of real interest rates. Should real interest rates rise, shorter-term bonds might be preferable.

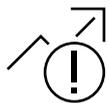
Treasury inflation-protected securities (TIPS) are treasury bonds that have their notional value adjusted in line with realized inflation. They are therefore a convenient solution for investors seeking to preserve real purchasing power. Currently, 10-year TIPS are priced such that they will outperform nominal Treasuries if the realized inflation over the next 10 years exceeds on average 2.0% per annum. This 10-year breakeven inflation implied by TIPS is actually the same as the Federal Reserve's inflation target. In other words, the market currently expects that the Fed will be able to keep inflation around its target over the next decade. However, the most recent January CPI reading for inflation is a bit higher at 2.5%.





## When do TIPS pay off?

TIPS outperform nominal bonds when realized inflation exceeds expectations. The Citi Inflation Surprise Index for the United States, which measures inflation surprises relative to market surveys, is at its highest in more than five years, and the reading only turned positive in February. This means that the US inflation data came in higher than expected after a five-year period of persistent under-shooting (Figure 1). Investors who believe that positive inflation surprises (i.e. higher than expected) will be more frequent for months to come should prefer TIPS over nominal bonds. How likely is that to happen? On the one hand, political developments in the US with the potential for fiscal stimulus (along with near full employment) are likely to be supportive of price growth. On the other hand, the potential Fed interest rate hikes will have a muting effect on inflation. The interplay between these two factors is likely to be key determinants of future inflation.

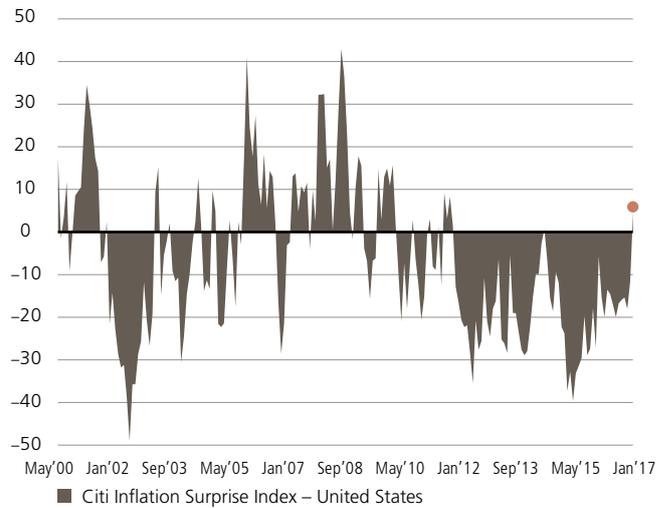


## What are the risks?

Inflation linkers are subject to interest rate risk, like other bonds. However, this risk is mitigated as inflation-linkers are only responsive to changes in real interest rates, while conventional bonds are also sensitive to changes in inflation expectations (and inflation insurance premium). Rising interest rates generally have a larger impact on longer-dated securities, making their valuations more volatile. Figure 2 shows the recent moves on real (TIPS) and nominal bond yields, at shorter-term (1-10 year) and longer-term (10+ year) maturities.

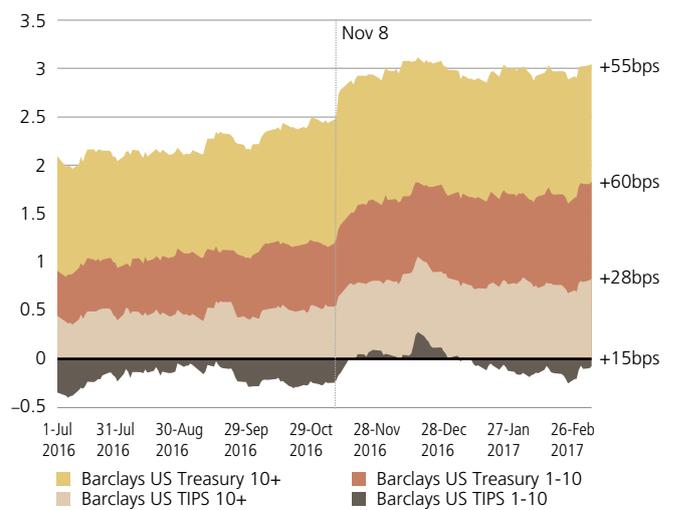
Following Trump's election on November 8th, the moves in nominal yields have been substantial, and more so on the shorter end of the curve (+60 bps for the 1-10 year vs +55bps for the 10+ year, from November 8th to February 28th). In comparison, over the same period, the move on shorter-term (1-10 year) and longer-term (10+ year) TIPS were significantly lower (+28bps and +16bps respectively). This demonstrates the effectiveness of TIPS in absorbing changes in inflation expectations. Interestingly, at the time of writing, the shorter-term 2Y breakeven (i.e. the difference between nominal and real yield) equals 212 bps, which is higher than the longer-term 10Y breakeven of 201bps. This inversion in the breakeven curve implies that investors are pricing in relatively higher inflationary pressure in the near future.

**Figure 1:** Citi Inflation Surprise Index (monthly data from May '00 to Feb '17)



Source: Bloomberg, UBS AM. Data as of 28 February 2017.

**Figure 2:** Yields on selected Treasury bond indices (daily data from Jul '16 to Feb '17)



Source: Barclays Live, UBS AM. Data as of 28 February 2017.



## What does it all mean for performance?

TIPS have outperformed nominal Treasuries by a cumulative 15% since 2000 (Figure 3), on the all-maturity benchmark. The only period of significant underperformance of TIPS was amidst the flight-to-liquidity at the peak of the financial crisis in 2008, which shifted the breakeven below zero, followed by sharp recovery. Looking at the performance over the last year, we clearly see two phases (Figure 4). The first half of 2016 was beneficial to long-term securities (both TIPS and nominal ones), in line with the “lower for longer” scenario. Later in 2016 (and mostly following the election of Trump), a considerable adjustment in inflation expectations took place, which led TIPS to outperform nominal treasuries rather significantly, particularly on the longer-end. Over the last year, shorter 1-10 year maturity TIPS and longer-term 10+ year TIPS delivered returns of 2.5% and 3.9% respectively. Nominal treasuries returned -0.5% and -5.3% respectively, for the same maturity buckets over that period. In other words, the recent adjustment on inflation expectations benefited TIPS vis-à-vis nominal Treasuries.

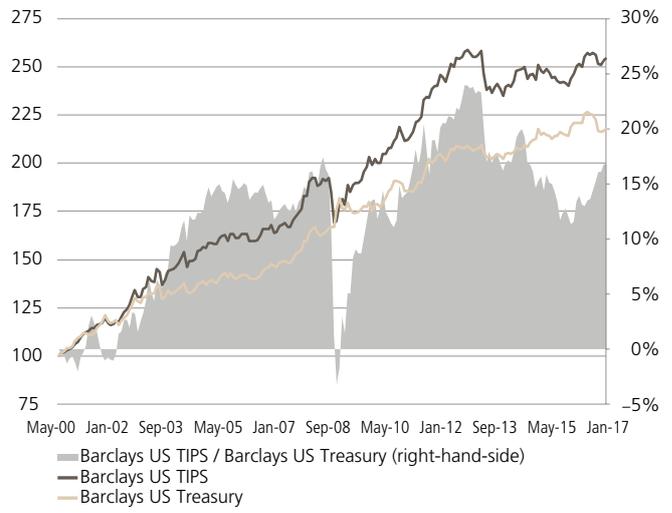


## How to make a choice?

Investors buying US Treasuries have to choose between nominal Treasuries and TIPS as well as on portfolio duration, i.e. short-term vs. long-term. The optimal choice rests on their views and preferences. An investor who anticipates inflation to be higher than expected should favor TIPS over nominal Treasuries. However, there are some caveats in these considerations. Most investors care about real consumption and are risk averse with respect to inflation. The resulting breakeven inflation embedded in TIPS might therefore be pushed above expected inflation due to this premium for inflation insurance. But it is worth noting that TIPS are less liquid than conventional Treasuries and thus command a relative illiquidity premium although that is less relevant for long term investors.

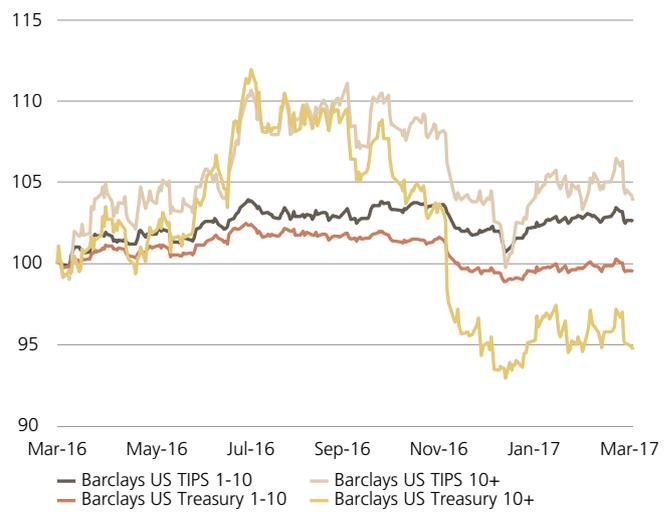
As for the duration, an investor expecting that real interest rates will rise might favor short-term securities although at the expense of lower yields at the beginning. If real rates rise, then an investor could subsequently buy into the longer-term securities. Moreover, shorter-term TIPS have historically tracked realized inflation more closely than longer-term TIPS as the latter are subject to more real interest rate risks. In other words, shorter-term TIPS are more suitable for investors aiming to track realized inflation closer and more concerned about the level of real rates, whilst longer-term TIPS are more suitable for investors wishing to preserve real purchasing power in longer-term and are less concerned about the level of real rates.

**Figure 3:** Performance of TIPS and nominal Treasuries (monthly total return data from May '00 to Feb '17)



Source: Barclays Live, UBS AM. Data as of 28 February 2017.

**Figure 4:** Performance of TIPS and nominal Treasuries (total return daily data from Feb '16 to Feb '17)



Source: Barclays Live, UBS AM. Data as of 28 February 2017.

**Past performance is not indicative of possible future returns.**

For more information, visit our homepage. [www.ubs.com/etf](http://www.ubs.com/etf)

**Pawel Janus**  
PhD, Head Passive Research, Director,  
UBS Asset Management

**Marcin Wojtowicz**  
PhD, Passive Research, Associate Director,  
UBS Asset Management

## Expand your portfolio with UBS ETFs.

Fund Name	Fee	AuM (GBPm)	NAV ccy	Replication	Distribution	ISIN	Bloomberg
<b>Government Bonds USA</b>							
UBS ETF (LU) Barclays US Treasury 1-3 UCITS ETF	0.20%	54	USD	Physical	Yes	LU0721552544	B7VPD81
UBS ETF (LU) Barclays US Treasury 1-3 hedged EUR UCITS ETF	0.25%		EUR	Physical	Yes	LU1324510525	BYYWGG7
UBS ETF (LU) Barclays US Treasury 7-10 UCITS ETF	0.20%	9	USD	Physical	Yes	LU0721552973	B4NV706
UBS ETF (LU) Barclays US Treasury 10+ hedged EUR UCITS ETF	0.25%	16	EUR	Physical	Yes	LU1459800113	BDBBJH2
<b>Inflation-Linked</b>							
UBS ETF (LU) Barclays TIPS 1-10 UCITS ETF	0.20%	419	USD	Physical	Yes	LU1459801434	BYNJ1X1
UBS ETF (LU) Barclays TIPS 1-10 UCITS ETF	0.20%		USD	Physical	No	LU1459801517	BDBBJB6
UBS ETF (LU) Barclays TIPS 1-10 hedged CHF UCITS ETF	0.25%	CHF	Physical	No	LU1459802168	BDBBJC7	
UBS ETF (LU) Barclays TIPS 1-10 hedged EUR UCITS ETF	0.25%	EUR	Physical	No	LU1459801780	BDBBJD8	
UBS ETF (LU) Barclays TIPS 1-10 hedged GBP UCITS ETF	0.25%	GBP	Physical	No	LU1459801947	BYWK760	
UBS ETF (LU) Barclays TIPS 10+ UCITS ETF	0.20%	11	USD	Physical	Yes	LU1459802754	BYNJ1W0

Source: UBS Asset Management as of 28 February 2017

Find all product details here:

[› UBS ETF Product Overview](#)



### Andrew Walsh

Head UBS ETF UK & Ireland  
Tel. +44-20-7901-5901  
Mob. +44-78-1804-7240  
andrew.walsh@ubs.com

### Florian Cisana

UBS ETF UK & Ireland  
Tel. +44-20-7901-5398  
Mob. +44-78-8009-6848  
florian.cisana@ubs.com

**Bloomberg:** UETF <GO>

**E-Mail:** ubs-etf-uk@ubs.com

**Website:** www.ubs.com/etf

### For marketing and information purposes by UBS

UBS Global Asset Management (UK) Ltd is a subsidiary of UBS AG. Registered in England. UBS Global Asset Management (UK) Ltd and UBS Global Asset Management Funds UBS Asset Management (UK) Ltd is a subsidiary of UBS AG. Registered in England. UBS Asset Management (UK) Ltd and UBS Asset Management Funds Ltd are authorised and regulated by the Financial Conduct Authority. UBS Asset Management Life Ltd is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. Telephone calls may be recorded.

**This document is for Professional Clients only. It is not to be distributed to or relied upon by Retail Clients under any circumstances.**

**The document has not been prepared in line with the FCA requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.**

The Luxembourg and Irish domiciled funds are recognised scheme under section 264 of the Financial Services and Markets Act 2000. They seek UK Reporting Fund Status. The protections offered by the UK's regulatory system, and compensation under the Financial Services Compensation Scheme, will not be available.

The Switzerland domiciled funds are not recognised under section 264 of the Financial Services and Markets Act and are therefore subject to the restrictions on promotion in section 238 of the Financial Services and Markets Act.

The returns payable to the fund are dependent on payments received by the fund from the swap counterparty under the terms of the relevant swap and, therefore are subject to credit risk of the swap counterparty. In the event that the swap counterparty defaults under the terms of the relevant swap, the funds may suffer a loss.

This material supports the presentation(s) given. It is not intended to be read in isolation and may not provide a full explanation of all the topics that were presented and discussed. Care has been taken to ensure the accuracy of the content, but no responsibility is accepted for any errors or omissions. Please note that past performance is not a guide to the future. The value of investments and the income from them may go down as well as up, and investors may not get back the original amount invested. This document is a marketing communication. Any market or investment views expressed are not intended to be investment research.

The document has not been prepared in line with the FCA requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information contained in this document should not be considered a recommendation to purchase or sell any particular security and the opinions expressed are those of UBS Asset Management and are subject to change without notice. Furthermore, there can be no assurance that any trends described in this document will continue or that forecasts will occur because economic and market conditions change frequently. This document does not create any legal or contractual obligation with UBS Asset Management. The recipient agrees that this information shall remain strictly confidential where it relates to the Investment Manager's business. The prior consent of UBS Asset Management (UK) Ltd should be obtained prior to the disclosure of commercially sensitive information to a third party (excluding the professional advisors of the recipient). Information reasonably deemed to be commercially sensitive and obtained from UBS Asset Management (UK) Ltd should not be disclosed. This information is supplied with a reasonable expectation that it will not be made public. If you receive a request under the Freedom of Information Act 2000 for information obtained from UBS Asset Management (UK) Ltd we ask that you consult with us. We also request that any information obtained from UBS Asset Management (UK) Ltd in your possession is destroyed as soon as it is no longer required. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG.

This document is issued by [UBS Asset Management (UK) Ltd] and is intended for limited distribution to the clients and associates of UBS Asset Management. Use or distribution by any other person is prohibited. Copying any part of this publication without the written permission of UBS Asset Management is prohibited. Care has been taken to ensure the accuracy of its content, but no responsibility is accepted for any errors or omissions herein.

© UBS 2017. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.