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Inflation Licked Bonds

by Alex Harvey, CFA

Before the 4th of April this year, it cost 85 pence to send a letter first class in the UK. After that date you have needed to stick another 10 pence stamp onto your letter to maintain its first-class status. But if you had a '1st' class stamp knocking about in a drawer, it effectively increased in value by an inflation busting 11.7% this year (and 11.8% the year before that). That's because, as I recently learned, in the UK a postage stamp with '1st' or '2nd' class on it holds its 'class' value through time, even after the annual increase in the price of sending post. Luck runs out for wannabe stamp arbitrageurs at the end of January 2023 however, as Royal Mail looks to introduce barcoding on these stamps, but there will be a two month 'stampnesty' when old stamps can be swapped for new.

50 years ago, it cost 3 pence and 2.5 pence respectively to send a letter by first- or second-class post in the UK[1]. At 95 pence and 68 pence today, that equates to an annualised increase of 7.2% and 6.8% respectively for first and second-class stamps. Over the last 25 years, a period of lower inflation (until this year), their prices have increased by an annualised 5.3% and 5% - more than twice the UK's Consumer Price Index (CPI) rate of 2.1% annualised over the same period. In fact, they almost match the 1-10 year UK Inflation Linked bond index's annualised return of 4.9%. That's pretty good inflation protection, if an unexciting one (apologies to the philatelists out there). And since 2001, Christmas hasn't tasted the same after the arrival of the first self-adhesive stamps.

When it comes to inflation though, postage costs are probably not front and centre of people's minds. Utility bills, food and petrol prices have all been rising sharply in recent months, with the last data release showing that consumer prices in the UK rose by 9.1% year-on-year through May, up slightly on the prior month's 9%. In the US, the equivalent number is 8.6% with the numbers for June out on Wednesday 13 July, expected to show another increase to 8.8%. Core inflation there is expected to fall again, as it did last month, in both the US and the UK but it remains at around 40-year highs.

One way to protect against inflation is by owning inflation linked bonds whose coupon and principal (the amount to be repaid) is linked to an underlying inflation index, CPI in the US and Retail Price Index (RPI) in the UK. They also embed the market's expectation for future inflation and can be a useful bellwether for inflation pricing. Back in March 2020 – what was arguably 'peak Covid' for financial assets – expectations for future inflation, as measured by the inflation 'breakeven', fell off a cliff such that US 5-year inflation expectations dropped as low as an annualised 0.11%. The US 10 year breakeven rate fell to 0.47%. This provided a significant relative value opportunity for our funds which held Treasury bonds, and which could switch into Treasury Inflation Protected Securities (TIPS). The 175bps increase in 10 year breakevens from mid-March 2020 to the end of June 2022 resulted in a whopping 20% outperformance of TIPS over nominal Treasuries.

As with most insurance though, you need to buy it before the event, and this trade was largely exhausted by the start of the year. Much of this inflation risk has since been recycled into strategies that benefit more directly from inflation once it is going up, rather than from future inflation expectations. Over the course of the last year, we have increased our exposure to real assets – those which have an intrinsic value, such as real estate and infrastructure – much of which generates an income that is directly or closely linked to inflation. As outcome based multi asset investors these strategies, along with equities, are some of the most effective at capturing this inflation 'pass through', and arguably their best returns remain ahead of them. A must have for any investment collector's album.

Sources:
1 https://channelx.world/2019/03/historic-royal-mail-stamp-prices-1971-2019
Unless stated all other sources Bloomberg Finance L.P.

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