



Standard Life Investments



# Investment Focus

## Global Index-Linked Bond Fund

In this Investment Focus, we examine the drivers of inflation-linked markets in 2010. We also focus on how we are exploiting current market themes within the Global Index-Linked Bond Fund.

This communication is intended for investment professionals and should not be relied on by anyone else.

### Election gloom looms

The UK is heading into an election year with the government's finances in disarray. For bond investors, one of the greatest fears is an inconclusive election result. The UK, other than in times of war, has little positive experience of hung parliaments on which to draw, and investors rightly fear policy paralysis. At the same time, the UK market is in the grips of an inflation spike. Base effects, high oil prices and the re-imposition of 17.5% VAT is likely to require Mervyn King writing to the

Chancellor to explain why inflation is exceeding the upper band of the target range.

However, wages and labour costs (key drivers of inflation) have been relatively subdued, in light of wage freezes and job cuts. As a result, we do not anticipate a worrisome level of inflation in the longer term, although volatility is likely to increase.

### Current drivers of inflation

Investors' future expectations of inflation are a key driver of inflation-linked bonds. While returns from conventional bonds such as gilts have suffered recently from increased risk appetite in the market place, inflation-linked bonds have performed well as investors have revised their inflation expectations. The US market is a key example of this. Inflation expectations, as measured by 10-year breakeven rates\* have increased to around 2.4% from near zero a year ago.

Investor demand is also a key factor driving index-linked bonds. As well as large flows into our own funds, there have been ongoing retail flows into US Treasury Inflation Protected Securities (TIPS), as well as very strong demand at the latest index-linked new issue from the Australian

\*The difference between the nominal yield on a conventional bond and the real yield on an inflation-indexed bond of the same maturity.

government. In the UK, however, pension fund investors appear to be waiting on the sidelines in anticipation of any minor cheapening of long-dated index-linked debt. Elsewhere, the European market is suffering on a relative basis due to a wave of supply.

Another significant factor investors should consider is risk premium, i.e. the cost of protecting against uncertain variables such as inflation. Currently, the extraordinary forces exerted on the global economy by the crisis and the various stimulus packages undertaken to address it have created a high level of uncertainty over the future path of inflation. Consequently, it is reasonable to suggest that investors may have to pay more in the future as market volatility increases.

### Pricing in political risk

A key event for the UK market in 2010 is the forthcoming general election. In political terms, it is difficult to assess what the market has priced in. As the UK election approaches, all market participants will become avid poll followers and banks are already calculating the probability of a hung parliament. In addition inflation, as measured by the Consumer Price Index, (CPI) has been above-market consensus in 16 of the last 21 months. Should this upward bias persist, pressure on wage negotiations is likely to increase. Although this will be muted by levels of unemployment, a post-election Labour or coalition government involving Labour would surely feel the heat from the unions in this environment. This exacerbates political risk to the market.

Sovereign risk has become a front-line issue in many countries in recent months, especially in Greece. Credit rating downgrades have led to the ejection of Greek inflation-linked bonds from our benchmark indices. While it should be stressed that the situation in the UK is not as desperate as in Greece, a downgrade would nonetheless cause problems, not least a rise in funding costs.

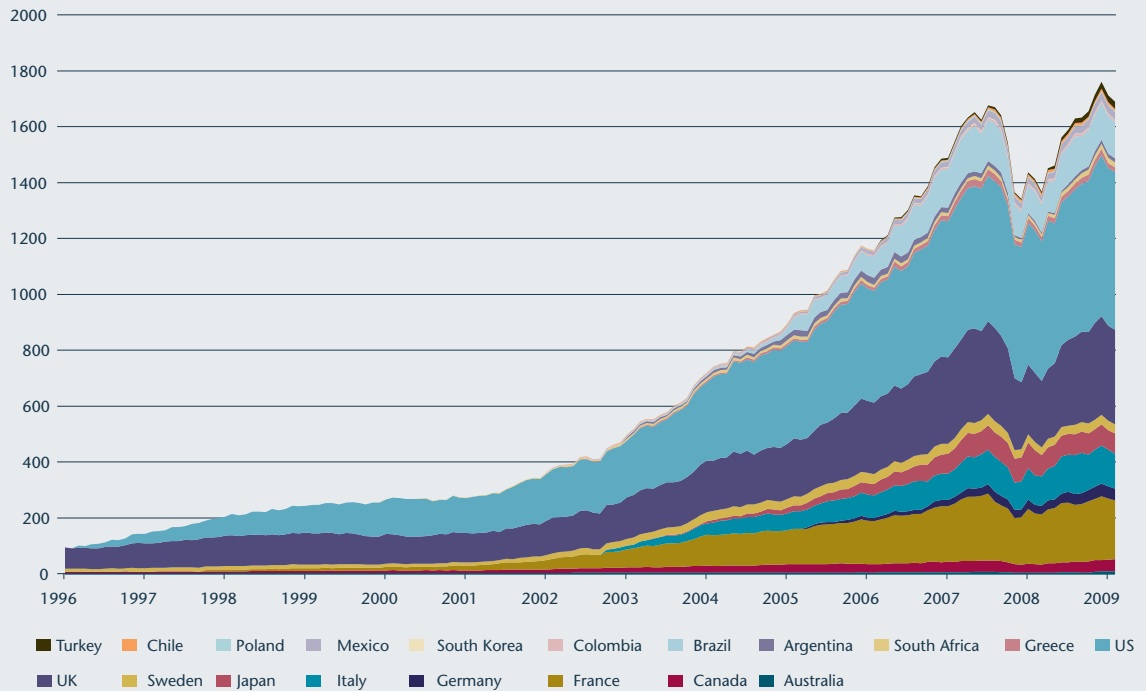
Our analysis has identified that the risk premium in the UK, as measured by the inflation swap curve, has re-established itself to a level approaching fair value. However, both US and Euro-zone CPI is still around zero, and in the current atmosphere of uncertainty, this risk premium should rise.

## Where's best to invest?

In the UK, high demand from pension funds looking to hedge inflation risk has led to a supply/demand imbalance. As a result, real yields (essentially a bond's yield after the effect of inflation) in the UK are extremely low (less than 0.5% for long-dated debt) relative to other countries. Real yields on long-dated debt in the US and parts of Europe are around 2.0% and in Australia approximately 2.6%. Therefore, access to a global portfolio is highly desirable.

As well as higher real yields, global portfolios are attractive because of the diversification benefits over a single country portfolio and the broader opportunity set generated. Activity in global index-linked bond markets has grown considerably in recent months with new bonds issued in the UK, Australia, Italy, France and US. The chart below shows the vast growth in the inflation-linked bond market over time.

Global Inflation-Linked Bonds Market Value (\$bn)



Source: Merrill Lynch

## Global Index-Linked Bond Fund

Our Global Index-Linked Bond Fund has scope to invest throughout the benchmark index and can also use derivative positions to express our views and manage risk.

Within our portfolios we use a number of different types of trade. A key strength of our investment process is our identification of trades that can be implemented across

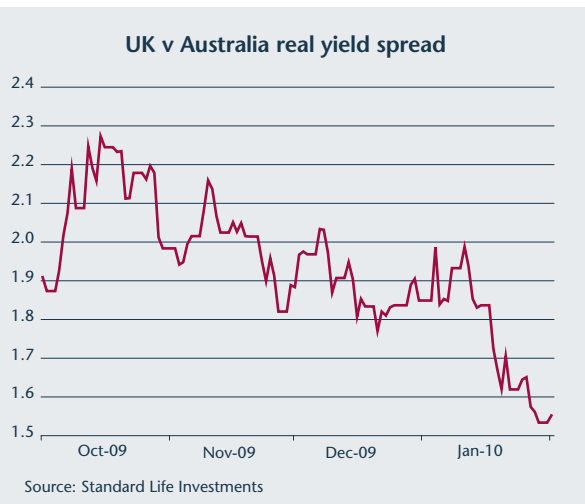
different portfolios. Given the level of resource across Standard Life Investments, and the in-depth experience of the team this gives us a competitive edge when identifying opportunities.

Some of the Fund's current positions are on the next page.

**Underweight UK relative to Australia and Europe**

We have a core underweight UK strategy on the basis that UK bonds are at risk of underperforming due to higher breakeven rates, concern over the fiscal debt/sovereign rating, the implications of quantitative easing ending and political uncertainty. Australia, on the other hand, is not subject to these risks to nearly the same extent as the UK. In addition, demand for Australian index-linked bonds is expected to pick up as the bonds become more liquid. Australia's first new issue in over four years took place in September 2009, and further supply will improve liquidity. Meanwhile, the outlook for inflation in Europe is more subdued. We favour core Europe as we anticipate a flight to quality within Europe as fiscal problems are examined in more detail.

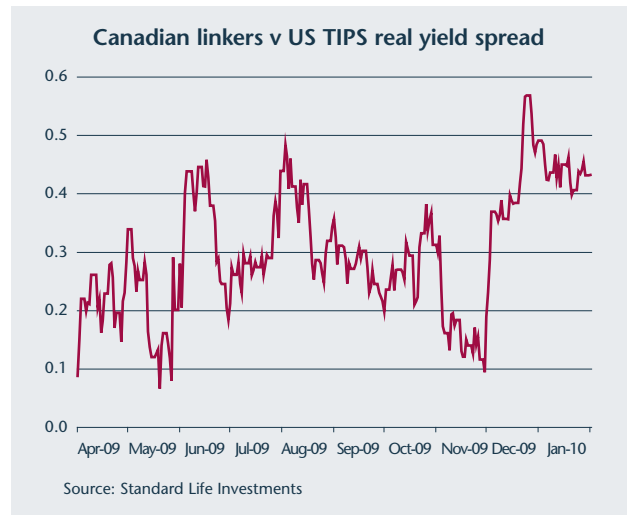
The chart below shows the spread, essentially the difference between UK and Australian real yields. We entered this position in September 2009. The spread has since contracted benefiting Fund performance, and we anticipate further spread tightening.



**Underweight Canada relative to the US**

Recent economic data in Canada have been encouraging and interest rate hikes are expected there ahead of any action taken by the US. Canadian index-linked bonds significantly outperformed US TIPS in December and we expect this to return to a normal range.

The chart below shows the spread between Canadian and US real yields. We entered this position in January 2010 in anticipation of the spread tightening over time.



**Usage statement**

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To find out more about our fund range, visit our website or alternatively speak to your usual contact at Standard Life Investments.

[www.standardlifeinvestments.co.uk](http://www.standardlifeinvestments.co.uk)

**Useful numbers**

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