

At the crossroads of inflationary direction

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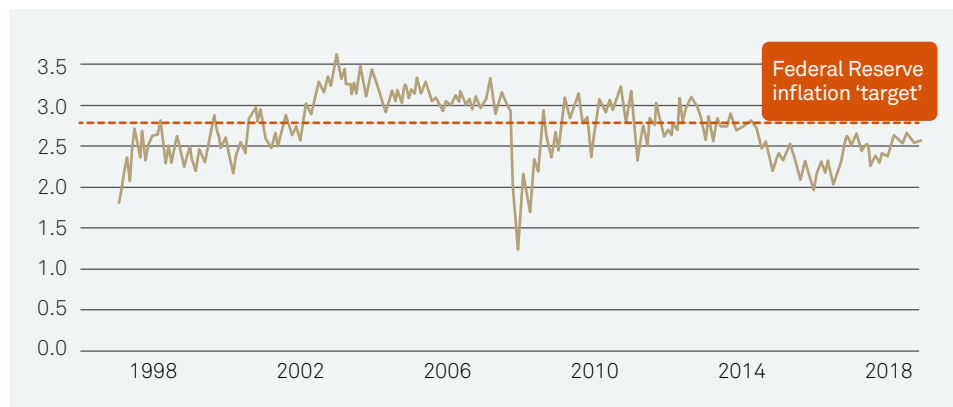
Is the multi-year bull-run in government bonds really over? It would certainly seem so. Global yields, led by U.S. front-end rates, have been on a modest upward trend since late 2016. How much further they increase as we move through 2019 could depend on the inflation outlook, which in

turn will likely take its cue from the outlook for wage growth.

Here, though, momentous forces are at play. Over the past two decades, the twin tides of globalisation and technological innovation have worked to undermine

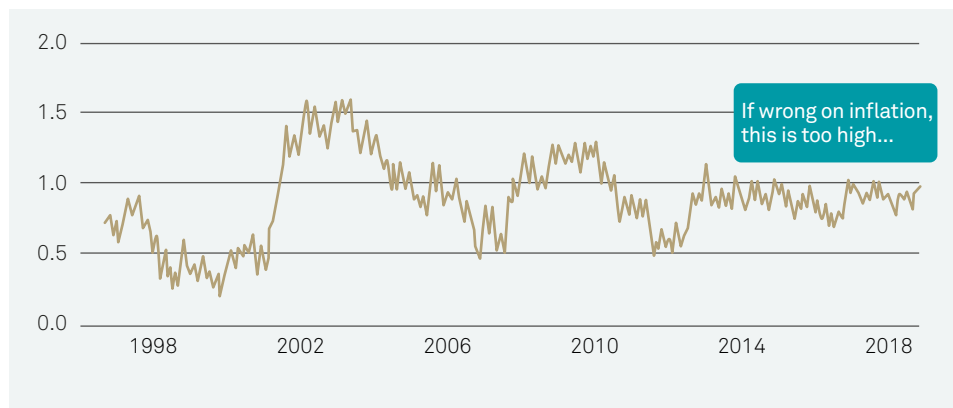
the bargaining power of labor. The result? A breakdown in the established relationship between unemployment levels and wages as defined by the Phillips Curve and, as a consequence, ever greater uncertainty about the future direction of inflation.

30-YEAR U.S. BREAKEVEN INFLATION (%)



Source: Bloomberg as at September 14, 2018.

30-YEAR REAL YIELDS (%)



Source: Bloomberg as at September 14, 2018.

For investors this could present a problem. If wage growth does remain subdued, upward pressure on bond yields is likely to be modest. If, on the other hand, wages and inflation expectations do rise, bond yields will likely spike. Where, then, could investors turn?

Given this background, one approach investors may want to think about is hedging inflation in an efficient way. The charts highlight the potential mispricing between 30-year breakeven rates and real yields on 30-year U.S. Treasury inflation-protected securities. If investors are concerned about inflation, then a combination of U.S. Treasury inflation-protected securities and U.S. breakeven strategies could be an option to consider.

All investments involve risk including loss of principal.

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