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Inflation & Rates

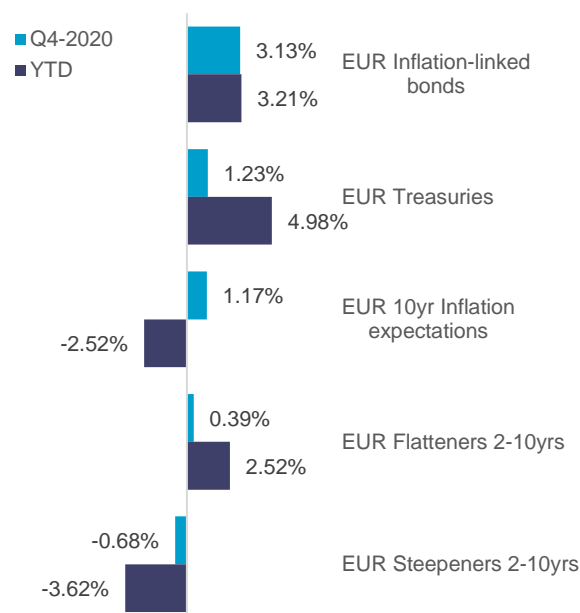
Explorer: EUR Q4 20

Lyxor's Inflation & Rates Explorer monitors the performance of selected Fixed Income indices. In this report we review the main trends in the EUR Fixed Income market over the past quarter, and how these trends influenced the performance of inflation-linked and curve strategies.

Key takeaways

- ▶ **EUR Government bonds** posted positive performance in Q4 2020, supported by further spread compression in France, Italy and Spain while Bund yields remained deeply anchored in negative territory.
- ▶ **Inflation-linked bonds ahead of nominal bond performance in Q4:** EUR inflation-linked bonds outperformed in Q4 2020, benefiting from the recovery in inflation expectations and limited moves in French OAT and German Bund yields.
- ▶ **Limited performance for curve strategies:** EUR curve strategies showed little performance in Q4 2020 as there was little change in Bund spreads. This followed a strong flattening of the yield curve in H1 2020.

Performance overview*



*Performance is stated in EUR and in gross total return. Past performance is not a reliable indicator of future performance. For indices' full names please refer to index glossary on p.4. Data as at 31/12/2020. Sources: Bloomberg, Lyxor International Asset Management.

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Market & performance overview

A better quarter for EUR inflation

Covid-19 left some scars on economic activity and prices following the restrictions put into place in late Q1 2020 across the euro area. At that time, the oil price rout and collapse in services prices (airline & hospitality) started to affect HICP headline prints across the euro area. The market correction in inflation-linked bonds at the height of the crisis has some similarities with previous market sell-offs. Nonetheless, the sell-off in EUR inflation-linked bonds was faster and **more abrupt than even 2008**.

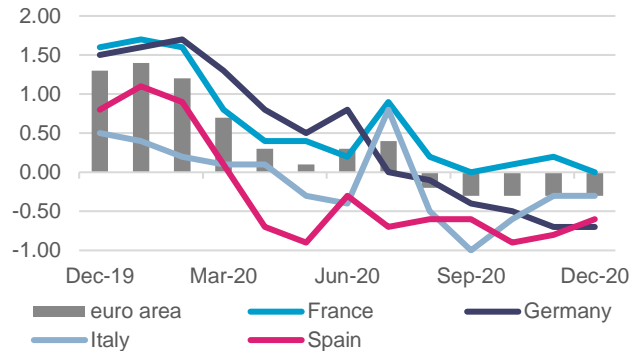
Headline HICP Inflation in the euro area headed into negative territory over summer 2020 and has remained there ever since, weighed down by the collapse in oil prices and the VAT cut in Germany (which came to an end in January 2021). However, underlying core measures started to show some signs of recovery, particularly in the services sector as restrictions were progressively lifted. As an example, reflation in the services sector has been driven by a base effect from airfares in the late part of the year. Freight costs also surged in Q4. Costs were pushed up due to Covid-related disruptions and increased demand for some imported goods in H2 2020 at a time when container capacity was limited.

While cyclical weakness in inflation is still priced in, inflation expectations – as measured with 5Y inflation swaps – have recovered in H2 2020, pushed up by market normalisation and further recovery in economic activity. However, spare capacity weighs on cost pressures and price gains. Looking ahead, the negative base effects from energy prices will wane from Q2 2021 along with those from the temporary German VAT cut. Statistical offices kept their basket weights unchanged in 2020 and a large reweighting is likely in 2021 (lower weight in energy & services prices, higher weights for consumer goods).

Over the longer term, the slack in product and labour markets and the stronger euro may keep a lid on inflation in the euro area. It will take some time for core inflation to trend back to its pre-crisis levels.

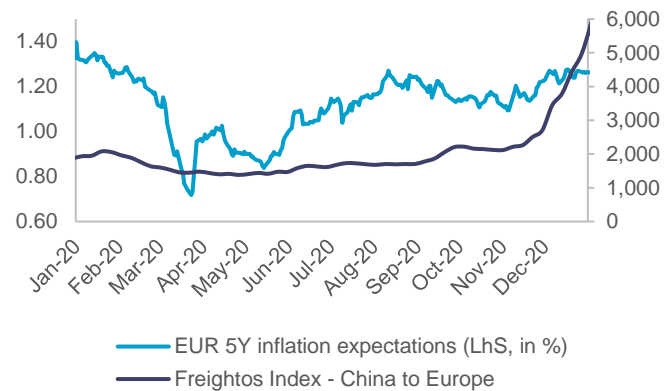
Strong base effect pushed headline inflation in negative territory in H2 2020

Headline HICP Inflation (% YoY, EU harmonised)



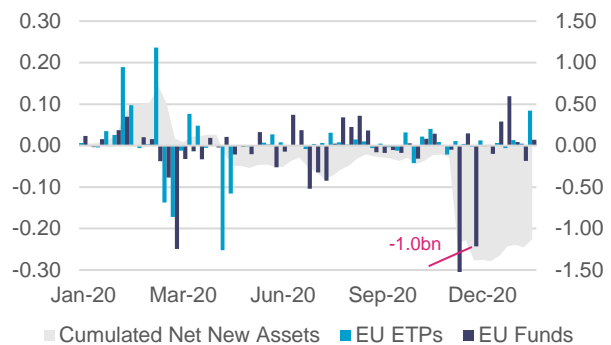
Surging freight costs could fuel further EUR inflation

EUR inflation expectations & freight costs



Reallocation into EUR inflation-linked funds in late Q4

EUR inflation-linked weekly flows (Funds and ETFs in €bn)



For all data sources: Bloomberg, Morningstar, Lyxor International Asset Management. Data as at 31/12/2020. Past performance is not a reliable indicator of future returns

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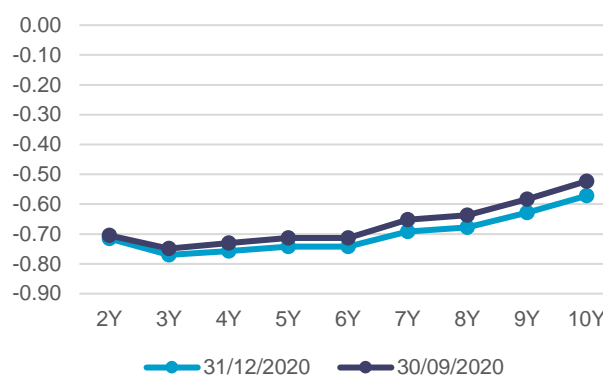
In this context, EUR inflation-linked bonds outperformed in Q4 2020, benefiting from the recovery in inflation expectations and limited moves in OAT and Bund yields. Meanwhile, inflation expectations strategies' performance was hampered by negative EUR repo rates due to the ECB's negative rate policy (see [p.8-11](#) for more details).

Bund yields remained deeply anchored in H2 2020

The spread between German 2Y Schatz and 10Y Bund yields, the most common measure of the yield curve, was little changed over H2 2020 as German Bund yields were heavily anchored across maturities. This came up after a strong flattening of the Bund yield curve in H1 2020 at the height of the Covid-19 crisis, at time when activity in the euro area was almost brought to a halt due to heavy restrictions to limit the spread of the virus.

In contrast with the US, market expectations are still for another rate cut from the ECB. This should leave the front end of the Bund yield curve well anchored in negative territory. The long end of the curve should eventually be supported by expectations that mass vaccination campaigns against Covid-19 will lead to widespread business reopening and spur economic growth.

In this context, EUR curve strategies showed little performance in Q4 2020 as there was little change in Bund spreads (see [p.12](#) for the detailed performance analysis). This followed a strong flattening of the yield curve in H1 2020.

Markets anticipate further rate cuts from the ECB
Implied Overnight Rate & Number of Hikes/Cuts**Little flattening in the Bund yield curve in Q4 2020**
German Bund yield curve (in percentage point)

For all data sources: Bloomberg, Lyxor International Asset Management. Data as at 31/12/2020. Past performance is not a reliable indicator of future returns.

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Index definition

Index Exposure	Index name	Bloomberg ticker
EUR Inflation-Linked bond	Bloomberg Barclays Euro Inflation Linked - All CPI Index The Index includes euro-denominated inflation-linked government bonds within the euro zone with maturities greater than one year.	LF96TREU
EUR 2-10 Year Inflation expectations	Markit iBoxx EUR Breakeven Euro-Inflation France & Germany Index The index is designed to provide exposure to breakeven inflation by entering into a long position in inflation-linked bonds issued by France and Germany and a short position in France and Germany sovereign bonds with adjacent durations.	IBXXEBF1
EUR 2-10 Year Inverse Inflation expectations	iBoxx EUR Inverse Breakeven Euro-Inflation France & Germany The index is representative of a short position in inflation-linked bonds issued by France and Germany and a long position in France and Germany sovereign bonds with adjacent durations.	IBXXEIBE
EUR Treasuries	Bloomberg Barclays Euro Treasury 50bn Bond Index The index is representative of the performance of EUR denominated government bonds issued by countries of the European Monetary Union with at least €50bn of government bonds in issuance. Eligible securities must have maturities of at least 1 year, with a minimum outstanding amount of €300m.	I35205EU
EUR Treasuries Highest Rated Macro Weighted	FTSE MTS Highest Rated Macro-Weighted Government Bond Index The index, denominated in EUR, is representative of the performance of eurozone government bonds that have the highest credit ratings. Bonds are weighted in the index according to macroeconomic indicators.	FMMPHRG5
EUR Flatteners 2-10 years	Solactive EUR Daily (x7) Steepener 2-10 Index The index tracks the investment performance of a systematic strategy whose returns are directly linked to changes in the German government bond yield curve. The index is constructed such that for a 1bp decrease in the steepness of the curve, the index is expected to increase roughly 7bps, though market factors may cause some deviation. The index consists of two underlying components: a short position in the Euro-Schatz-Futures and a long position in the Euro-Bund-Futures.	SOED7STT
EUR Steepeners 2-10 years	Solactive EUR Daily (x7) Flatteners 2-10 Index The index tracks the investment performance of a systematic strategy whose returns are directly linked to changes in the German government bond yield curve. The index is constructed so that for a 1bp increase in the steepness of the curve, the index is expected to increase roughly 7bps, though market factors may cause some deviation. The index consists of two underlying components: a long position in the Euro-Schatz-Futures, and a short position in the Euro-Bund-Futures.	SOED7FTT

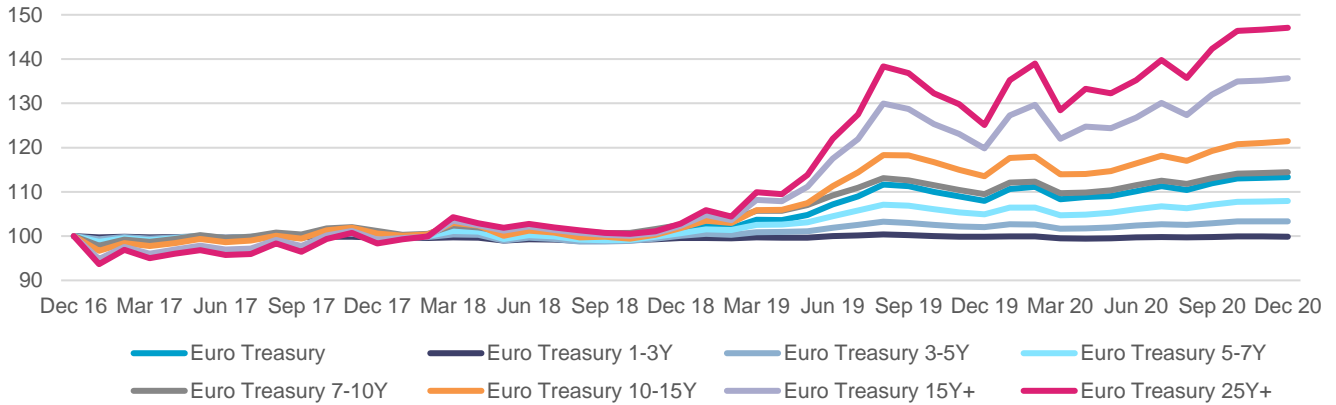
Source: Bloomberg, Solactive, IHS Markit, FTSE MTS, Lyxor International Asset Management.

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EUR Treasuries

Bloomberg Barclays Euro Treasury 50bn Bond Index and buckets

Index performance

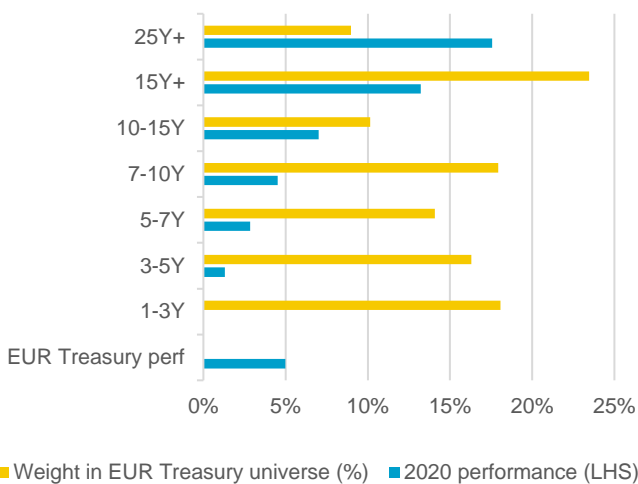


Base 100 = 01/06/2016
 Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020.
 Past performance is not a reliable indicator of future returns

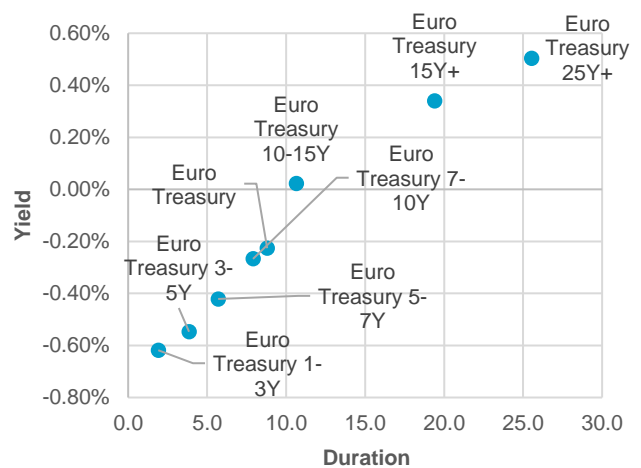
	Duration	Yield to Worst	QoQ yield change (in bps)	Q4 2020	2020	2019
Euro Treasury	8.8	-0.23%	-12.7	1.23%	4.98%	6.76%
Euro Treasury 1-3Y	1.9	-0.62%	-11.0	0.07%	0.02%	0.29%
Euro Treasury 3-5Y	3.9	-0.55%	-12.6	0.40%	1.30%	1.89%
Euro Treasury 5-7Y	5.7	-0.42%	-12.1	0.80%	2.84%	4.26%
Euro Treasury 7-10Y	7.9	-0.27%	-13.0	1.17%	4.52%	6.74%
Euro Treasury 10-15Y	10.6	0.02%	-16.9	1.85%	7.01%	11.50%
Euro Treasury 15Y+	19.4	0.34%	-13.3	2.80%	13.23%	17.12%
Euro Treasury 25Y+	25.5	0.50%	-11.2	3.35%	17.56%	21.67%

Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020. Performance is stated in USD and in gross total return. Past performance is not a reliable indicator of future returns

Index breakdown by maturity buckets



Yield Duration profiles



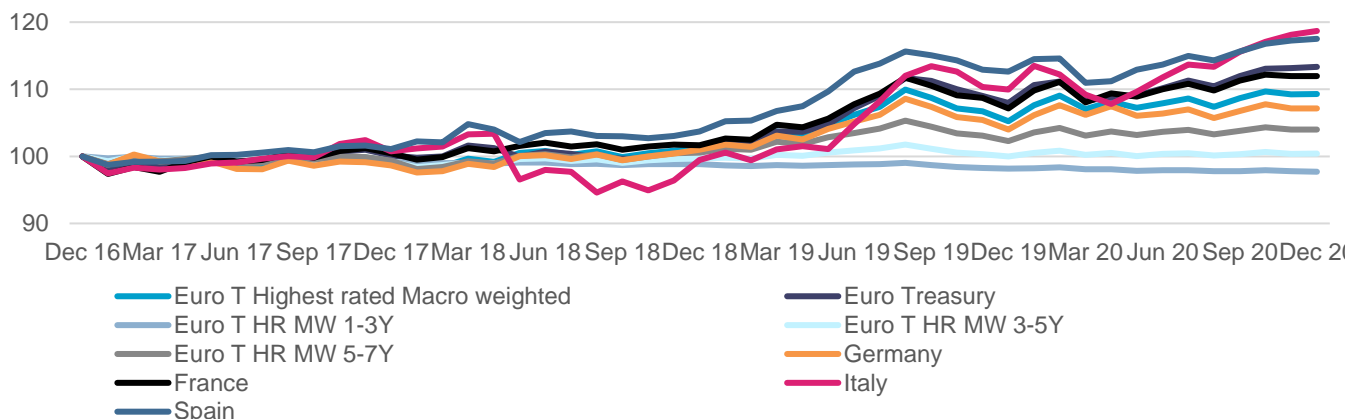
Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020.
 Past performance is not a reliable indicator of future returns

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EUR Treasuries – Highest Rated Macro Weighted

FTSE MTS Highest Rated Macro-Weighted Government Bond Index and buckets

Index performance



Base 100 = 01/06/2016

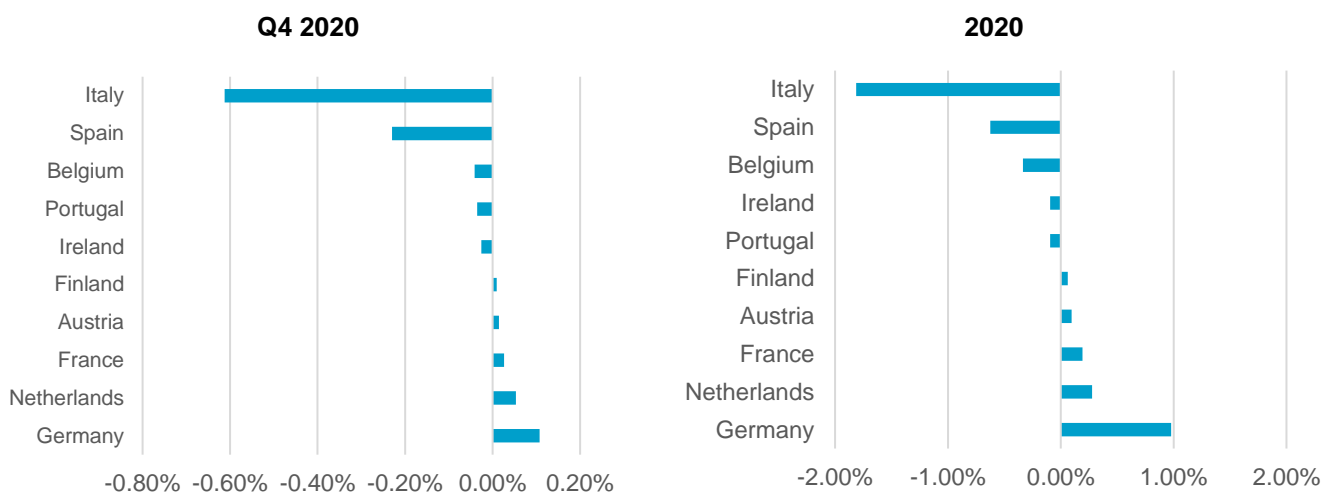
Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020.

Past performance is not a reliable indicator of future returns.

	Duration	Yield to Worst	QoQ yield change (in bps)	Q4 2020	2020	2019
Euro T Highest rated Macro weighted	9.2	-0.51%	-5.0	0.55%	3.83%	3.99%
Euro Treasury	8.8	-0.23%	-12.7	1.23%	4.98%	6.76%
Euro T HR MW 1-3Y	2.0	-0.72%	-4.0	-0.11%	-0.49%	-0.64%
Euro T HR MW 3-5Y	4.0	-0.72%	-3.0	0.10%	0.44%	0.29%
Euro T HR MW 5-7Y	5.9	-0.67%	-3.0	0.19%	1.66%	1.71%
Germany	8.4	-0.61%	-4.1	0.33%	3.01%	3.01%
France	9.4	-0.38%	-6.3	0.63%	4.51%	5.41%
Italy	7.7	0.29%	-27.8	2.70%	7.93%	10.59%
Spain	8.6	-0.07%	-16.1	1.61%	4.35%	8.57%

Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020. Performance is stated in USD and in gross total return. Past performance is not a reliable indicator of future returns

Estimated impact relative to Euro treasury (weight difference * Total return)



Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020.

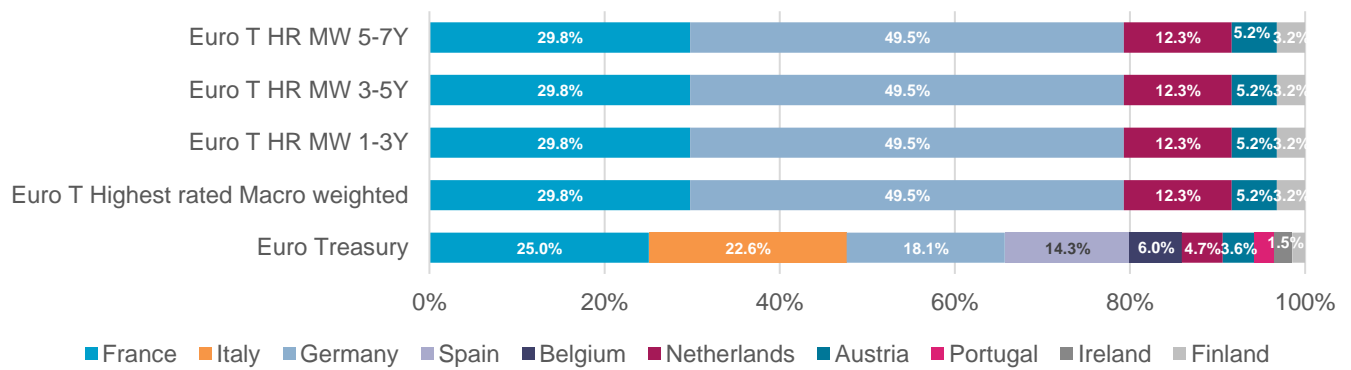
Past performance is not a reliable indicator of future returns

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Index breakdown by country issuers



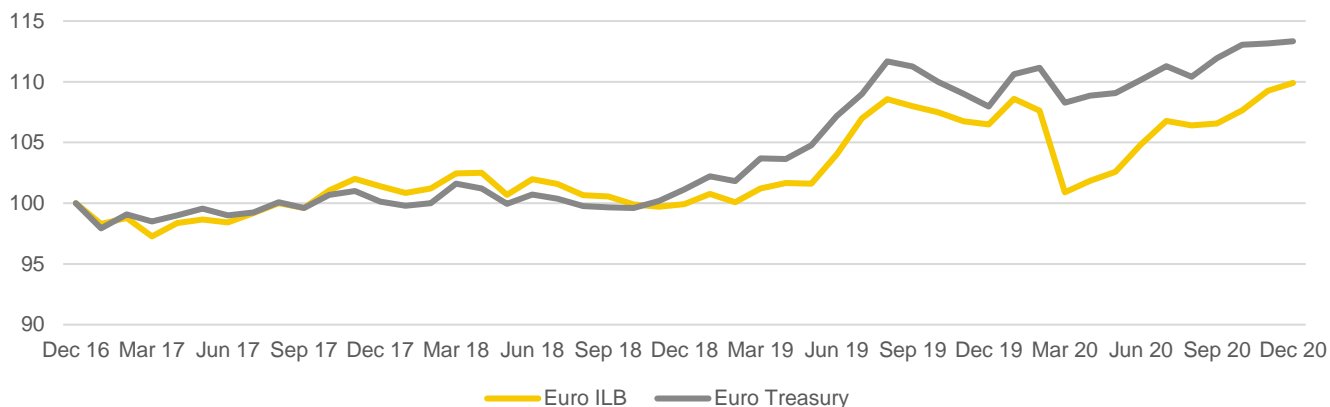
Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020.
Past performance is not a reliable indicator of future returns

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Inflation-linked bonds

Bloomberg Barclays Euro Inflation Linked - All CPI Index and buckets

Index performance



Base 100 = 01/06/2016

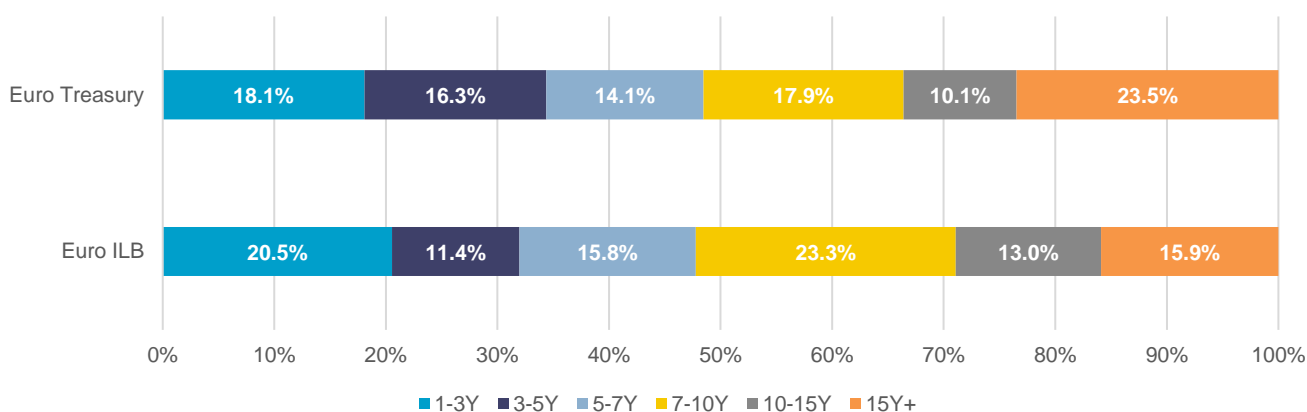
Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020.

Past performance is not a reliable indicator of future returns

	Duration	Yield to Worst ¹	QoQ yield change (in bps)	Q4 2020	2020	2019
Euro ILB	8.5	-1.07%	-48.0	3.13%	3.21%	6.57%
Euro Treasury	8.8	-0.23%	-12.7	1.23%	4.98%	6.76%
Euro ILB 1-3Y	2.2	-1.21%	-61.0	0.95%	-0.75%	1.18%
Euro ILB 3-5Y	3.7	-1.26%	-66.0	1.55%	0.02%	2.54%
Euro ILB 5-7Y	5.8	-1.22%	-43.0	2.14%	0.84%	3.64%
Euro ILB 7-10Y	8.5	-1.10%	-40.0	2.85%	1.89%	7.41%
Euro ILB 10-15Y	11.6	-0.62%	-41.0	5.37%	6.77%	9.33%
Euro ILB 15Y+	20.2	-0.94%	-55.0	6.36%	11.70%	16.18%

Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020. Performance is stated in USD and in gross total return. Past performance is not a reliable indicator of future returns

Index breakdown by maturity buckets



Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/12/2020.

Past performance is not a reliable indicator of future returns

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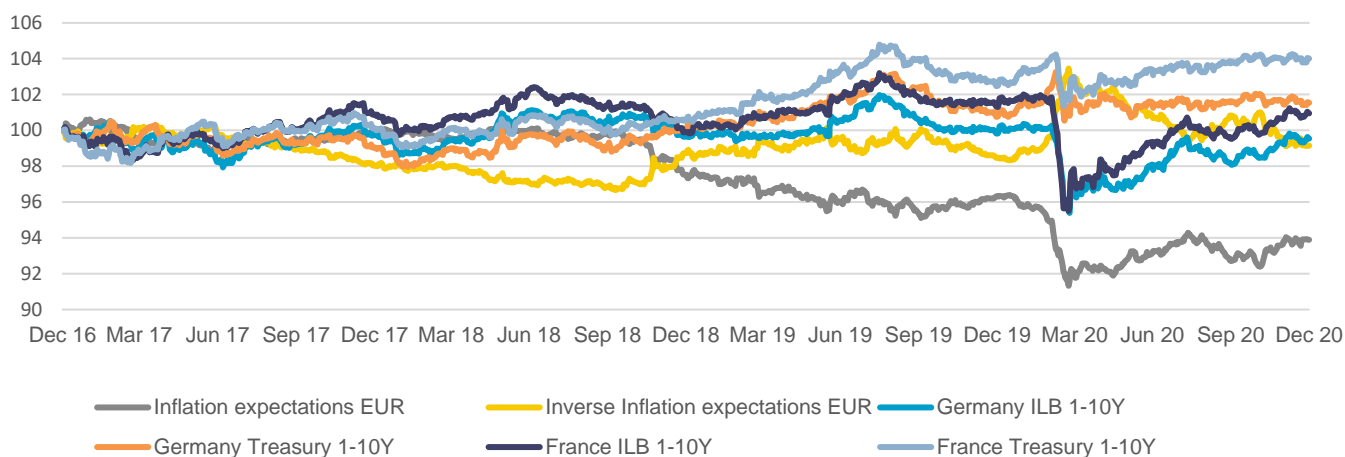
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10 Year Inflation Expectations

iBoxx EUR Breakeven Euro Inflation France & Germany Index
iBoxx EUR Inverse Breakeven Euro-Inflation France & Germany Index

Index performance



Base 100 = 01/06/2016

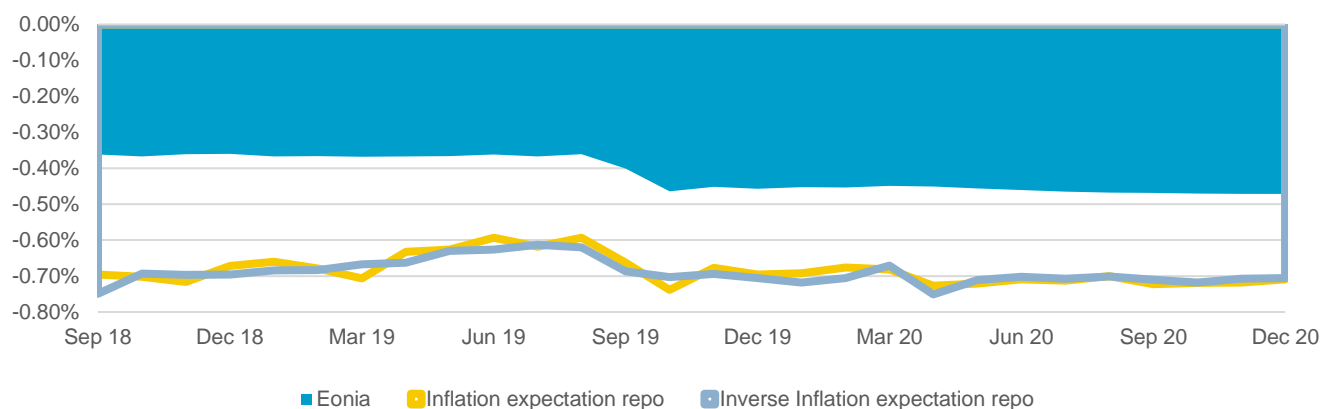
Sources: Lyxor International Asset Management, Markit. Data as at 31/12/2020.

Past performance is not a reliable indicator of future returns

	Q4 2020	Q3 2020	2020	2019
Inflation expectations EUR	1.17%	-0.37%	-2.52%	-1.23%
Inverse inflation expectations EUR	-1.57%	-0.09%	0.70%	-0.27%
Germany ILB 1-10Y	1.41%	0.06%	-0.29%	0.17%
Germany Treasury 1-10Y	-0.02%	-0.01%	0.77%	0.73%
France ILB 1-10Y	1.42%	0.20%	-0.35%	1.42%
France Treasury 1-10Y	0.25%	0.33%	1.49%	1.92%

Sources: Lyxor International Asset Management, Markit. Data as at 31/12/2020. Performance is stated in USD and in gross total return. Past performance is not a reliable indicator of future returns

Average repo return



Sources: Lyxor International Asset Management, Markit. Data as at 31/12/2020.
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iBoxx EUR Breakeven Euro Inflation France & Germany Index

The index performance is the result of:

- The difference between the realised daily returns of the Inflation-Linked Bonds (ILB) basket and the EUR Treasuries (EUT) bond basket
- This performance is adjusted for the cost of repo and rebalancing, when applicable.

	Q4 2020		Q3 2020		YTD 2020		2019	
	Performance		Performance		Performance		Performance	
Inflation-linked basket performance	1.67%	ILB	0.17%	ILB	-0.20%	ILB	1.69%	ILB
Treasuries basket performance	0.28%	Treas	0.30%	Treas	1.44%	Treas	2.18%	Treas
Average Scaling Factor	100.12%	SF	100.13%	SF	100.42%	SF	100.1%	SF
Average Repo return	-0.18%	Repo	-0.18%	Repo	-0.71%	Repo	-0.66%	Repo
Rebalancing costs	0.02%	RC	0.04%	RC	0.18%	RC	0.06%	RC
Estimated performance Inflation expectations EUR								
ILB - SF * (Treas- Repo) - RC	1.19%		-0.36%		-2.52%		-1.22%	
Actual index performance	1.17%		-0.37%		-2.52%		-1.23%	

Sources: Lyxor International Asset Management, Markit. Data as at 31/12/2020. Past performance is not a reliable indicator of future returns

iBoxx EUR Inverse Breakeven Euro-Inflation France & Germany Index

The index performance is the result of:

- The difference between the realised daily returns of the EUR Treasuries bond basket (EUT) and the Inflation-Linked Bonds (ILB) basket.
- This performance is adjusted for the cost of repo and rebalancing, when applicable.

	Q4 2020		Q3 2020		YTD 2020		2019	
	Performance		Performance		Performance		Performance	
Inflation-linked basket performance	1.67%	ILB	0.17%	ILB	-0.20%	ILB	1.69%	ILB
Treasuries basket performance	0.28%	Treas	0.30%	Treas	1.44%	Treas	2.18%	Treas
Average Scaling Factor	99.88%	SF	99.87%	SF	99.59%	SF	99.90%	SF
Average Repo return	-0.18%	Repo	-0.18%	Repo	-0.71%	Repo	-0.66%	Repo
Rebalancing costs	0.02%	RC	0.05%	RC	0.18%	RC	0.07%	RC
Estimated performance Inverse Inflation expectations EUR								
Treas - SF * (ILB - Repo) - RC	-1.58%		-0.08%		0.74%		-0.24%	
Actual index performance	-1.57%		-0.09%		0.70%		-0.27%	

Sources: Lyxor International Asset Management, Markit. Data as at 31/12/2020. Past performance is not a reliable indicator of future returns

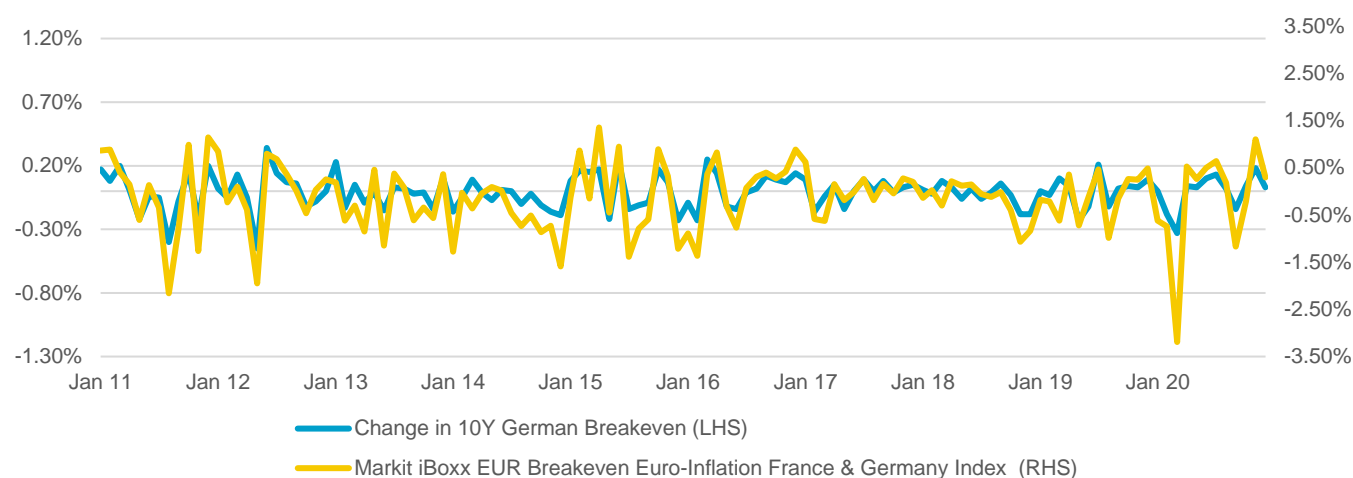
MARKETING DOCUMENT - FOR PROFESSIONAL AND QUALIFIED INVESTORS ONLY**How does the index behave vs. the theoretical EUR breakeven inflation rate?**

The index is designed to capture changes in breakeven inflation rate. Due to the non-linear relationship between changes in yield, return and fluctuations in market supply and demand, the magnitude of Index movements compared to changes in breakeven inflation varies from time to time.

The comparison between the index level and the breakeven rate can only be directional. The relationship between the changes in the two series is, however, clearly visible (chart below).

Historically, across the entries sample period, **a 1% absolute change in the breakeven inflation rate corresponded to an approximately 4% change in the index level.**

The correlation level can vary over time and should not be used as a systematic rule.

Markit iBoxx EUR breakeven Euro – inflation France & Germany vs changes in average breakeven*

*based on monthly observation

Sources: Lyxor International Asset Management, Markit. Data as at 31/12/2020.

Past performance is not a reliable indicator of future returns.

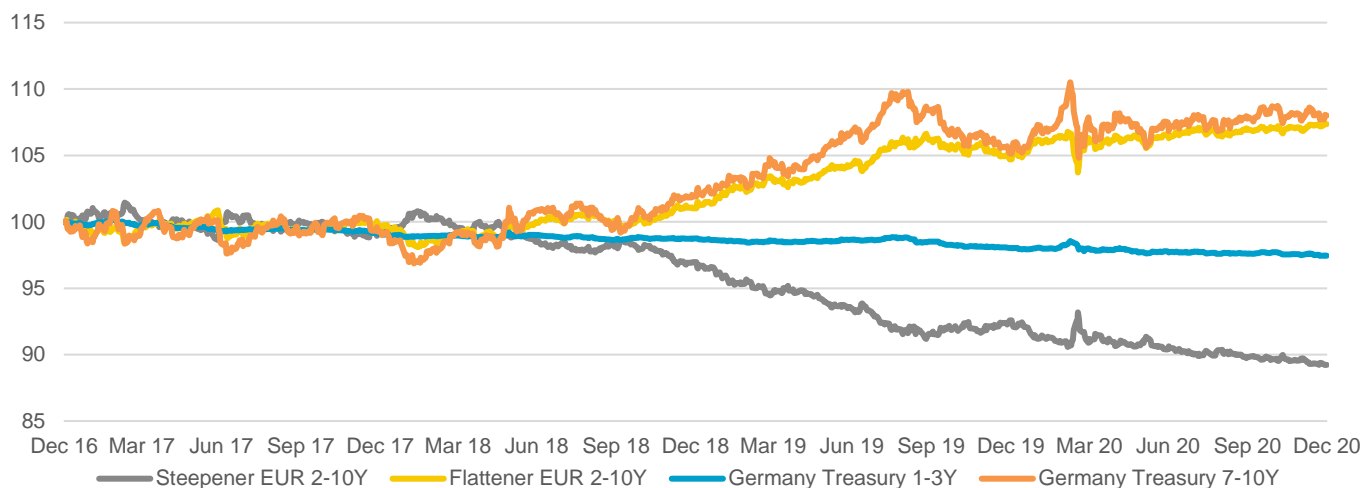
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Curve strategies

Solactive EUR Daily (x7) Flattener 2-10 Index

Solactive EUR Daily (x7) Steepener 2-10 Index

Index performance



Base 100 = 01/06/2016

Sources: Lyxor International Asset Management, Solactive, Bloomberg. Data as at 31/12/2020.

Past performance is not a reliable indicator of future returns

	Q4 2020	Q3 2020	2020	2019
Steepener EUR 2-10Y	-0.68%	-0.64%	-3.62%	-4.53%
Flattener EUR 2-10Y	0.39%	0.34%	2.52%	3.65%
Germany Treasury 1-3Y	-0.16%	-0.18%	-0.59%	-0.73%
Germany Treasury 7-10Y	0.22%	0.28%	2.74%	3.16%

Sources: Lyxor International Asset Management, Solactive. Data as at 31/12/2020. Performance is stated in USD and in gross total return. Past performance is not a reliable indicator of future returns.

Index performance analysis

	Q4 2020			Q3 2020			2020		
	Performance	Average weight over the period		Performance	Average weight over the period		Performance	Average weight over the period	
10Y Future basket	0.45%	F ^{10Y}	78.5% (a)	0.48%	F ^{10Y}	77.6% (a)	4.32%	F ^{10Y}	78.4% (a)
2Y Future basket	-0.05%	F ^{2Y}	365.8% (b)	-0.02%	F ^{2Y}	368.2% (b)	0.06%	F ^{2Y}	367.5% (b)
Cash	-0.12%	Csh		-0.12%	Csh		-0.47%	Csh	
Transaction costs	0.03%	TC		0.03%	TC		0.14%	TC	
Estimated performance Steepener EUR									
(b)*F ^{2Y} - (a)*F ^{10Y} + Csh - TC	-0.68%			-0.60%			-3.76%		
Actual index performance	-0.68%			-0.64%			-3.62%		
Estimated performance Flattener EUR									
(a)*F ^{10Y} - (b)*F ^{2Y} + Csh - TC	0.38%			0.30%			2.55%		
Actual index performance	0.39%			0.34%			2.52%		

Sources: Lyxor International Asset Management, Solactive, Bloomberg. Data as at 31/12/2020.

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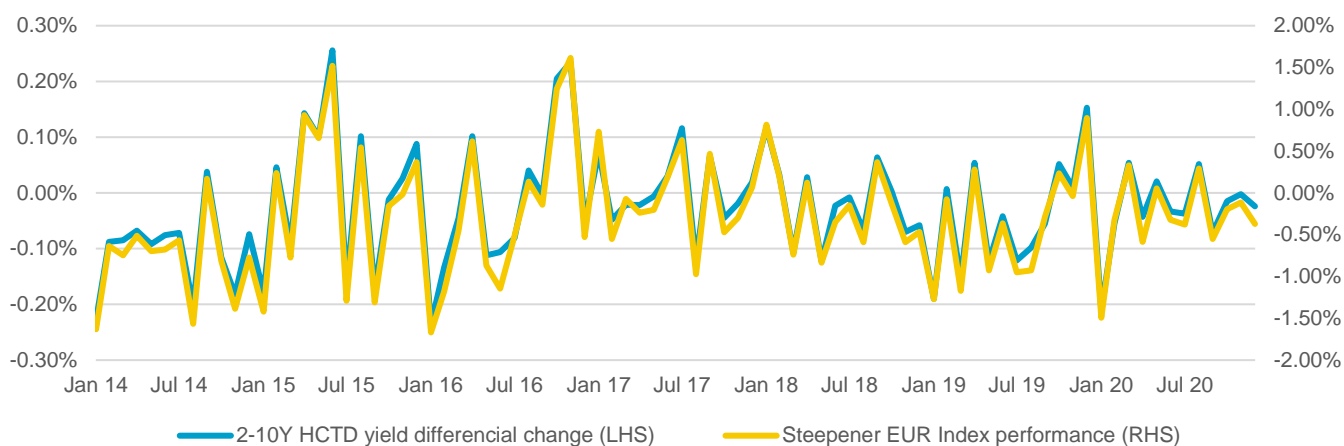
MARKETING DOCUMENT - FOR PROFESSIONAL AND QUALIFIED INVESTORS ONLY**How does the index behave vs. the 2-10yr differential in Bund yields?**

The index is designed to capture changes in the 2-10Y yield differential in Bund yields. Due to the non-linear relationship between changes in yield and return and fluctuations in market supply and demand, the magnitude of Index movements compared to changes in breakeven inflation varies from time to time.

The comparison between the index level and the yield differential can only be directional. The relationship between the changes in the two series is, however, clearly visible (chart below).

Historically, across the entries sample period, **a 1bp absolute change in the 2-10yr Bund yield differential corresponded to an approximately 7bp change in the index level.**

The correlation level can vary over time and should not be used as a systematic rule.

Solactive EUR Daily (7x) Steepener 2-10yr vs changes in average 2-10yr yield differential*

*based on monthly observation

Sources: Lyxor International Asset Management, Solactive, Bloomberg. Data as at 31/12/2020.

Past performance is not a reliable indicator of future returns

MARKETING DOCUMENT - FOR PROFESSIONAL AND QUALIFIED INVESTORS ONLY**Knowing your risk**

It is important for potential investors to evaluate the risks described below and in the fund prospectus on our website www.lyxoretf.com

Capital at risk

ETFs are tracking instruments: Their risk profile is similar to a direct investment in the Underlying index. Investors' capital is fully at risk and investors may not get back the amount originally invested.

Replication risk

The fund objectives might not be reached due to unexpected events on the underlying markets which will impact the index calculation and the efficient fund replication.

Counterparty risk

With synthetic ETFs, investors are exposed to risks resulting from the use of an OTC swap with Societe Generale. In-line with UCITS guidelines, the exposure to Société Générale cannot exceed 10% of the total fund assets. Physically replicated ETFs may have counterparty risk if they use a securities lending programme.

Concentration Risk

Thematic and Smart Beta ETFs select stocks or bonds for their portfolio from the original benchmark index. Where selection rules are extensive it can lead to a more concentrated portfolio where risk is spread over fewer stocks than the original benchmark.

Bloomberg

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Underlying risk

The Underlying index of a Lyxor ETF may be complex and volatile. For example, when investing in commodities, the Underlying index is calculated with reference to commodity futures contracts exposing the investor to a liquidity risk linked to costs such as cost of carry and transportation. ETFs exposed to Emerging Markets carry a greater risk of potential loss than investment in Developed Markets as they are exposed to a wide range of unpredictable Emerging Market risks.

Currency risk

ETFs may be exposed to currency risk if the ETF is denominated in a currency different to that of the Underlying index they are tracking. This means that exchange rate fluctuations could have a negative or positive effect on returns.

Liquidity risk

Liquidity is provided by registered market-makers on the respective stock exchange where the ETF is listed, including Societe Generale. On exchange, liquidity may be limited as a result of a suspension in the underlying market represented by the Underlying index tracked by the ETF; a failure in the systems of one of the relevant stock exchanges, or other market-maker systems; or an abnormal trading situation or event.

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