

MARKETING DOCUMENT - FOR PROFESSIONAL AND QUALIFIED INVESTORS ONLY

# Inflation & Rates

## Explorer: USD Q1 2021

Lyxor's Inflation & Rates Explorer monitors the performance of selected Fixed Income indices. We review the main trends in the US Fixed Income market over the past quarter, and how these trends influenced the performance of Inflation-linked and Curve strategies.

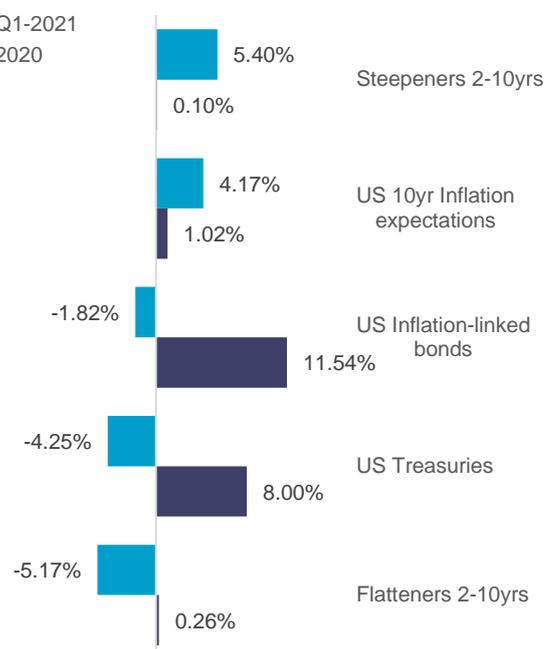
### Key takeaways

- ▶ **Curve and inflation-expectations strategies strongly outperformed traditional bonds in Q1:** Of all the strategies reviewed in this report, US curve-steepening performed best in Q1 2021. Market expectations about the economic recovery pushed the long end of the UST yield curve higher, while the front end stayed deeply anchored at low levels.

The 10yr inflation expectations strategy also performed well, supported by stronger inflation prints as US economic activity recovered. Flows into US inflation-linked bond ETPs accelerated over the quarter.

- ▶ **Traditional inflation-linked and nominal bonds underperformed** against neutral duration strategies such as inflation expectations. The sharp rise in long-term Treasury bond yields hit overall performance of those exposures.

### Performance overview\*



\*Performance is stated in USD 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 31/03/2021. Sources: Bloomberg, Lyxor International Asset Management.

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Market & performance overview

Surging yields fuelled curve strategies' performance

The spread between 2Y and 10Y Treasury yields, the most common measure of the yield curve, widened further in Q1 2021, accelerating a trend ignited at the turn of the year.

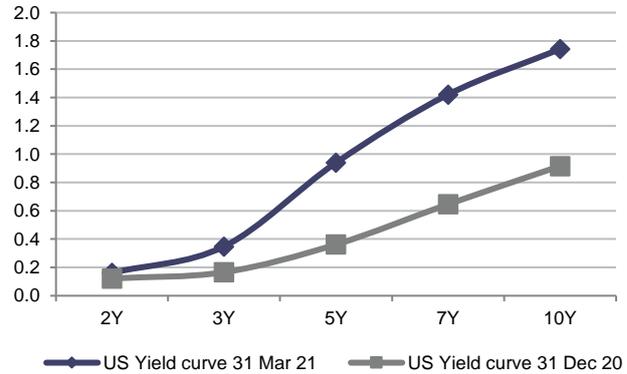
The long end of the US Treasury curve was supported by expectations that the US economic recovery is on track, supported by the rollout of Covid-19 vaccines and fiscal support. Investors were pushed to sell further safe-haven Treasuries in favour of riskier assets.

The steeper US yield curve suggests markets do not expect the Fed to cap yields in the short term by shifting bond purchases to the long end of the curve. CFTC data also show high level of bearish bets across maturities with net non-commercial positions on UST Futures close to historical highs in Q1.

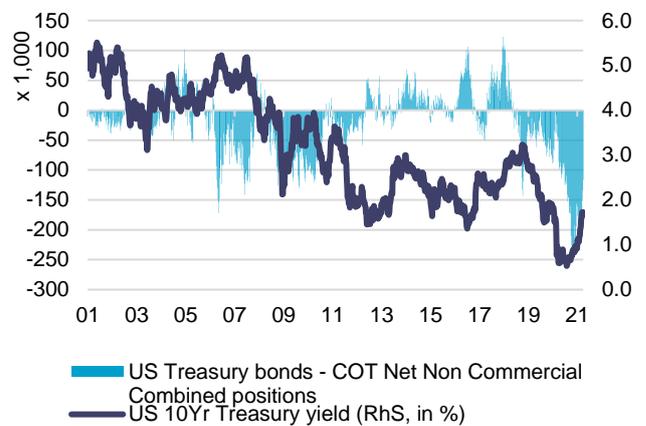
Market anticipations for the first rate-hike have also built up. Current market pricing for Fed funds futures imply a 100% chance of a 25 basis-point rate increase by December 2022, up from only 50% on 1 February 2021. This remains at odds with the Fed's stated goal to keep policy rates low until core PCE is sustainably above 2% and full employment is achieved. The front end of the UST yield curve remained very well anchored over the quarter. Looking ahead, with the passage of the US government's new \$1.9trn Covid relief bill, the Fed is likely to upgrade its growth forecast, but the recovery in inflation should remain transitory for now.

In this context, US curve-steepening strategies benefited from the surge of 10Y vs. 2Y Treasury yields over the quarter (see p.10 for the detailed performance analysis).

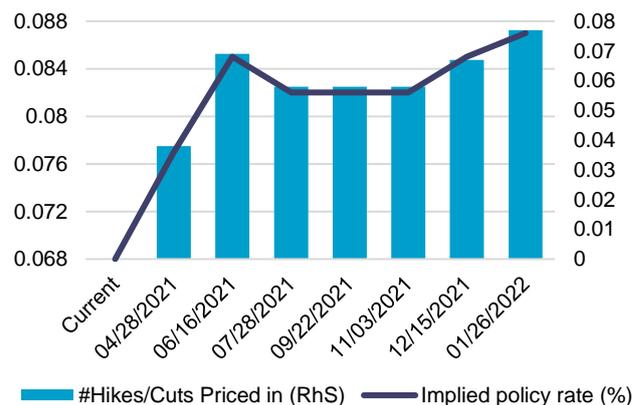
Bear steepening of the US yield curve accelerated



Bearish bets on Treasuries close to record high  
US Treasuries yield & Treasuries futures net positions



A first policy rate hike anticipated by end 2022  
US Implied Overnight Rate & Number of Hikes/Cuts



Sources: Bloomberg, CFTC, Lyxor International Asset Management. Data as at 31/03/2021. Past performance is not a reliable indicator of future returns.

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**The build-up in price pressures favoured inflation-expectations strategies**

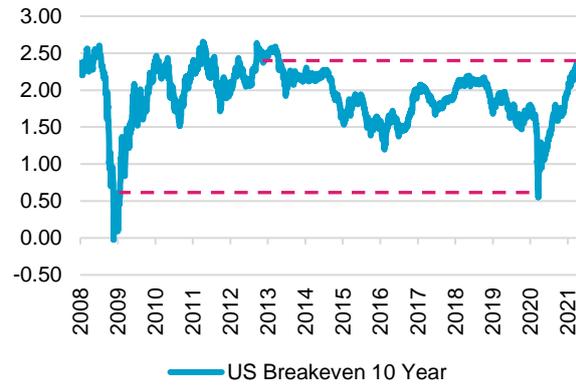
The pick-up of Inflation-expectations accelerated in Q1 2021, supported by further recovery in US economic activity. Inflation-expectations strategies posted strong gains over the quarter thanks to their close-to-neutral duration, as real rates collapsed further (see [p.6-8](#) for a full overview). Still, more traditional exposures such as US TIPS outperformed nominal bonds in the bond sell-off.

Prices gained further momentum as economic activity recovered. While the recovery in energy price gains still drive gains (the jump in gasoline price accounted for almost half the overall March advance), core prices also gained traction. In March, they hit the highest monthly increase in seven months. Gains were driven by higher cost of car rentals and hotel rooms as pandemic lockdown measures progressively come to an end.

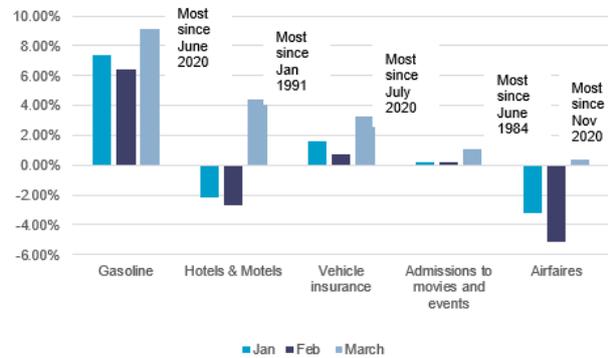
Recent survey data also point to developing cost pressures. The Institute for Supply Management's figures shows that more than half of service providers reported higher price in March, the largest share since 2011. The ISM's manufacturing survey showed about 72% of manufacturers said the same – the second-most since 2008.

Looking ahead, many factors should contribute further to the build-up in inflation expectations. This includes the positive base effect coming from the strong recovery in oil and other commodity prices as the US economy gets back to work. Supply-chain disruptions during the pandemic are also likely to distort prices in some sectors. Base effects from lower inflation prints from last year should lead to higher inflation prints over the coming months.

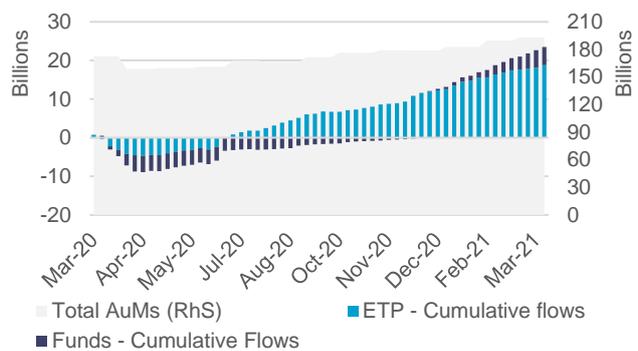
**US Inflation expectations accelerated in Q1 2021**  
*US 10yr inflation breakeven (in %)*



**Reopening rebound**  
*Price recovery in selected consumer items (% MoM)*



**Flows piled up into USD inflation-linked ETPs**  
*US inflation-linked weekly flows (Funds and ETFs in €bn)*



Sources: Bloomberg, Bureau of Labor Statistics, Morningstar, Lyxor International Asset Management. Data as at 31/03/2021. Past performance is not a reliable indicator of future returns

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## Index definition

Index Exposure	Index name	Bloomberg ticker
<b>US Inflation-Linked bonds</b>	Bloomberg Barclays US Govt Inflation-Linked All Maturities TR Index The index offers an exposure to the US Treasury Inflation Protect Securities (TIPS Market)	BCIT1T Index
<b>US 10-Year Inflation Expectations</b>	Markit iBoxx USD Breakeven 10-Year Inflation Index The index is representative of the performance of a long position in the 6 last issuances of U.S. 10-year Treasury Inflation-Protected securities and a short position in U.S. Treasury bonds with adjacent durations. The difference in yield between these bonds is commonly referred to as a "breakeven rate of inflation" and is considered to be a measure of the market's expectations for inflation over a specified period of time.	IBXXUBF1 Index
<b>US 10-Year Inverse Inflation Expectations</b>	Markit iBoxx USD Inverse Breakeven 10-Year Inflation The index is representative of the performance of a short position in the 6 last issuances of U.S. 10-year Treasury Inflation Protected securities and a long position in U.S. Treasury bonds with adjacent durations.	IBXXUIBE Index
<b>US Treasuries</b>	Bloomberg Barclays US Treasury TR Index The Index measures US dollar-denominated, fixed rate, nominal debt issued by the US Treasury	LUATTRUU Index
<b>US Flattener 2-10 years</b>	Solactive USD Daily (x7) Flattener 2-10 Index The index tracks the investment performance of a systematic strategy whose returns are directly linked to changes in the US treasury 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 2Y US Treasury Bond Futures and a long position in the 10Y US Treasury Ultra Bond Futures.	SODU7FTT Index
<b>US Steepener 2-10 years</b>	Solactive USD 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 US treasury yield curve. The index is constructed such 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 2Y US Treasury Bond Futures and a short position in the 10Y US Treasury Ultra Bond Futures.	SODU7STT Index

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

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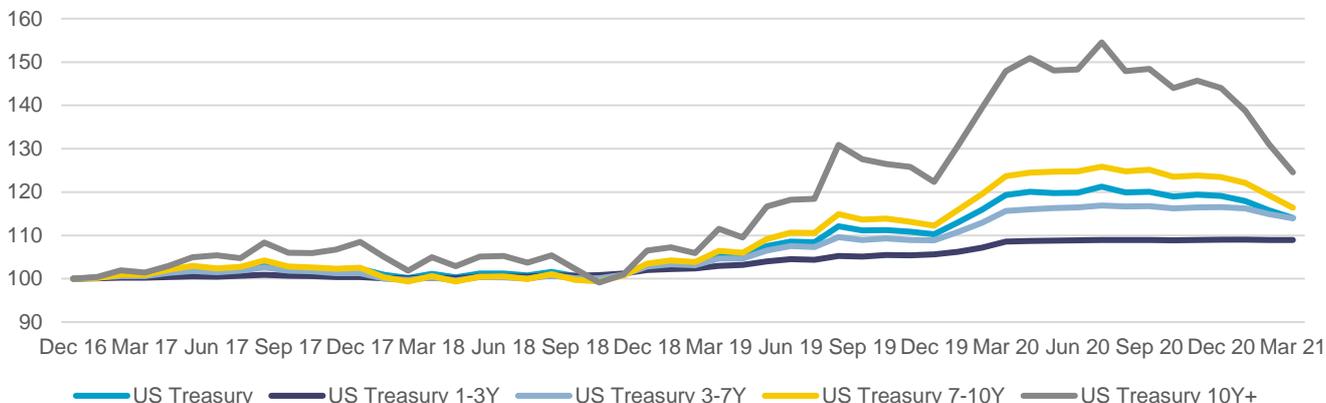
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# Treasuries

## Bloomberg Barclays US Treasury Index and buckets

### Index performance

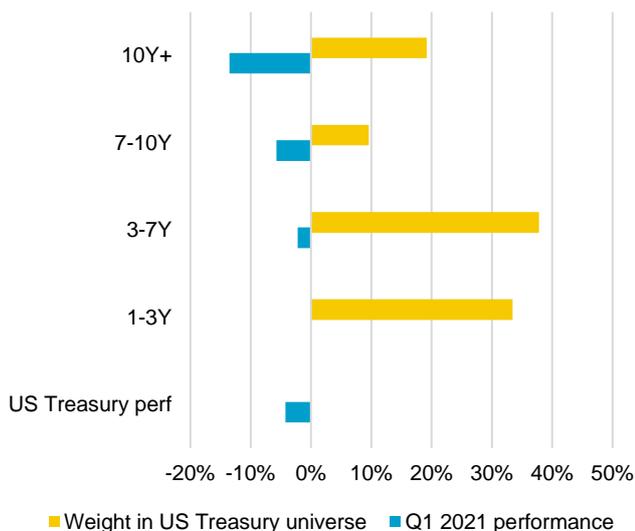


Base 100 = 01/06/2016  
 Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/03/2021.  
 Past performance is not a reliable indicator of future returns

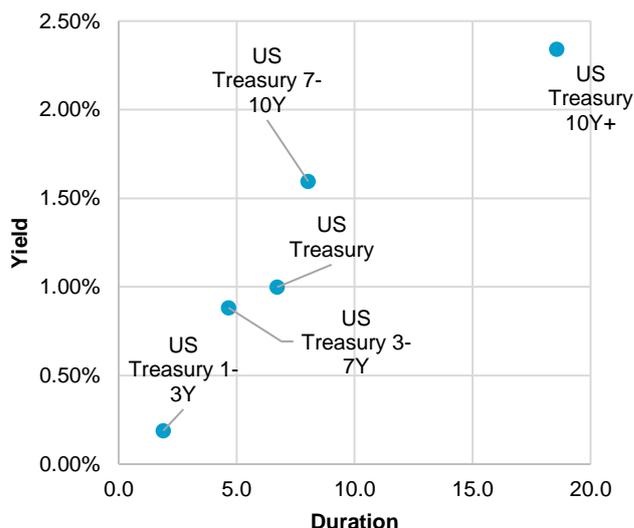
	Duration	Yield to Worst	QoQ yield change (in bps)	Q1 2021	Q4 2020	2020
US Treasury	6.7	1.00%	42.6	-4.25%	-0.83%	8.00%
US Treasury 1-3Y	1.9	0.19%	5.2	-0.05%	0.04%	3.16%
US Treasury 3-7Y	4.7	0.88%	52.3	-2.20%	-0.20%	7.06%
US Treasury 7-10Y	8.0	1.60%	81.5	-5.74%	-1.31%	9.98%
US Treasury 10Y+	18.6	2.34%	83.0	-13.51%	-3.00%	17.70%

Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/03/2021. 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 31/03/2021. Past performance is not a reliable indicator of future returns

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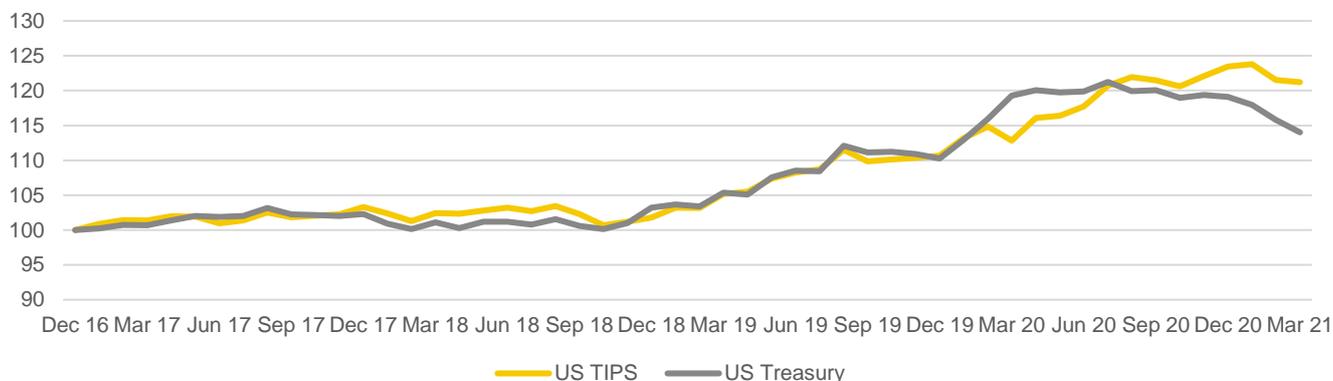


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## Inflation-linked bonds

## Bloomberg Barclays US Government Inflation-Linked Bond Index

## Index performance



Base 100 = 01/06/2016

Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/03/2021.

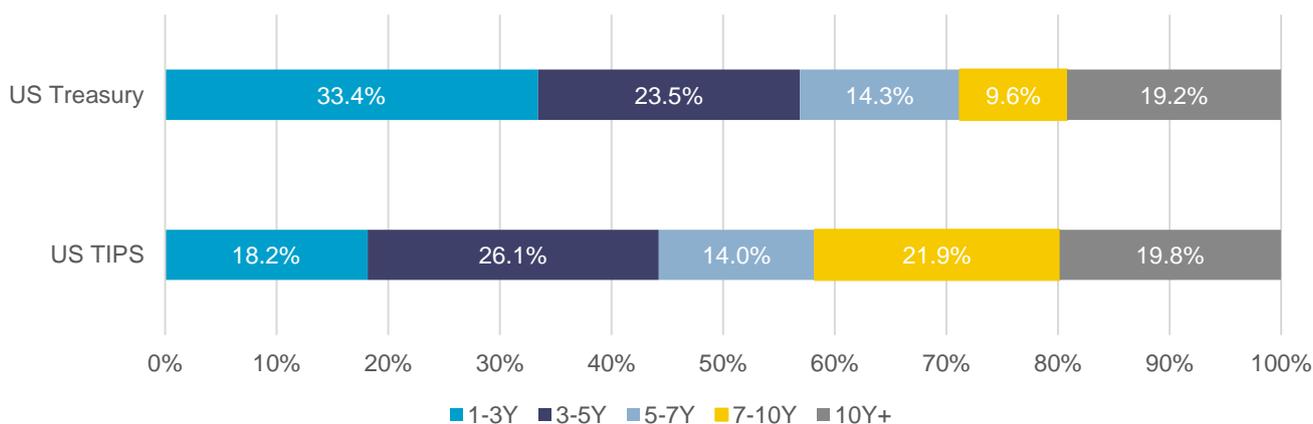
Past performance is not a reliable indicator of future returns

	Duration	Yield to Worst <sup>1</sup>	QoQ yield change (in bps)	Q1 2021	Q4 2020	2020
US TIPS	8.3	-1.35%	-4.0	-1.82%	1.63%	11.54%
US Treasury	6.7	1.00%	42.6	-4.25%	-0.83%	8.00%
US TIPS 1-3Y	1.9	-2.54%	-80.0	1.35%	1.17%	3.77%
US TIPS 3-5Y	4.0	-1.93%	-24.0	1.00%	1.71%	7.32%
US TIPS 5-7Y	6.0	-1.31%	23.0	-0.72%	1.96%	10.26%
US TIPS 7-10Y	8.1	-0.91%	31.0	-1.89%	1.60%	12.30%
US TIPS 10Y+	21.7	-0.02%	44.0	-8.59%	1.75%	24.86%

<sup>1</sup> Yield to worst stated in real terms for TIPS and nominal terms for US Treasury.

Sources: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/03/2021. 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 31/03/2021

Past performance is not a reliable indicator of future returns

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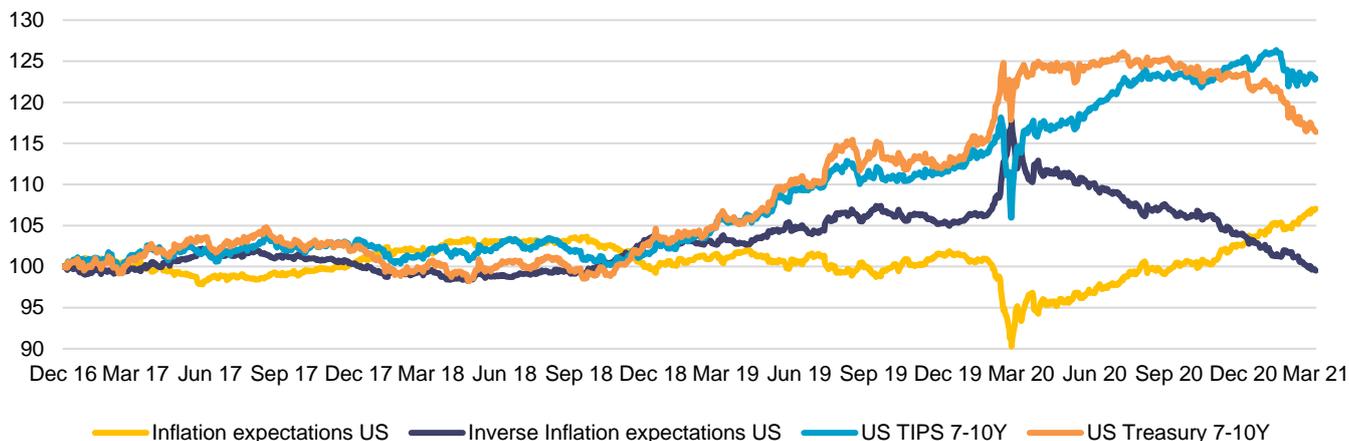
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## Inflation Expectations

Markit iBoxx USD Breakeven 10-Year Inflation index  
 Markit iBoxx USD Inverse Breakeven 10-Year Inflation Index

### Index performance

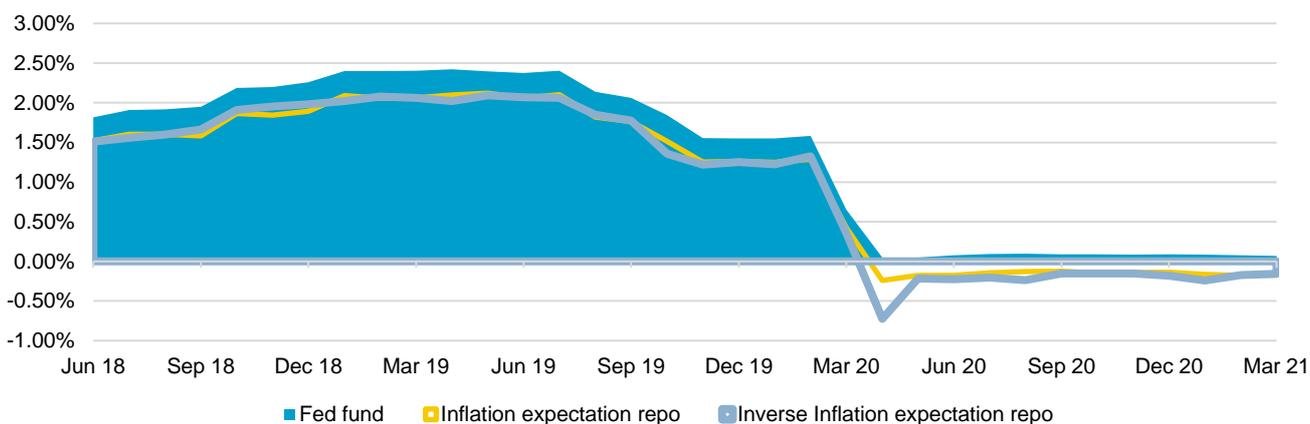


Base 100 = 01/06/2016  
 Sources: Lyxor International Asset Management, Markit. Data as at 31/03/2021.  
 Past performance is not a reliable indicator of future returns

	Q1 2021	Q4 2020	2020	2019
Inflation expectations US	4.17%	3.10%	1.02%	2.15%
Inverse Inflation expectations US	-4.10%	-2.98%	-1.27%	1.38%
US TIPS 7-10Y	-1.89%	1.60%	12.30%	9.43%
US Treasury 7-10Y	-5.74%	-1.31%	9.98%	8.49%

Sources: Lyxor International Asset Management, Markit. Data as at 31/03/2021. 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 31/03/2021.  
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## Markit iBoxx USD Breakeven 10-Year Inflation index

The index performance is the result of:

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

	Q1 2021		Q4 2020		2020		2019	
	Performance		Performance		Performance		Performance	
TIPS basket performance	-2.42%	TIPS	1.50%	TIPS	12.55%	TIPS	9.85%	TIPS
US Treasuries basket performance	-6.30%	UST	-1.55%	UST	10.41%	UST	8.65%	UST
Average Scaling Factor	102.14%	SF	104.79%	SF	107.46%	SF	109.96%	SF
Average Repo return		Repo	-0.04%	Repo	1.85%	Repo	1.85%	Repo
Rebalancing costs		RC	0.00%	RC	0.08%	RC	0.09%	RC
<b>Estimated performance Inflation expectations US</b>								
TIPS - SF * (UST - Repo) - RC	3.92%		3.08%		1.42%		2.29%	
Actual index performance	4.17%		3.10%		1.02%		2.15%	

Sources: Lyxor International Asset Management, Markit. Data as at 31/03/2021. Past performance is not a reliable indicator of future returns

## Markit iBoxx USD Inverse Breakeven 10-Year Inflation index

The index performance is the result of:

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

	Q1 2021		Q4 2020		2020		2019	
	Performance		Performance		Performance		Performance	
TIPS basket performance	-2.42%	TIPS	1.50%	TIPS	12.55%	TIPS	9.85%	TIPS
US Treasuries basket performance	-6.30%	UST	-1.55%	UST	8.65%	UST	8.65%	UST
Average Scaling Factor	97.92%	SF	95.44%	SF	90.96%	SF	90.96%	SF
Average Repo return	-0.05%	Repo	-0.04%	Repo	1.82%	Repo	1.82%	Repo
Rebalancing costs	0.05%	RC	0.00%	RC	0.10%	RC	0.10%	RC
<b>Estimated performance Inverse Inflation expectations US</b>								
UST - SF * (TIPS - Repo) - RC	-4.03%		-3.01%		-1.32%		1.25%	
Actual index performance	-4.10%		-2.98%		-1.27%		1.38%	

Sources: Lyxor International Asset Management, Markit. Data as at 31/03/2021. Past performance is not a reliable indicator of future returns

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**How does the index behave vs. the theoretical US breakeven inflation rate?**

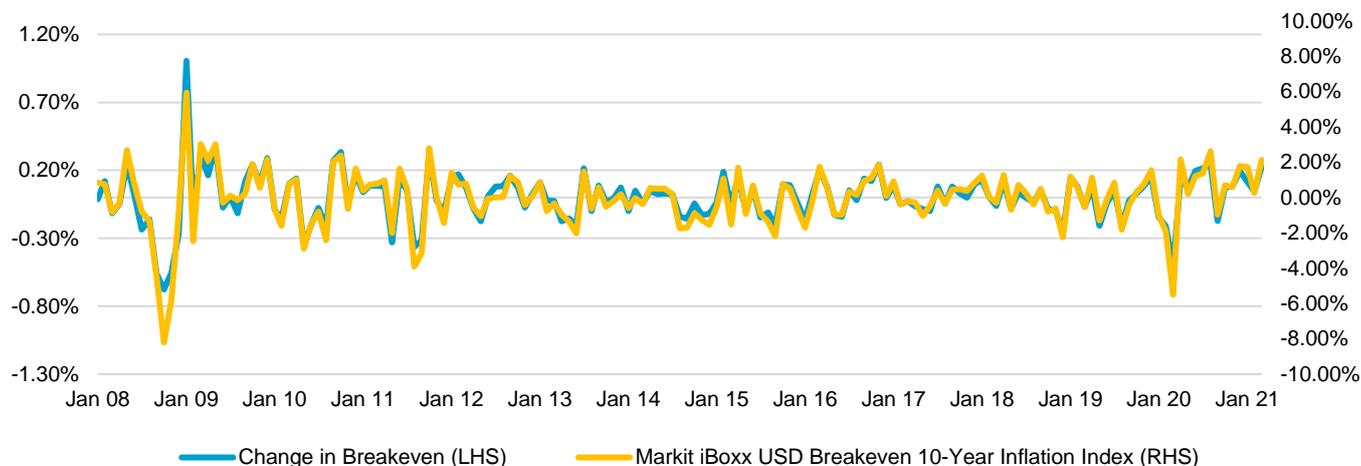
The index is designed to capture changes in the 10-year breakeven inflation rate. Due to the non-linear relationship between changes in yield, return and fluctuations in market supply and demand, the magnitude of Index movements compared to changes in breakeven inflation varies from time to time.

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 1bp absolute change in the breakeven inflation rate corresponded to an approximately 8bp change in the index level.**

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

**Markit iBoxx USD breakeven 10-year inflation vs changes in average breakeven\***



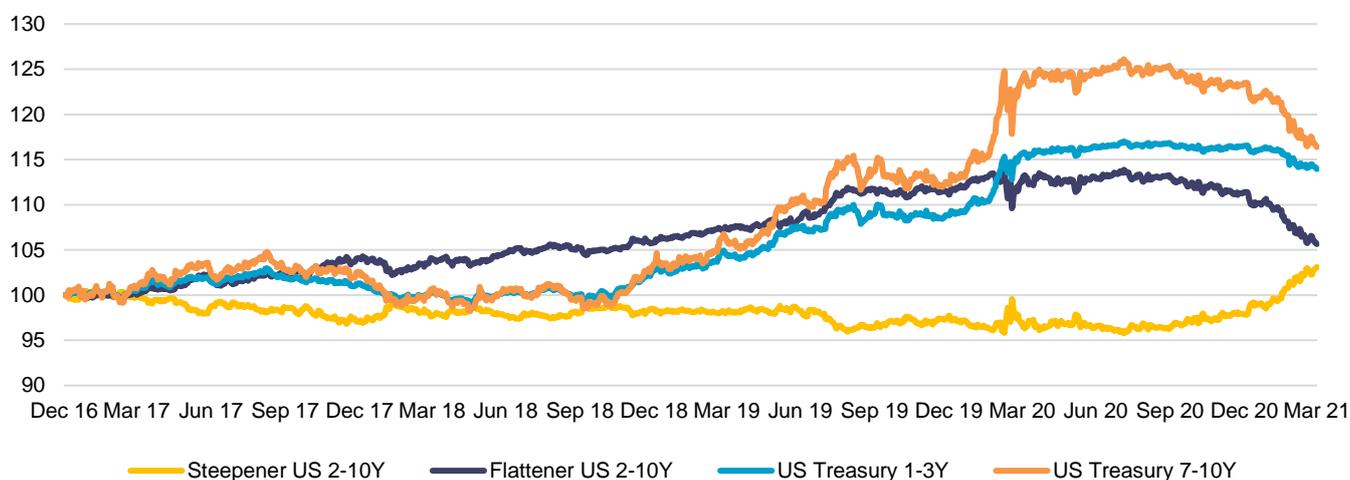
\*based on monthly observation  
 Sources: Lyxor International Asset Management, Markit. Data as at 31/03/2021.  
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## Curve strategies

Solactive USD Daily (x7) Flattener 2-10 Index  
Solactive USD Daily (x7) Steepener 2-10 Index

## Index performance



Base 100 = 01/06/2016

Sources: Lyxor International Asset Management, Solactive, Bloomberg. Data as at 31/03/2021.

Past performance is not a reliable indicator of future returns

	Q1 2021	Q4 2020	2020	2019
Steepener US 2-10Y	5.40%	1.42%	0.10%	-0.72%
Flattener US 2-10Y	-5.17%	-1.42%	0.26%	5.00%
US Treasury 1-3Y	-0.05%	0.04%	3.16%	3.59%
US Treasury 7-10Y	-5.74%	-1.31%	9.98%	8.49%

Sources: Lyxor International Asset Management, Solactive. Data as at 31/03/2021. Performance is stated in USD and in gross total return. Past performance is not a reliable indicator of future returns.

## Index performance analysis

	Q1 2021				Q4 2020				2020			
	Performance	F <sup>10Y</sup>	Avg weight	(a)	Performance	F <sup>10Y</sup>	Avg weight	(a)	Performance	F <sup>10Y</sup>	Avg weight	(a)
10Y Future basket	-7.06%	F <sup>10Y</sup>	76.3%	(a)	-1.85%	F <sup>10Y</sup>	76.0%	(a)	10.09%	F <sup>10Y</sup>	77.8%	(a)
2Y Future basket	-0.07%	F <sup>2Y</sup>	386.0%	(b)	0.01%	F <sup>2Y</sup>	387.7%	(b)	2.20%	F <sup>2Y</sup>	373.9%	(b)
Cash	0.02%	Csh			0.02%	Csh			0.37%	Csh		
Transaction costs	0.03%	TC			0.03%	TC			0.19%	TC		

Estimated performance Steepener US			
(b)*F <sup>2Y</sup> - (a)*F <sup>10Y</sup> + Csh -TC	5.11%	1.46%	0.55%
Actual index performance	5.40%	1.42%	0.10%
Estimated performance Flattener US			
(a)*F <sup>10Y</sup> - (b)*F <sup>2Y</sup> + Csh -TC	-5.14%	-1.47%	-0.18%
Actual index performance	-5.17%	-1.42%	0.26%

Sources: Lyxor International Asset Management, Solactive, Bloomberg. Data as at 31/03/2021.

Past performance is not a reliable indicator of future returns

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**How does the index behave vs. the 2-10yr differential in US Treasury yields?**

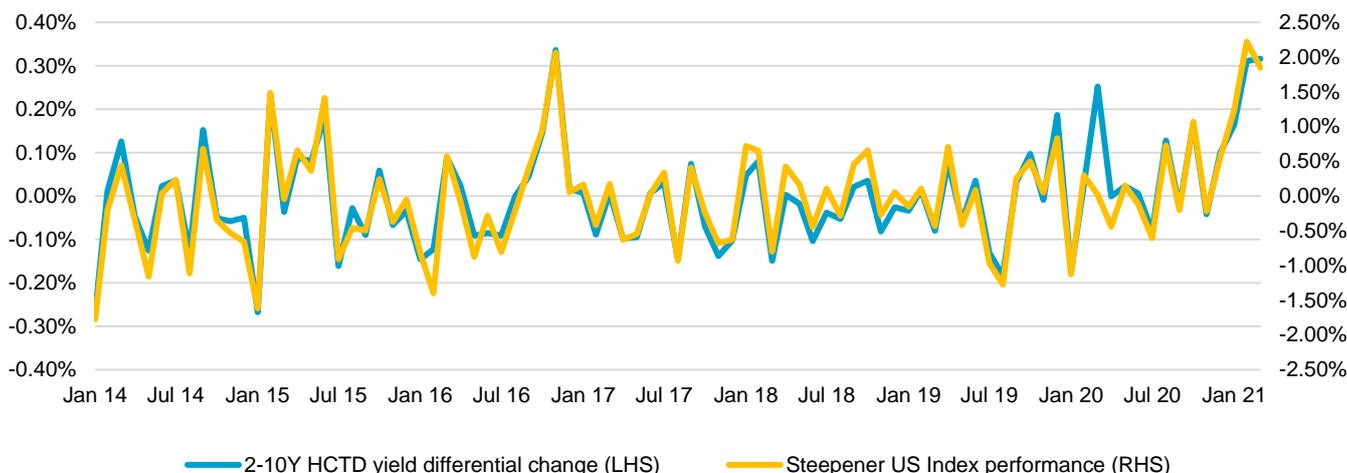
The index is designed to capture changes in the 2-10Y yield differential in US Treasuries. Due to the non-linear relationship between changes in yield and return and fluctuations in market supply and demand, the magnitude of Index movements compared to changes in breakeven inflation varies from time 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 US Treasury 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 USD 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 31/03/2021.  
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It is important for potential investors to evaluate the risks described below and in the fund prospectus on our website [www.lyxoretf.com](http://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.

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