PRESS RELEASE

MONDAY 23 APRIL 2018

LLOYDS BANK
Private Banking

FOR IMMEDIATE RELEASE

Markus Stadlmann, Chief Investment Officer Lloyds Bank Private Banking: "Bonds no longer a safe harbour – absolute return funds are the new conservative anchor of multi-asset portfolios."

"Bonds often make up 30-70% of multi-asset investment portfolios and act as their conservative anchor, so it's important for investors to be aware of the **increasing likelihood of a prolonged bond bear market**. Investors who follow the old adage that bond weighting in a portfolio should match your age may find themselves in a difficult place, particularly if they are approaching retirement.

Which asset class will replace bonds in multi-asset portfolios?

"Absolute Return funds can be the new conservative anchor in diversified portfolios, and would expect to generate a higher positive absolute return than investment grade and high yield bonds. These funds will typically move counter to many traditional asset classes. They utilise financial models and computer driven decision making processes that achieve solid investment performance whichever way financial markets move – be it a bull or bear market. These funds aim to make our portfolios more robust, and continue to generate positive absolute returns even during adverse financial market conditions.

"Absolute Return funds lead on the use of emergent technology, such as artificial intelligence (AI) and machine learning, to leverage the opportunities of big data, and their systems can identify trends, opportunities and risks with speed and accuracy, allowing rapid redeployment of capital. With markets exiting a period of unusually high stability in traditional asset classes, we expect this will align our portfolios well for the long term future.

"Finally, behavioural risk and bias are already recognised by leaders as a significant risk in business decisions and Absolute Return funds have reinforced their risk management capabilities through the application of de-biasing techniques to combat even unconscious behavioural bias in decision making or overfitting of data. Further, advanced analytics can then measure the role played by such bias in previous suboptimal trading decisions.

"With the headwinds of negative risk premiums, inflation and monetary policy shifts, bonds are not set to deliver compelling risk-adjusted returns over the next decade. Gradually, we have been shifting our client portfolios further away from bonds and into Absolute Return, where we see better risk reward over the long term.

Why investors should be more concerned about higher inflation over the long term:

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"Getting the long term inflation outlook right will prove decisive in understanding whether bond price trends will surprise investors on the upside or downside.

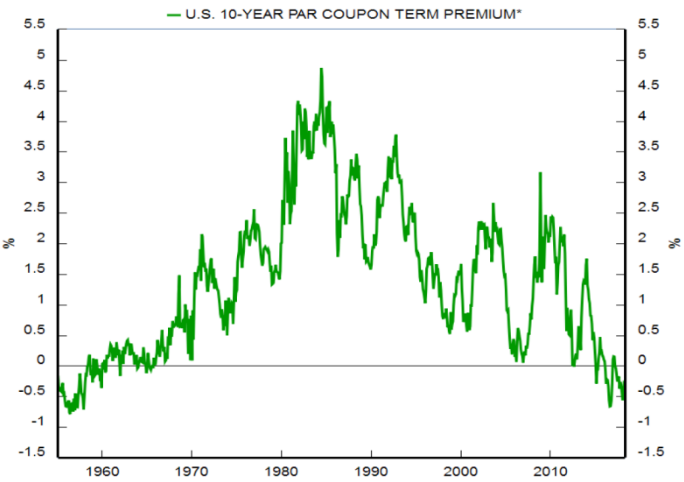
- **The rising longevity and ageing of populations has, among many other effects, an impact on inflation**. The consumption behaviour of retirees has changed in developed countries around the globe. They are spending more and saving less than previous generations. This is coupled with a steady reduction in the size of the workforce as baby boomers continue to move out of employment and into retirement. As a consequence, wage growth will rise up in major economies such as Germany, the US and the UK. Both these developments will increase the uptrend on inflation modestly.

- **Manufacturing industries are seeing spare capacity collapse**. With current capacity collapsing this pushes manufacturing costs higher. Several developed and emerging economies are also approaching full employment levels putting upwards additional upward pressure on employee wages.

- **Projections for work force automation are overly optimistic for the short term.** Some studies have indicated that productivity will soon improve by recent innovations in artificial intelligence and robotics. As always, the availability of new technologies is seen as too positive for the next few years.

- **The Trump Administration and Brexit have already shown the geopolitical landscape is influential to inflation**. Fractious topics such as migration and inequality stimulate movements towards populist politics – with inflationary repercussions. Populist movements and policies will often be positioned directly against the interests of investors. We are already witnessing the introduction of additional tariffs, rising import costs and a retraction from globalisation in trade.

Each of the four aforementioned structural drivers of inflation will contribute to a cumulative rise of consumer price over the next ten years. We expect this to take Central Banks by surprise. Our projections place them behind the curve; trying to catch up by raising short term interest rates. If an inflationary rally is poised to surprise central banks then it is sure to do the same for bonds. Since the term premium for holding long-dated bonds is low to negative in major fixed income markets, investors will have little incentive to add to their holdings and so prices will be forced to head south.



BCA Research, Lloyds Bank plc, February 2018

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"Other factors are also putting downward pressure on bond prices. Central banks are now beginning to unwind almost a decade worth of monetary policies that can be loosely referred to as 'Quantitative Easing' or 'QE'. These policies have seen them take on trillions of Sterling in both corporate and government bonds. As they look to reduce the volume of bonds they hold we will see some of the markets biggest buyers slow and start to move to the sell side. This will both undercut the demand and boost the supply, majorly tipping the scales towards a downturn in prices. As a second order effect, debt servicing costs and national budgets will be impacted by any increase in interest rates. Higher rates will result in greater costs to service the £164tn of outstanding global debt.

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[1] IMF World Economic Outlook update, January 2018

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