

ILBs to tap demand for price protection

Bonds

Katja Bühner

The federal government has relaunched its inflation-linked bonds (ILBs) program to tap into growing demand for protection against rising prices and take pressure off its nominal bond program as concerns linger that mounting supply will weaken investor interest.

After months of speculation, the government's debt agency, the Australian Office of Financial Management, announced on Friday that it would resume selling inflation-linked securities, which it last issued in 2003.

The bonds have been in short supply and the market now stands at \$6 billion.

The reintroduction of the bonds would assist by "widening the range of available debt instruments, diversifying risk and tapping additional sources of investor demand", the debt agency said in a statement. The AOFM declined to comment on the announcement.

The resumption of indexed bonds is expected to improve the financing of long-term infrastructure, as ILBs would act as a pricing benchmark and risk management tool.

Indexed financing is attractive for infrastructure projects, whose revenues are linked to inflation.

The AOFM gave no details on the maturity or volume of debt it plans to sell, suggesting it would begin

Price pressure



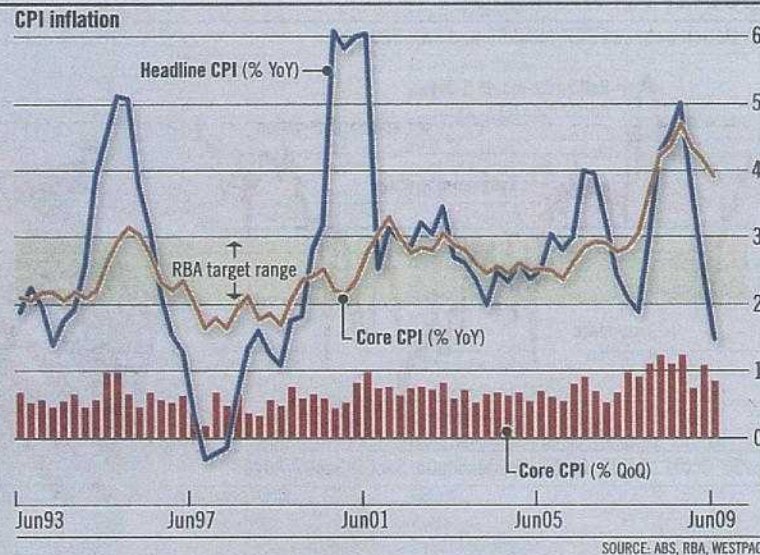
sales over the next two months.

The indexed bonds will be of benchmark size, with the same structure and features of those already on issue.

Unlike the traditional auction process, the government will hire a syndicate of dealers to manage the bond sales.

This follows the British government's decision to adopt a syndicate process to sell some of its debt, which some investors interpreted as a sign of concern about its escalating borrowing requirements.

The government hopes that by



SOURCE: ABS, RBA, WESTPAC

diversifying its product range, this will underpin demand and keep a lid on the cost of financing the government's debt issuance program, which is forecast to peak at \$300 billion over the next few years.

"As well as marginally reducing the required issuance volume of conventional bonds, issuing inflation-linked bonds creates a direct financial incentive for the government not to inflate away their debt burden," said Ben Alexander, a principal at Ardea Investment Management, which is a specialist manager of ILBs. "At the margin

this is a positive signal for investors in all Australian assets."

Demand for the bonds hinges on the outlook for inflation.

While global economic weakness makes for a benign inflation outlook, there are concerns that overseas governments' quantitative easing strategies and large stimulus programs will reignite inflation down the track, which will seep into the local market via higher import prices.

Aside from an inflation hedge, ILBs are a risk management tool for investors such as pension funds, which are exposed to inflation in

their business activities because they run defined benefit schemes. These pay retirees a fixed benefit regardless of how investment markets fare.

UBS executive director of inflation-linked trading Andrew Barnett said demand for ILBs would be particularly strong among superannuation funds.

"Asset allocation will probably be less skewed towards equity, property and infrastructure type assets as a result of the financial crisis. This presents a more sensible investment for super funds," he said.

Perennial Investment Partners senior portfolio manager Noel Murphy welcomed the reinstatement of ILBs and said they presented good value as inflation expectations remained subdued.

"Inflation-linked bonds represent the best value when no one thinks they need inflation protection. By the time inflation rises, they're generally pretty expensive forms of inflation hedges," he said.

"Investors need to think about the next stage of the economic cycle. You always want to buy your umbrella on a sunny day."

In May, the AOFM said it was considering extending its yield curve by selling longer-dated nominal bonds, as well as issuing ILBs, as part of an attempt to meet a record budget deficit.

It is understood that investors didn't express much interest in nominal bonds that have longer maturities.