

Inflation Linked Bonds – Q1 2009 and outlook for inflation

Summary Q1 2009

Australian breakeven inflation rose dramatically over the quarter helping inflation linked bonds outperform nominal bonds. Breakeven inflation as measured by the inflation zero coupon swap market rose by around 0.5% across all maturities, (Fig. 1), but continues to remain cheap relative to this time last year (Fig. 2) and still well priced if the market's fears of higher long term inflation are realised. The majority of the move occurred in January 2009 when breakeven inflation widened significantly as banks resumed buying; having earlier reduced risk and positions late in 2008 at the height of global financial turmoil. Also in January institutional investors continued to reduce short breakeven inflation positions and the more hawkish sentiment around long-term inflation also contributed to the continued widening.

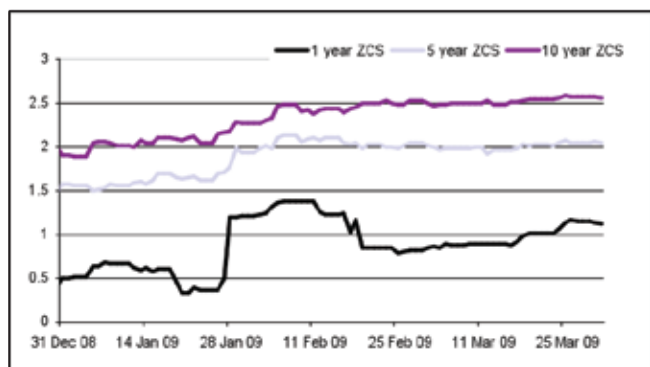


Fig 1

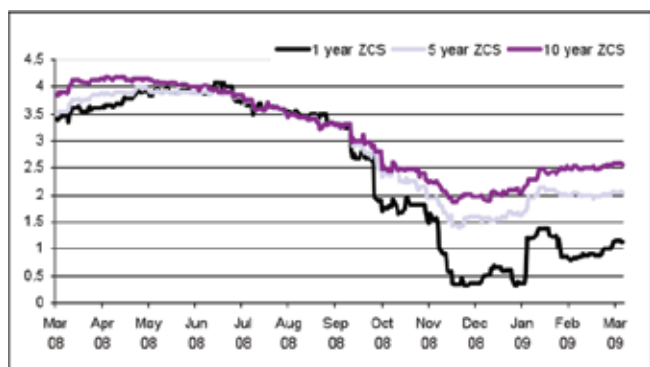


Fig 2

On February 20th S&P revised down the credit rating of the Queensland Government and the government's debt-borrowing agency Queensland Treasury Corporation (QTC) from AAA to AA+. Currently QTC has one bond on issue maturing in 2030. On the news of the downgrade the spread to the government bond widened by around 0.15%, while other semi government bonds moved out roughly 0.10% in sympathy.

Late in March the Federal Government opened its guarantee facility to State Government debt. The guarantee facility however is unlikely to have an immediate impact on the inflation linked bond market as: a) State Governments are unlikely to seek a guarantee with an associated cost for bonds already on issue; and b) the guarantee, if sought, is only available for maturities inside the longest Commonwealth government bond (currently 2021). As much of the semi issuance in inflation-linked instruments has been for longer maturities, barring further longer dated Commonwealth issuance, new semi government issuance is likely to be outside of the guarantee facility window.

At the beginning of April the Australian newspaper carried a story suggesting that the Commonwealth will announce a new inflation linked bond in the May budget, which would most likely be a 2030 or 2035 maturity. The potential issuance of another Commonwealth bond, in addition to the three currently outstanding, is seen as a positive for the inflation linked bond market as it would improve liquidity and potentially attract new allocation to the asset class. It would also aid in liquidity for the semi-government bonds as it would provide a more accurate benchmark for pricing these bonds.

The Outlook for Inflation

As governments around the world continue to increase the size of their fiscal and monetary policy stimulus, the sentiment towards longer-term inflation has turned more hawkish. Although economic downturns have traditionally been associated with periods of slowing

inflation or even outright deflation, a number of risks suggest that this may not be the case this time around. By their nature, many of the policy initiatives being employed by governments and central banks around the world ultimately pose an inflationary risk, and indeed have been developed and implemented with this objective in mind.

The source of this risk can be explained as follows. Firstly, central banks around the world – in some cases assisted by governments – have been purchasing large amounts of bad assets from the private sector. These purchases have included both bonds and equity, the latter in exchange for capital extended to troubled financial institutions. In addition to bad asset purchases, central banks in the US and the UK and Japan have also embarked upon a program of quantitative easing, which in practice involves the outright purchase of good assets (usually government bonds) by the central bank. The key element to recognise is that the purchase of these assets – both good and bad varieties – is undertaken using money effectively created ('printed') by the central bank. As such it represents a dramatic expansion in the central bank's balance sheet and a dramatic expansion in the supply of money. With more money chasing the same amount of real resources, this tends to eventually lead to inflation.

At present, the only saving grace in this scenario is simply that the current weak state of economic growth means that inflation may not come to pass right away. The timing of any inflationary impact also depends on the health of the financial sector and its ability to distribute credit around the broader economy. Given the financial sector's current questionable health, this may act to dampen any immediate inflationary pressures, only for them to reappear with greater strength over time. Consequently, much of the uncertainty present in

the inflation linked bond markets relates to when – not whether – these stronger inflation outcomes will come to pass. An important additional element when considering this question is the non-linear response of the economy and individuals to price pressures. What this means is that increases in the money supply may continue for some time with no apparent inflationary impact, but all of a sudden, once these increases are seen as inflationary by individuals, the inflationary impact can be dramatic, permanent and difficult for policy makers to undo.

In addition to the direct inflationary impact of asset purchases and quantitative easing, broader structural developments in the economy also suggest that inflation will be less benign than recent decades. Most notably, the exchange rate and trade imbalances which provided cheap imported goods to the industrial world now look to be unwinding, leading to greater imported inflation in the industrial world. Moreover the large declines in labour costs associated with the emergence of manufacturing in the developed world are unlikely to be repeated over coming years, thus removing a major disinflationary impulse which helped keep inflation low over recent decades. Finally, although commodity prices have collapsed in line with the sharp falls in near-term economic activity, the broader questions of scarcity of both manufacturing and food commodities have yet to be resolved and may pose a more gradual risk to inflation coming from the supply side of the equation.

With developments in both the policy environment and the real economy pointing to considerable uncertainty surrounding inflation but with pronounced upside risks, it is not surprising that expectations from inflation linked bond markets currently point towards low inflation right now, and an increasing chance of higher inflation in future.