ARDEA Investment Management

New Issuance in Inflation Linked Bonds (ILBs) – effects of supply August 2009

On 7 August, the Australian Office of Financial Management (AOFM) announced that the Australian Commonwealth ILB market would be reopened with the issue of a new benchmark line. Following this, NSW Treasury (TCorp) outlined their continuing plans to issue ILBs with the potential to include new maturities.

These announcements, particularly that from AOFM, represent not only the most significant increase in the supply of sovereign ILBs since 2003 but also the highly desired issuance of long-dated bonds into the Australian market.

What are they issuing?

AOFM have committed to issuing plain vanilla capital indexed bonds (CIBs). These bonds pay coupon and principal plus inflation adjustment – e.g. a 4% coupon plus 2% inflation becomes a 6% annual return to the investor. Bond cash flows are as shown in the below table, but it is important to note that the principal is adjusted for inflation and grows substantially over the life of the bond:

Period (Quarters)	Quarterly Headline CPI	Inflation-adjusted Principal	Coupon @ 4% / 4
0		1,000,000	
1	0.90%	1,009,000	10,090
2	0.50%	1,014,045	10,140
3	0.75%	1,021,650	10,217
…	…	…	…
40 (Maturity of 10yr bond)	1.00% (avg over life of bond)	1,488,864 (final principal repayment)	14,889

When are they issuing?

It is expected that the bonds will be available in late September or early October. Details regarding size and maturity of the new line were held back and are expected to be announced shortly. One point that was made clear is that AOFM will not issue into existing lines. Therefore, we can only anticipate that a 2025 line will be issued as it is politically expedient (given the sensitivities around the Federal Government deficit) and will also provide the market with a government real yield curve beyond 10 years.

How much are they issuing?

The announcement by AOFM indicated a strong commitment to ensure that the new line is liquid. Based on an analysis of existing bonds, this could require issuance of up to $2 - $2.5 billion in this line. As it was likely that Australian ILBs would be excluded from the Barclays Global Inflation Index without new issuance, there must be at least $700 million which is the minimum size required to maintain its position in the benchmark. A further commitment to issue new lines into the future could see total issuance exceed $4 billion.

What effect will the additional supply have on investor demand?

This latest issuance will come at a high absolute real yield which represents an entry opportunity into the market. There are many domestic investors that have indicated their reluctance to participate in the sector without confirmation of greater supply. Given concerns surrounding inflation, an increasing number of retirees seeking income protection and the attractive yield available, we expect that some existing investors may also take the opportunity to switch out of global ILBs back to Australian holdings.

Through retaining the Australian ILB exposure in the Barclays Global Inflation Index, along with rumoured changes to withholding tax legislation, there is also likely to be new demand from offshore investors. Australian sovereign

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issuance is highly attractive compared to other OECD countries as the risk of deflation (a bad scenario for ILBs generally) is much lower in Australia than in other countries that have been hit harder by the global financial crisis.

What will be the market impact of the new issuance?

AOFM is attempting to minimise the market impact of issuing while also providing a useful backstop for existing investors. Through a bookbuild process, different to how nominal bonds are currently being issued, AOFM hopes that they are able to test the market and overall demand for inflation linked bonds. The announcement included a 'switching' facility for current owners of 2010 bonds to move into the new lines which will smooth out the typical duration impact on the market when these bonds mature. Benchmark duration will thus be extended via monthly recalculations as bond owners take up the buyback offer. Also, given that the 2010 is set to mature in August next year, net new issuance will initially be only approximately $1 billion (as the capital value of the bonds has increased over the period through the indexation to inflation, as demonstrated in the earlier CIB example).

Overall, the physical market is likely to reach $20 billion next year.

Current Physical Market

- Total Size on Issue = $18bil and growing
  - Commonwealth Bonds = $9.8bil – new issuance in Sep/Oct 2009
  - Semi Govt Bonds = $3.8bil – new issuance over 2009/2010
  - Corporate Bonds = $4.2bil

Derivative Market

- Total Size (approximate) = $20bil+ and growing
  - Zero Coupon Swaps – Most liquid and traded inflation linked derivative
  - Capital Indexed Swaps – Modelled on Physical CIB's
  - Indexed Annuity Swaps – Modelled on Indexed Annuity Bonds

How has the market reacted since the announcement was made?

Not surprisingly, the 2010 bond has been bid up by the market, rallying 32bps from 7 August close to 12 August. This is due to the 'switching' facility that AOFM indicated would be available. The impact on real yields has otherwise been small with the announcement already priced in.

Overall, we do not expect there to be any significant impact from the reopening of supply by the Commonwealth. While we believe that extra liquidity will be a strong drawcard for the sector, attracting investors who have stayed out of the market since issuance was discontinued in 2003, there are more pertinent reasons for considering the sector. Australian ILBs, at current prices, offer significant value relative to other offshore inflation protection options. For domestic investors, this is an entry opportunity for those with longer-dated liabilities that would benefit from inflation protection. For those taking a more opportunistic stance, we expect that the current cheap entry point into ILBs is likely to dissipate over time, as new investors emerge to take up supply . Therefore, we consider it likely that the first participants in the new issuance will be rewarded with the most attractive pricing. If demand is greater than expected, history suggests that the sector could get expensive quite quickly.

Postscript – what has TCorp announced they will issue?

Not to be overlooked because of the momentous AOFM announcement, TCorp have confirmed that they will initially be issuing additional supply on a quarterly basis into their existing lines: 2025 and 2035 CIBs. Over the coming Financial Year, TCorp will also look to diversify issuance with new lines, potentially shorter dated CIBs or a longer dated Index Annuity Bond. Timing and details of these future lines will be determined according to investor interest and borrowing demands.

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An inflation update

While our outlook for inflation has not changed much since our First Quarter commentary, some of the key points are deserving of iteration:

- although economic downturns have traditionally been associated with periods of slowing inflation or even outright deflation, this is unlikely to be the case this time around due to the dramatic expansion in central banks' balance sheets paid for through an equally dramatic expansion in the supply of money.
- the health of the financial sector and its ability to distribute credit around the broader economy will affect the timing of higher inflation. Given the financial sector's current questionable health, this may act to dampen any immediate inflationary pressures (as occurred in the most recent CPI announcement), only for them to reappear with greater strength over time.
- structural developments in the broader economy (such as exchange rate and trade imbalances, declines in labour costs in manufacturing industries and scarcity in commodities), the scale of which are unlikely to be repeated, points to inflation being less benign than in recent decades.

With the economic environment remaining uncertain, it is not surprising that expectations in the ILB markets are for low inflation right now and an increasing chance of higher inflation in the future.

Ardea Investment Management

Ardea offers distinctive expertise in inflation-linked bonds (ILBs), which are attracting significant interest in the current economic climate.

Ardea's focus is on protecting capital for their clients with the potential for capital appreciation. To achieve this, Ardea are fundamentally driven investors who apply a strong quantitative and risk framework to their investment decisions. In essence, Ardea combine a top-down approach to economic analysis with a bottom-up security selection process.

Ardea customise their investment approach to meet their clients' needs by switching on or off, or scaling, three broad investment strategies - credit, interest rates and arbitrage. Within each of these strategies, Ardea have the ability to further diversify a portfolio by implementing multiple trade ideas, which can be tailored to meet specific investment needs.

Ardea commenced operation in November 2008 with their first client mandates in May 2009. As at 30 June 2009, the team managed over $270 million with further commitments currently being finalised.

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