ARDEA Investment Management

ILB Market Update
March 2010

Strong Outperformance in March Quarter

Australian ILBs recorded solid gains during the quarter, outperforming nominal bonds, bank bills and the global ILB market. This strong performance occurred despite nominal yields rising over the quarter, as a significant increase in inflation expectations was enough to keep real yields broadly stable, thus protecting ILBs.

Inflation expectations for periods out past five years are now sitting around the top end of the RBA's target band of 2-3%. In normal economic circumstances this might lessen the scope for further gains from holding ILBs but, in the current financial climate, inflation could still trend higher for longer. As such, ILBs are still attractive even with breakeven inflation currently on the high side.

Recent issuance continues to be well supported by the market. Indeed the impact on pricing from supply has been more muted than usual, a function of the significant demand seen from new investors. AOFM's strong commitment to issue has brought the sector back on the radar of domestic consultants and clients, as well as offshore investors managing to the Barclays World Inflation Index. Global investors chasing Australia's high real yield have also participated.

Currently, the weighted average real yield on the UBS Government Inflation Index is just under 3%. At this level, investors looking for a real return of 3% plus inflation can achieve their target using largely government risk (70% of the index) and a small amount of semi government risk. By increasing the exposure to semi government bonds, investors can lock in a real yield closer to 3.25%.

Fig. 1 Index returns 31/12/09 to 31/03/10

INDEX	RETURN %
UBS Government Inflation	2.59
UBS All Inflation	2.53
UBS Composite	1.26
UBS Government Nominal	1.06
UBS Bank Bill	1.02
Barclays World Inflation Index	-1.59

Source: Bloomberg

Real Yields at 3% Good for ILBs

From a **historical perspective**, real yields in Australia have rarely moved above 3.5% for any significant period of time. The only recent occasion where this occurred was in the late 1990s, as the RBA increased interest rates to take back the stimulus earlier supplied during the Asian crisis of 1997-1998. Going back further, real yields were higher in the early 1990s, although at that time the moderation in inflation had yet to be fully achieved, and real yields were being held deliberately high in order to "lock in" what at that time was the newly emerging low-inflation environment.

From a **fundamental perspective**, it is difficult for real yields on high-quality government bonds to remain persistently above the underlying real rate of economic growth in the economy (currently also estimated at approximately 3%). Unless the economy can persistently grow at a much higher real rate of economic growth, real yields cannot justifiably remain higher than 3% for extended periods.

From a **demand perspective**, many institutional investors target real yields of 3% as a key buying level. This includes funds which target a CPI-plus style return, defined benefit plans, hedge funds looking to invest at attractive entry levels, and offshore investors looking to lock in an attractive real yield spread relative to the much lower real yields available in other advanced economies.

From a **supply perspective**, recent issuance from the Commonwealth and the States has kept the market cheap, relative to what would have been seen without this supply. This cheapness has contributed to higher real yields than would have otherwise been the case. With supply forecast to return to more normal levels over coming years, this particular source of cheapness is not likely to be sustained and thus represents a short-term opportunity for investors.

Finally, from a **credit perspective**, recent concerns about the creditworthiness of some of the smaller Euro economies, and that of the large, heavily indebted major economies, has made Australian government bonds signficantly more attractive for offshore investors. From an offshore perspective, Australian ILBs offer that rare combination of a higher real yield *and* a higher credit quality investment. As such this represents a large source of additional demand from offshore investors, and is another factor acting to constrain real yields from moving higher.

Taken in isolation these developments are unusual enough, but together they reinforce what appears to be a "soft ceiling" on real yields above 3% in Australia. With real yields currently at these levels, this represents a significant opportunity for investors. This includes those looking to increase their allocations from current levels, but is also the case for large investors looking to enter the Australian ILB sector for the first time. The opportunity is also timely for those looking to repatriate funds out of low-yielding global ILBs and into Australian ILBs, in order to obtain direct protection against Australian inflation.

Market Growth led by New Issuance

Ongoing Commonwealth issuance and significant new supply from the States has boosted the ILB market to just over $20 billion in market value. The commitments made by these key issuers have seen the resumption of ILBs as a core allocation for fixed income investors.

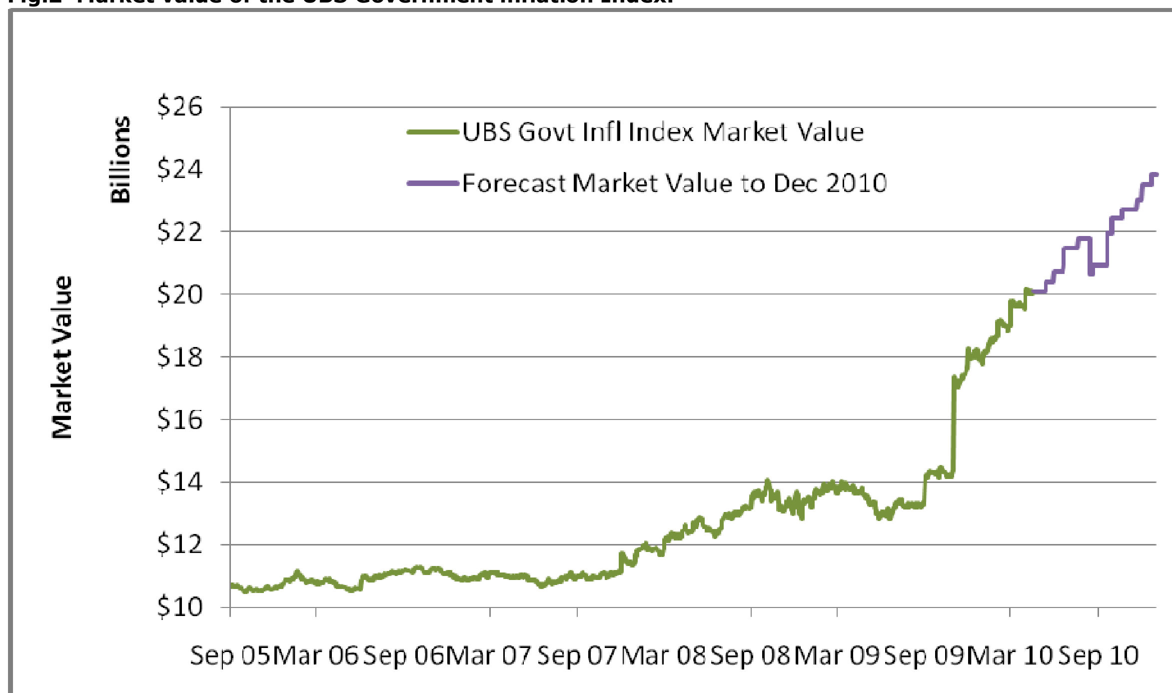
Though the ILB market remained open during the AOFM's cessation of ILB issuance, in part supported by ongoing issuance from the States (notably NSW TCorp), larger investors were understandably reluctant to participate in a market which was no longer growing. Although some investors were still accessing the local market in decent size through this period, others moved into a range of 'substitute' asset classes, ranging from global ILBs through to property and other asset classes intended to display some correlation with Australian CPI.

The return of the Commonwealth and States has seen the physical ILB market grow from around $10bil in 2006 and $13bil in early 2009 to a very substantial $20bil by September 2009. Projections for the end of 2010 are for the size of the market to reach approximately $24bil, with the market to grow another $4-$5bil to almost $30bil by the end of 2011.

The current amount of issuance is clearly large, and offers a unique opportunity for larger institutions looking to invest in size. However in our view, the most important development is the recommitment by the AOFM to again establish a large, liquid and continuing ILB market in Australia. It is for this reason that investors who had previously been forced to look elsewhere are now returning, either from other assets back into ILBs, or from globals back to domestic.

The inflation derivatives market has also grown substantially since the first sizable trades in 2006. In our view, the derivatives market played an important role in ensuring that the ILB market remained viable during the absence of Commonwealth physical issuance. Inflation derivatives allow investors to create synthetic ILBs, and in the absence of large issuance, they were used by many investors to hedge against inflation linked liabilities. Estimates indicate that the amount of inflation derivatives traded to date is actually larger than the amount of physical issuance currently available. This means that the true size of the inflation linked market (physicals plus derivatives) is at least $45bil.

Fig.2 Market value of the UBS Government inflation Index.



Source: UBS

Market Outlook for ILBs

Key influences on the outlook for ILBs include the ultimate extent of tightening by the RBA, and whether inflation expectations globally can remain low and anchored. Achieving the latter is potentially where the greatest risks lie, and indeed where ILBs can perform most strongly.

In terms of the outlook for interest rates, we expect the RBA to increase interest rates further over the remainder of the year. With housing prices now a focus, the extent of interest rate increases will ultimately depend on the degree of traction gained in reining in house prices at levels perceived as sustainable. Though there are some early signs of progress, it remains to be seen whether these will bring about a longer-lasting pause in house price growth. The other main influence on the interest rate outlook continues to be China, and developments in Asia more broadly. While the risks of falling asset prices and associated deleveraging in China have increased, it would appear that domestic-led strength is currently sufficient to maintain these asset prices, though this remains a month-by-month proposition. A successful transition towards more domestic-led growth looks uncertain, but would bring about more stable longer term growth prospects in Asia, with associated benefits for Australia.

Turning to inflation, market expectations of inflation over the next 10 years have recently moved above 3%, which is significant because it is the upper end of the RBA's 2-3 per cent target for inflation. However, there are a number of reasons why we think these levels are appropriate at this point in the cycle. One is simply that the risk of higher inflation over the coming ten years can be judged to be greater than it was over the past decade. This reflects the possible future influence of resources and energy shortages, the potential for significant increases in medical and other administered costs, and simply the fact that recent rates of inflation have been very low compared to the historical experience.

An additional reason for the current high inflation expectations is the risk that policymakers globally may turn "soft" on inflation in order to pursue other objectives judged more important, such as growth, employment and the stability of the financial sector. In some countries there is also the possibility that inflation may be

tolerated in order to lower government debt burdens, an outcome which could have broader effects reaching beyond the immediate countries concerned. If these objectives are achieved to the detriment of the low inflation objective, then it is perhaps reasonable to expect a somewhat higher rate of inflation over the medium term.

A number of shorter-term factors are likely to keep breakeven inflation rates high and potentially above current levels. These include continued positive news out of China, which would be viewed as broadly positive for Australian markets, thus driving a further increase in nominal yields. Breakeven inflation rates would likely increase as well, simply as a function of the beta between nominal yields and real yields (by which real yields rise, but not by as much as nominal yields). We also would expect ongoing pressure on resource utilisation generally in Australia, should the current positive economic environment continue. This would ensure that employment market conditions remain very favourable, as any further expansions in employment would take the labour market to relatively tight levels.

Our expectations for breakeven rates are contingent on a continued positive economic environment for Australia, and the risk scenario for this outlook remains one where the world's major economies suffer a relapse back towards GFC-type conditions. A similar risk could arise if the current very strong economic conditions in Asia were to be unwound rapidly, rather than gradually. Either of these outcomes could translate to some deleveraging of the housing market and the broader financial economy in Australia. The market response to these scenarios would involve a return to risk aversion, including falling nominal yields, falling real yields, and falling breakeven inflation rates. At present this remains a risk to the outlook rather than the central scenario, but it is one we are watching closely.

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 31 March 2010, the team managed over $500 million including a pooled fund solution for smaller institutional investors.