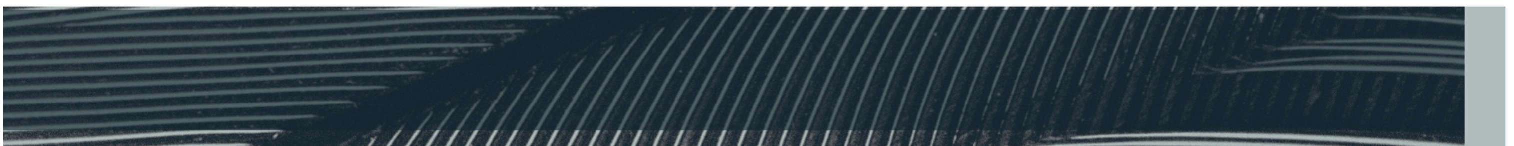
ARDEA
Investment Management

An inflationary crisis?

The last couple of months have been all about the credibility of the US and European currencies being undermined by various unfortunate events. Investors have been struggling with a very odd challenge, namely finding alternative stores of value, and price pressures have had some curious effects. Despite Switzerland being far too small a country to be the safe haven alternative to the Euro or US dollars, its currency has increased alarmingly. Australian dollars have traditionally been a barometer for global growth yet we feel pretty rich when we go overseas these days. Japanese Yen seems not too bad as a safe haven currency despite everything. Of course there is no beating that anachronistic store of value, the pretty yet somewhat useless gold, which leaves one wondering whether it is really in the planet's best interests to go out of our way to dig up so much more of the stuff, since that must surely be the logical next step given its current market price.

Taking a step back from the issue, it seems to us that concern about hard currency as a store of value must really be a concern about the potential for longer-term inflation. Why then have prices of inflation-linked bonds not risen to levels that would leave you scratching your head about the difference between recent historical and breakeven inflation rates?

Source: Ardea, Bloomberg



There is a reason. The lesson that the global financial crisis (GFC) supposedly taught us was that inflation-linked bonds (ILBs) always underperform in a crisis. Part of the reason is that flight-to-quality means to the most liquid assets and ILBs are marginally less liquid than nominal bonds – QED.

Perhaps we have been too easily convinced by the above argument, since it is possible that not all crises are alike. In particular, the GFC was a deflationary crisis; therefore it was quite rational for assets to flow from inflation-protection (ILBs) into assets which benefit from deflation, namely nominal bonds. This time, however, the US's quantitative easing programmes were aimed at avoiding Japan-style deflation. This time, the entities most directly affected by the crisis are the ones standing next to the printing presses. One cannot completely rule out deflation as a risk in US and Europe (particularly Europe) if economic growth slumps below what is currently expected.

ILBs are currently being watched closely by the ILB traders – will they start to behave like a risky asset and come under pressure on the 'risk-off' days? Not so far.

Sensibly positioning portfolios for the risks that are developing must include looking at where prices have responded and where they haven't. It also entails thinking about risk versus potential return, which means thinking in terms of good, bad and ugly scenarios.

We have mentioned currencies and commodities so next some comments about bond markets. International bond prices have been given a boost by quantitative easing which is designed to push global government bond yields lower, thus making them expensive and thereby making US treasuries unattractive investments.

As far as global ILBs go, break-even inflation definitely has plenty of upside if governments are faced with a choice between default, severe austerity and tolerating inflation.

In Australia, investors have pushed three-year government bonds to levels that seem well out of line with most expectations of future cash rate movements, so they have a pretty big safe haven premium in them. Australian ILB break-even inflation on the other hand is below most expectations for Australian headline inflation (as can be seen in the earlier chart).

Ardea's main portfolio positions at present are overweight 10-year Australian ILBs against three-year bond futures – we are positioned so that portfolios benefit significantly should current events prompt a more substantial reassessment of future inflation concerns, while still benefiting marginally if yields move lower in parallel.

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From an asset allocation point of view, that is equivalent to being overweight Australian ILBs and cash versus underweight Australian fixed interest (AFI). We think it makes less sense to be overweight global bonds, whether nominal or inflation linked.

While we think this investment approach makes sense from a strategic perspective, an additional challenge is how to incorporate this into existing portfolios, which may be heavily weighted towards nominal bonds. Often asset allocators tell us that they have trouble creating (or enlarging) an 'inflation bucket' in their portfolio structure. One possible solution is simply to incorporate the above beliefs into an AFI-benchmarked portfolio. This involves applying the same set of views and strategies to a portfolio whose core assets are AFI, and has the advantage of gaining access to the desired inflation protection strategies without the need to greatly restructure portfolios or change strategic allocations.

Ardea Investment Management

Ardea Investment Management is a fixed interest boutique with a specialisation in managing inflation-linked strategies. The business commenced in 2008 and currently manages over $1.4 billion in funds under management. The Principals have an average of fifteen years' experience in investment markets.

Inflation-linked strategies are attracting significant interest in the current economic climate, due to the greater certainty provided by real-return investments. Ardea's distinctive expertise in this asset class means that we are one of the only specialists dedicated to protecting client portfolios against the risk posed by persistent, long-term inflation.

Working with our clients, we are able to help achieve portfolio outcomes that protect either real returns or the liability profile from inflation risk. Our portfolio management approach can be tailored to our clients' objectives by switching on or off, or scaling, three broad investment strategies – credit, duration and arbitrage.

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