Inflation-linked bonds: are they expensive?

It is no surprise that inflation linked bonds (ILBs) have outperformed recently. Inflation has become a recurrent theme in current global economic discourse, particularly in the wake of 'QE2' in the US and rising food and energy prices. And against a backdrop of stagnating or falling economic growth, we anticipate that investors will continue to benefit from a defensive allocation to ILBs.

Why is inflation higher?

Since the early 1980s, inflation targeting has been a principal tenet for governments and central banks. However, fragile economic growth following the financial crisis has seen global monetary policy kept at extremely expansionary levels. Inflationary pressures have also been allowed to build in the key areas of energy, commodities and food, reflecting capacity constraints and supply shortages in these sectors. While inflation may prove useful in softening the sovereign debt burden, it also places pressure on weary consumers faced with another round of belt tightening, making them especially more reluctant to spend.

In a global environment where stimulating growth has been favoured over containing inflation, Australian policymakers have stated that they will stand firm on their targets but with potentially little effect. Growth remains precariously balanced as mortgage-owners are stretched and evidence of a two-speed economy continues to build. Broader increases in production inputs combined with low unemployment and the tragically high number of natural disasters have put even further pressures on costs.

Isn't all inflation the same?

If these inflationary pressures were simultaneously occurring with economic growth, otherwise known as 'demand-pull inflation', it would be easy for policymakers to put up cash rates. In an environment where demand is high, controlling inflation becomes an easier proposition because growth is buoyant.

However, when supply is constrained and inflation is rising regardless of what is happening to economic growth, also known as 'cost-push inflation', raising interest rates may quash economic growth whilst having minimal impact on inflation.

Won't cash protect my portfolio against inflation?

When demand is high and the economic growth continues to bubble along, the investment return earned on cash is highly correlated with inflation. Intuitively, this makes sense as interest rates go up to put controls on excessive consumption and to keep growth going stronger for longer.

Yet, this is not the current economic environment faced by investors. The fragility of economic growth, both in Australia and abroad, makes it less certain that the central bank will raise rates to target inflation. In this scenario, cash may be a good investment for the first year but if inflation continues to rise unabated, the CPI indexation of ILBs gives investors inflation protection in all circumstances.

From a broader viewpoint of portfolio construction, the longer duration of ILBs will also cushion investment returns as growth assets may travel sideways or wane.

What role do ILBs have for my portfolio?

The performance of ILBs represents a combination of their two key characteristics, that is, their indexation to inflation and their behaviour as a fixed income investment.

During favourable investment environments, these two characteristics will often offset each other, as the positive impact of indexation to rising inflation is offset by the detraction from holding a fixed income instrument when yields are rising. Importantly, in this scenario most other assets in an investor's portfolio will be performing strongly, and less reliance is placed upon the defensive characteristics of ILBs.

During unfavourable investment environments, ILBs perform strongly due to the positive contribution from holding a fixed income instrument when yields are falling. In the particularly challenging environment where inflation is also rising, ILBs provide an additional benefit from their direct indexation to inflation. This benefit does not arise if inflation is stable or falling, but these are benign outcomes for the investor which, unlike rising inflation, may not require specific protection strategies.

This benign scenario is, unfortunately, not the economic environment that investors are currently experiencing. Inflation is already pushing at the upper limits of the RBA's target range and the causes for this cannot be dismissed as merely one-off events. The experience of recent decades, where investment returns have been influenced by the benefits of an extended period of disinflation, is also an inadequate guide to the future. Instead, the temptation to allow inflation to move ahead of its band so that growth has the chance to thrive and survive may be impossible to resist.

In this environment, it should not come as a surprise to learn that the price of taking out insurance against inflation has risen, and therefore ILBs are not as cheap as they have been. However, it does not follow that ILBs are necessarily expensive at current levels. Indeed, to view them as such is taking the optimistic view that today's inflation outlook absolutely cannot worsen any further, in which case there would be no need for inflation protection in the first place.