New Commonwealth 2035 Inflation Linked Bond

New Bond Lengthens Yield Curve

The Australian Office of Financial Management this week announced the launch of a new inflation linked bond with a real coupon of 2.0% and a maturity of 21 August 2035. This represents a significant extension of the yield curve from the previous long-dated linker, maturing in 2030, and now provides a sovereign real yield curve extending out beyond the 20-year tenor.

The announcement is also being reported as consistent with the Commonwealth government's objective to lengthen the maturity of its debt profile, and thus reduce the frequency which existing debt must be rolled. This move and other debt management practices more broadly are also gradually transforming the Australian government bond market to a structure more similar to that observed in most offshore markets, with a large variety of issues available across a broad maturity spectrum. This change is a positive one from a market depth and liquidity perspective.

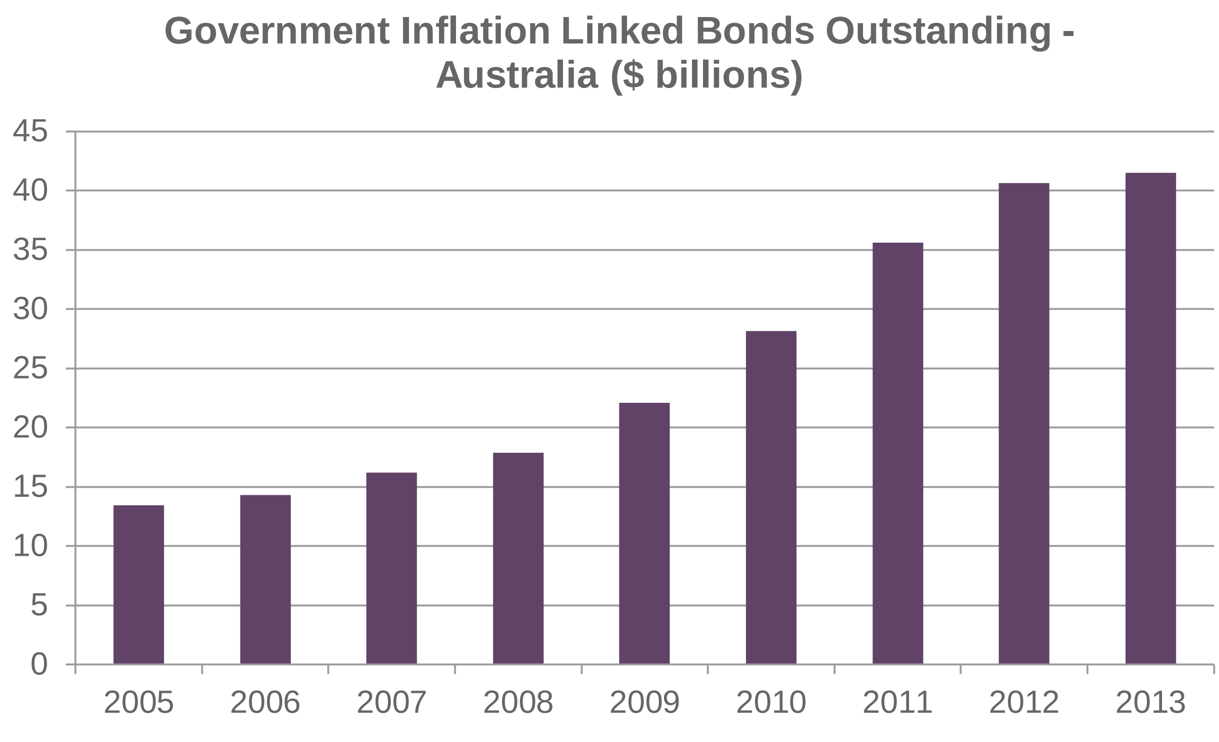
Market Implications

The announcement of a new security generally involves some modest cheapening in the market as yields move higher to accommodate the additional volume, and this has been the case with the current issue as long-dated yields in particular have moved slightly higher over the past week. Affected securities include the existing long-dated Commonwealth 2035s, and also other long-dated State government inflation linked bonds and indexed annuity bonds.

While the adjustment in market yields represents a small decline in value for existing holders, on the positive side the increase in real yields will result in more favourable investment returns over the long term. Moreover, once the initial impact of the new issuance has settled, likely within a month or two, the new anchor point represented by the Commonwealth 2035 linker will provide a new benchmark security against which many other long-dated securities can be priced, including bonds such as the NSW TCorp 2035s.

This should result in greater pricing transparency around these securities and greater liquidity, leading to more stable valuations over time.

The introduction of the new bond will also increase the size of the physical inflation linked bond market to over $40 billion. Over the past five years the market has more than doubled in size and this demonstrates the ongoing commitment of the Commonwealth and AOFM to developing and supporting the inflation linked bond market. This represents a clear change in policy from the earlier issuance hiatus between 2005 and 2009.



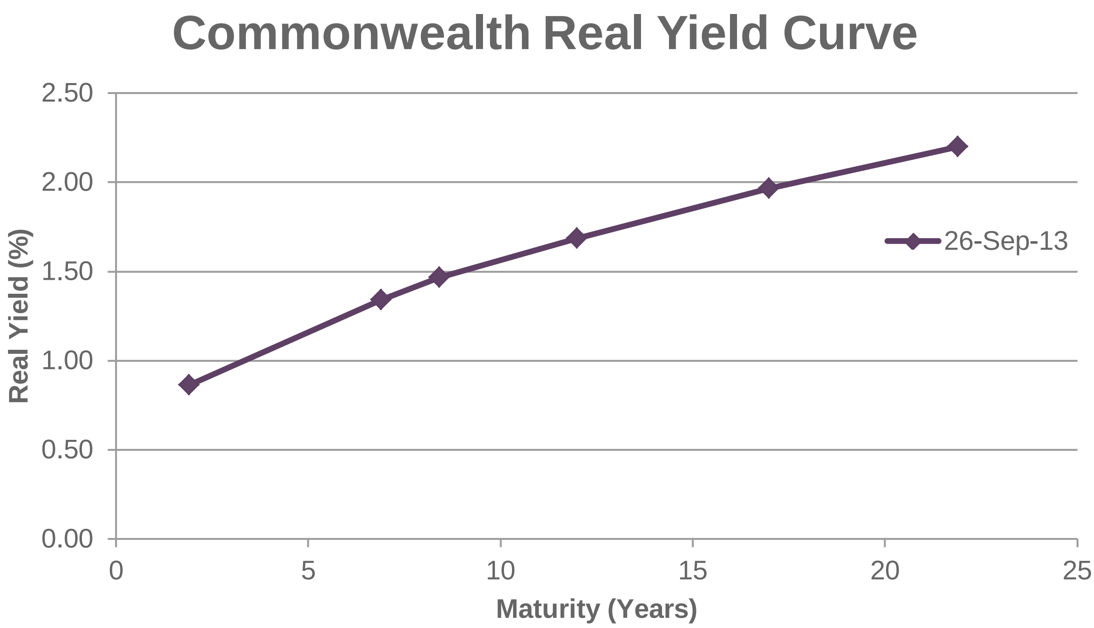
Source: Ardea Investment Management, UBS

Market Pricing

The syndication commenced with an initial size of $500 million at a spread of 25 to 29 basis points over the existing 2030 indexed bond, but following strong interest from investors and offshore interest, the deal size was upgraded to $2.1 billion, with the final yield coming at 2.20%.

Given this strong performance we expect the issue to perform well over coming weeks, particularly once it becomes eligible for inclusion in domestic bond indices (from October) and in global indices (from November).

With the announcement of the yield on the new security, the real yield curve is now slightly upward sloping in the long-end and positively sloped overall, demonstrating the additional compensation available to investors from holding longer-dated securities.



Source: Ardea Investment Management, Bloomberg

Our Strategy

When the syndication was announced our view was that the issue would result in strong demand, as has been the case recently for other similar securities, and also reflecting the still-high yield differential available in Australia compared to most other markets. With this in mind we committed early to buying a portion of the new issue on behalf of client portfolios, at clearing levels. This early commitment helped to minimise downscaling given the strong investor demand.

The inclusion of these securities in client portfolios results in a modest lengthening of duration, and as a result we have also conducted a number of other trades aimed at offsetting this impact. The bringing of the new issue to market also resulted in a considerable volume of trading activity in the broader market as other investors sought to adjust their own portfolios. As a result of this we were also able to access extremely attractive prices on other securities which we have included in portfolio adjustments where appropriate.

Ardea Investment Management
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