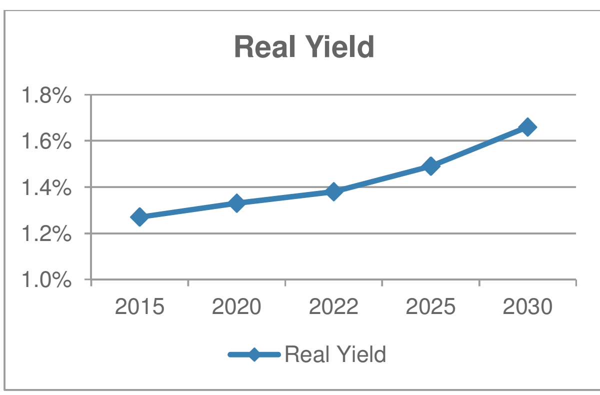
New inflation-linked bond issued

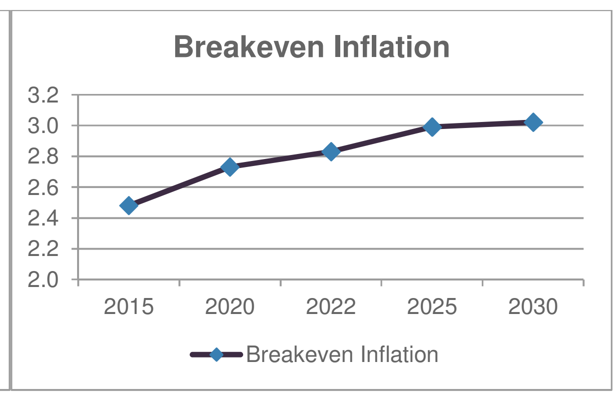
The Australian Office of Financial Management (AOFM) has today issued a new inflation-linked bond (ILB). The bond is a new benchmark line with a maturity date of February 2022. The tender occurred via syndication with a deal size of $A900 million.

Pricing of this bond

The new 2022 bond slots in between the existing 2020 and 2025 bonds, tapping into significant domestic demand for ILBs with a duration of less than 10 years. This is also the most liquid part of the market because of the high outstanding values of these earlier issued bonds.

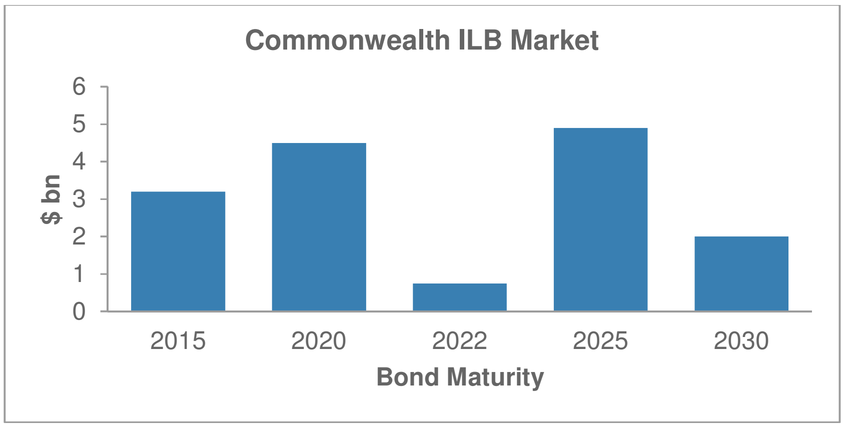
The pricing of the bond, with a real yield of 1.37% and a breakeven of 2.83%, represents good value for ILB investors. Demand for Australian inflation-linked bonds has slowly shifted further out the curve, amid continued interest from offshore investors and ongoing recognition domestically of the need for inflation protection. Breakeven inflation rates have also recently begun rising in the long end of the curve. While the move in the long-end has, to date, been influenced by the absence of comparable long-dated nominal bonds, any further increase would represent a more fundamental shift in inflation expectations.





Total market

With the new 2022 bond, the physical ILB market, comprising of Commonwealth and Semi Government bonds, is now over $32 billion. Combined with the estimated size of the inflation derivative market, the total inflation-linked market is over $60 billion.



Impact on benchmark

The benchmark is recalculated at the end of each month to reflect the bonds that have settled during that period. The duration of the 2022 bond is 9.4 years, which is similar to the current duration of the benchmark. The new issue of this bond is not expected to have a large impact on the benchmark, given the similar duration and the small overall size of the tender.

Valuation of the sector

The Australian ILB market continues to look attractive value for those investors seeking long term inflation protection. Breakeven inflation is well below the upper end of the RBA band with the prospective risk for a spike in global inflationary pressures.

When compared with similar maturity US TIPS and UKTis, which are currently trading at negative real yields, the 2022 looks attractive versus its global counterparts. It is expected that the tender should be well subscribed by offshore investors. Demand from offshore investors has recently provided ongoing downward pressure on yields, given the large volumes involved and the small amount of debt outstanding in Australia. This influence could well be sufficient to prevent real yields from backing up much at all.

Further issuance for sector

This syndication replaces the normal monthly tender scheduled for February, leaving four monthly tenders for the remainder of the Financial Year. Total issuance for the Financial Year, including this new 2022 bond, is just below $1.5 billion. The full year issuance target set by AOFM is $2 billion while New South Wales Treasury continues to issue inflation-linked bonds as well.

Supply of inflation swaps has also recently increased and this trend is expected to continue. As breakeven levels rise, inflation derivative issuance becomes more attractive to the issuers of inflation and this tends to result in an increase in supply.

About Ardea Investment Management

Ardea Investment Management is an investment boutique specialising in the management of fixed interest strategies. The business commenced in 2008 with the Principals having an average of fifteen years' experience in investment markets. The team now manages over $2.3 billion in funds under management on behalf of their clients.

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 they are one of the only specialists dedicated to protecting client portfolios against the risk posed by persistent, long term inflation.

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

Within each of these strategies, Ardea also have the ability to further diversify a portfolio by implementing multiple trade ideas, which can be tailored to meet specific investment needs, including liability matching. The team's deep understanding of the inflation-linked derivatives market (which currently comprises half of the available investment universe) allows them to implement innovative investment portfolios whilst providing clients with full transparency through the use of detailed risk analysis.