Inflation Linked Bonds (ILBs) – new issuance
October 2009

After six patient years of waiting for Commonwealth issuance in the ILB sector, investors were not disappointed. The Government's, albeit conservative, target of $A1 billion was smashed with $A4 billion issued into a new 2025 security. This was Australia's largest ever single government bond issue, clearly showing the demand for long dated bonds as offers for over $A5.5 billion were received.

What was issued and at what price?

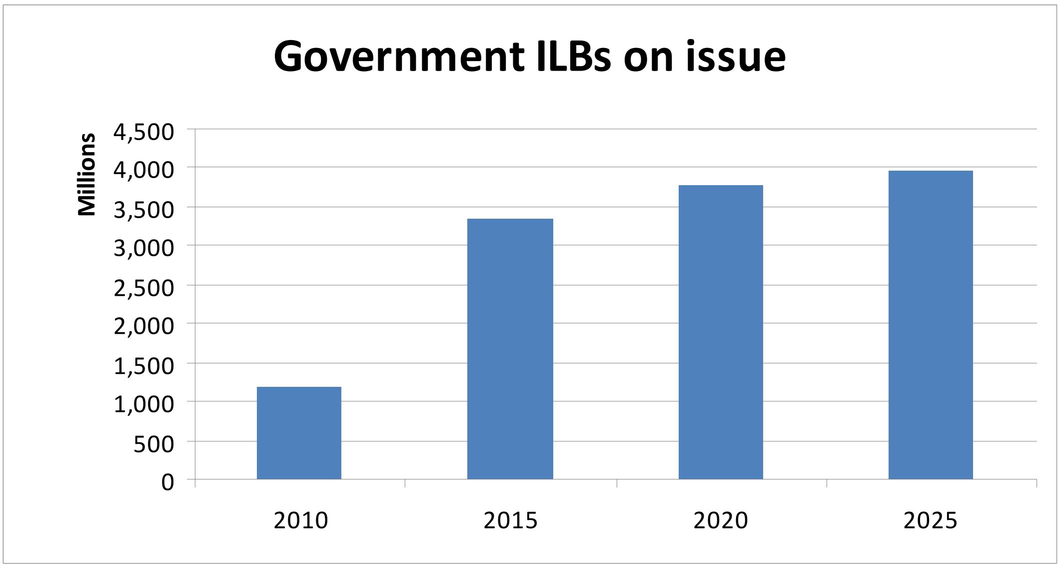
The Australian Office of Financial Management (AOFM) issued a new capital indexed bond with a maturity date of 20 September 2025. The first coupon payment will be on 21 December 2009 and quarterly thereafter adding to the market's liquidity (as other bonds have coupons payable in August, November, February and May).

Initial guidance expected the bond to be priced within 0 – 5bps of the yield of the 2020 bond. Given that the yield curve is currently flat, the new 2025 line was reasonably priced at 3.04% with 2020 bonds trading at 3.03%. Initially after the issue, the new bond performed well as those who were scaled back due to the oversubscription looked to buy the bonds in the secondary market.

AOFM announcements clearly stated that they would issue into demand and that they wanted to ensure that the new line was a sufficient size in the index. Their decision to not take up all of the demand offered ($4 billion issued versus $5.5 billion in the book build) provides continued price tension and liquidity in the sector. At a transaction size of $4 billion, AOFM also increased Commonwealth ILB issuance by almost 50% given the value of available Commonwealth bonds was $9.5 billion (in an overall physical ILB market of $18 billion).

What does the market look like now?

As shown in the diagram below, Commonwealth ILB issuance is now $13.5 billion with a yield curve extending beyond 15 years.



Where did demand come from?

AOFM has disclosed that three quarters of demand came from domestic investors with many offshore investors waiting for certainty regarding the removal of non-resident interest withholding tax before participating. Changes to the relevant tax legislation are expected by late November.

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How many investors switched from holding the 2010 bond to the 2025?

Existing holders of 2010 bonds were offered the opportunity to switch their current investment into the new 2025 line. Some $700 million face value ($1.1bil market value) of the 2010 bonds was consolidated, equalling roughly half of the current issue. As the price that AOFM were offering to do the switch was worse than expected, the amount consolidated was at the lower end of the market's expectations.

What has been the impact on the benchmark?

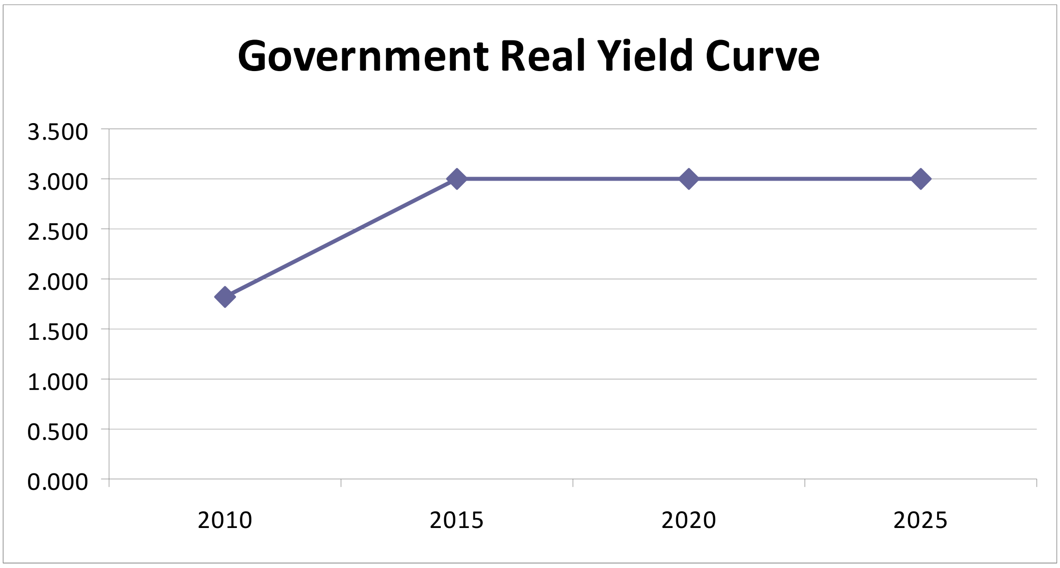
So far there has been no impact on the benchmark. The benchmark is updated at the end of each month to reflect the bonds that have settled during that period. As the 2025 issuance and the consolidation of the 2010's will not settle until next week, an update to the benchmark will not occur until October 31st.

In duration terms, we expect the UBS Government Inflation Index will move from 7.6 years to approximately 9.2 years. As a result of this, it is likely that October will be an active month in the market as index managers update their portfolios to reflect these changes. As half of the 2010 bonds on issue have been consolidated the index move on the maturity of the remaining 2010 bonds (in August of next year) has been reduced to around 0.6 years.

What was the effect of supply on valuation in the sector?

Real and nominal yields moved higher during the week, but this largely reflected the release of positive economic data and higher expectations of the cash rate being lifted before year's end. Given the extremely large amount issued, the direct impact of the supply on market pricing was negligible.

In our view, ILBs as a sector remain on the cheaper side of fair value although supply has seen prices come off from the start of 2009. The yield curve remains flat at the longer end representing good value. Technical factors related to supply, rather than pure fundamentals, have often been more important drivers of value in this sector. With a commitment to continued issuance from AOFM, we anticipate that this may change with more emphasis placed on economic conditions.



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Was the price in line with inflation expectations?

The Australian economy continues to show signs of strength with consumer confidence feeding better than expected retail sales and reigniting housing prices. With a commitment to keep inflation in a 2 – 3% band, the Reserve Bank faces the challenging task of maintaining a monetary environment conducive to kindling further growth in the Australian economy while not allowing inflation to flare. Consumers have not taken a fair dose of medicine during this crisis and remain overleveraged, particularly to the housing sector. Against this backdrop it would be politically irresponsible for the RBA to move interest rates to a more neutral stance too quickly so therefore we expect that inflation may be allowed to move outside the stated policy band. The economic situation remains precarious and therefore it is not surprising that expectations in the ILB markets are for low inflation right now and an increasing chance of higher inflation in the future.

Is AOFM likely to continue an ILBs issuance program?

AOFM has said that they will continue with their ILB issuance program. The intention is to have both existing and new security lines at “index size”, which would be approximately $5 billion each. We do not expect any new issuance into the 2025 line this year, although market consensus suggests that there will be additional issuance in calendar year 2010.

Potential new issuance may come in the form of a new line of 2030 dated securities or increasing the existing the size of the 2015 and 2020 lines. AOFM has stated that this will be based on market conditions and demand for these securities. In addition, the changes to the non-resident interest withholding tax legislation, scheduled for November 2009, will provide a potential catalyst for further issuance this calendar year as the Government aims to tap into offshore interest and demand in the relatively attractive real yield.