ARDEA Investment Management

Inflation Linked Bonds – Q4 2008 and Outlook

Summary Q4 2008:

The dramatic fall in Australian breakeven inflation continued in the last quarter of 2008. The main drivers over the quarter were asset allocation moves away from ILBs, continuing supply, falling demand for inflation protection and a slowing in speculative buying.

Asset allocation away from ILB's – equity market collapsed

Redemptions, losses on equities and FX hedge losses drove the ILB market down as investors sold ILBs to re-balance their portfolios.

Increased supply

ILB supply continued to have a negative impact on ILB's throughout Q4. In October a large PPP deal saw a large amount of supply flow into the ZCS market. NSWTC tendered an increase on their 2025 CIB in November. The size of the tender was scaled back as it was not well supported.

Demand for inflation protection fell

The price of oil rose to a high of close to US$150 in the middle of the year – only to fall to cUS$40 by the end of the year. This fall directly influences Headline CPI values, and indirectly reduces business and personal costs – thus reducing ongoing core inflation. As ZCS rates (and inflation linked bonds) are measured on Headline inflation – the impact of the fall in oil price is immediately felt by the inflation market – with the impact felt hardest in short dated tenors (although felt across the curve).

With the fear of inflation subsiding the urgent need to match inflation liabilities was reduced.

Risk reduction and drop in speculative buying

Speculation (by banks, hedge funds, fund managers etc) reduced significantly in Q3 and Q4 which reduced liquidity further – thus market moves were larger than otherwise. Speculators have historically been quite prominent in the ILB market and have served the purpose of providing liquidity when levels become extreme. However, as volatility in other markets increased, risk position sizes were reduced or completely closed accordingly. Even at current attractive levels speculative trading has not returned to the market.

Outlook for the Australian ILB market

Short term outlook

The short term outlook for ILBs is that we saw the lows in late 2008, however breakeven inflation will most likely stay low for some time. An increase in breakeven to occur we will most likely need to see an increase in inflation and a rise in equity markets, both seemingly not likely to occur in the near future.

1-3 year outlook

While the RBA targets 2-3% inflation, in most environments it is easier to generate higher inflation, as the risk of keeping inflation too low can lead to a recession. As a general principle therefore inflation lower than 2.5% is a good buying opportunity.

With the RBA responding to the current financial crisis by loosening monetary policy, the risk is that the stimulus this provides can be overdone, leading to higher inflation going forward.

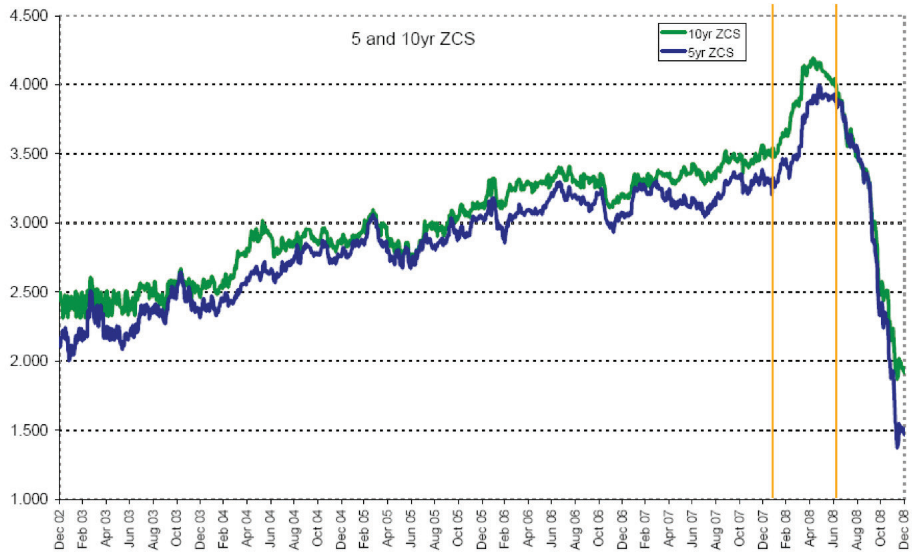
Our view is that ILBs have the potential going forward to do well in both a weak (real yields falling) or strong (higher inflation) economic environment.

Positive for ILB performance

- Strong equity market may mean a shift back to ILBs as rebalancing reverses.
- A heightened focus on inflation-linked securities into asset allocation for defined contribution as well as defined benefit funds.
- Growing number of participants in Australian market should improve liquidity in bonds and swaps, and could also mean that the Australia product moves onto the radar of global players.

Negatives for ILB performance

- As mentioned previously the main risk for investing in ILBs at present is that of Australia slipping into a deflationary environment such as that experienced in Japan. However, in our opinion because Australia is a much more open economy than Japan, and has a central bank willing to permit exchange rate depreciation as a policy tool, Australia's risk of deflation is much lower. Swap supply could potentially be reduced as risk aversion continues.
- Potential for more issuance from semi governments and PPP structures. (while negative for performance of the sector it is a positive for new ILB investors).



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