Rising inflation and a neutral RBA: what does it mean for fixed income portfolios?

With the release of last week's Statement on Monetary Policy, and following the February RBA meeting press release, the market has correctly identified a pronounced shift in stance by the RBA, from its earlier dovish outlook to one which is more balanced and likely to involve a period of stability in policy rates going forward.

At the same time, recent inflation releases have come as something of a surprise to both markets and the RBA. Inflation has now been stronger than expected for two consecutive quarters, and as a result the RBA's own inflation projections are now exceeding the upper end of the 2-3 per cent target band, at 3¼ per cent on the upside.

With both bond rates and breakeven inflation rates moving around considerably, the effect on investor portfolios can be hard to gauge. However, from first principles, this environment is one that is actually very favourable for fixed income returns, and especially favourable for fixed income portfolios with inflation protection.

At a more medium term horizon, these developments also raise the question of how long central banks–both global and domestic–are likely to tolerate higher inflation as a trade-off for achieving satisfactory economic growth. While the answer to this question is inevitably one that will evolve over time, what we can say is that uncertainty in this area has increased, and the risk of upside outcomes to inflation has risen. Taking out explicit protection against inflation in the form of inflation linked bonds is we believe a prudent approach to recognising this uncertainty.

Impact of neutral policy stance on bond rates

The shift to a neutral policy stance implies many things, but first and foremost is that, in the words of the RBA, policy rates are likely to experience a period of stability going forward. With policy rates currently very low at 2.5 per cent, investors could rightly conclude that this represents a continuation of recent fixed income returns, which have been on the low side.

The return on fixed income assets however is much more closely related to prevailing bond rates, rather than cash rates. Cash rates, being the rate for overnight funds, bear only an indirect relationship with longer-term rates on bonds, which can extend for a year out to 10 years and beyond. With the 10-year bond rate tracking broadly around 4 per cent, this represents a much better prospective return for investors than a 2.5 per cent cash rate.

Investors can also take comfort in the fact that this rate of return is equally relevant for inflation linked bonds as well. While real yields on inflation linked bonds are much lower at around 1½-2 per cent, this represents the return before the inflation indexation. Once inflation is added back, which is the case with inflation linked bonds, the return increases to 4 per cent or more depending on actual inflation outcomes. Again this represents a much healthier rate of return than a 2.5 per cent cash rate would suggest.

Recent changes in inflation

Inflation is most directly affected by changes in the Australian dollar exchange rate, and with the currency having weakened considerably from its highs, we are beginning to see increases in the prices of traded components of the CPI. As well as the direct exchange rate effect, the earlier low inflation outcomes delivered via globalisation and cheap labour costs, most notably from China, have also tailed off. This has the effect of making imports more expensive, regardless of what the exchange rate is doing. Together these factors account for a significant part of the recent strength in inflation outcomes.

The other part of the story is a more difficult one however, and that is the persistent strength in non-traded, or domestic, prices. These are prices for goods and services that are not traded on international markets, and therefore whose inputs are largely domestically determined. Inflation on these goods and services continues to run at around 4 per cent, but of greater concern is that prices on these components show very little sensitivity to economic conditions.

This creates a considerable upside risk to inflation, as any increase in traded goods inflation is not likely to be offset by changes in the seemingly immovable non-traded inflation component, resulting in material increases in headline inflation.

There is also the concern that any increase in inflation may not be dealt with as swiftly as investors might like. While central banks have established a very strong track record and institutional framework to deliver certainty around forward-looking inflation expectations, and to tackle undesired inflation by changing interest rates, our concern is that this framework was established in a much more benign historical environment than the one currently. In the current environment, asset prices, financial stability, and employment are all arguably greater priorities for policymakers than low and stable inflation. So while we do have some confidence that central banks will be able to deal with inflation, at the same time we think it prudent to prepare for the possibility that they may not.

Impact of inflation on fixed income returns

While inflation plays an important part in determining the returns on inflation linked bonds, it becomes an even more important consideration when inflation is changing, or when inflation is becoming more uncertain.

With the recent strong inflation releases, and, most importantly, with the RBA's neutral stance on rates and thereby on inflation, the risk that investors will have to withstand a period of higher inflation has increased dramatically.

Where does this leave fixed income investors? For holders on nominal bonds, the unfortunate outcome is that higher inflation is detrimental to bond returns. This is nothing new, as inflation has always been the enemy in eroding away fixed financial returns. While an investor in nominal bonds can still expect to earn something close to prevailing yields of 4 per cent in dollar terms, in real, after-inflation terms these dollars will be worth less. The effective real return, after inflation, could therefore be 1 per cent, or even lower, should inflation increase further.

On the other hand, fixed income portfolios with inflation protection stand to benefit directly from the increase in inflation. The indexation feature on inflation linked bonds, or the inflation payment on inflation swaps, means that any increase in inflation is reflected directly in the return of the asset.

For example, an increase in inflation above 3 per cent would result in a larger inflation payment on inflation linked bonds, This would ensure that the real, after-inflation return on these assets is maintained despite the increase in inflation. This stable real return results in a considerable outperformance of these securities relative to their nominal equivalents, whose real return gets eroded to a greater and greater degree as inflation increases.

Combining both the policy rate outlook and the potential for increased inflation results in a moderately positive return for conventional fixed income investors, who are at least able to benefit from higher prevailing bond rates. Inflation-protected portfolios perform especially strongly however as they capture both a higher yield given the increase in bond rates, and they benefit from inflation indexation as each additional increase in inflation carries through to the indexation on these assets.

With this in mind we would encourage investors to have confidence in fixed income returns being at least likely to outperform the results of recent years, but we would also remind investors to be mindful of the impact of a pronounced increase in inflation on fixed rate nominal returns.

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