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Talking Point



Outlook for UK Inflation-Linked Bonds

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These are challenging times for the UK inflation-linked bond market. Over the last three years, inflation has been much more volatile than in the preceding ten years, reflecting an increase in size and frequency of short-run factors. Thus, the retail price index (RPI) printed 3.7% in January, rising sharply from 2.4% in December. The Governor of the Bank of England, in an open letter to the Chancellor, described the spike as 'temporary', driven by the re-instatement of VAT at 17.5% and the continued increase in the price of crude oil and export prices. With these factors set to wane over the upcoming months, the Governor argued that excess capacity will help pull inflation down sharply in the second half of the year. Key to this will be the speed of disinflation.

The dynamics of the market are also worthy of comment. These bonds account for around 20% of the UK gilt market. They differ from conventional gilts, in that the semi-annual coupon payments and the capital repayment on redemption are adjusted in line with inflation, as measured by RPI. In the ordinary course of events, linkers, therefore, offer protection against the loss of purchasing power caused by inflation. That said, when inflation turns negative, the cash flows are lowered accordingly and there is no floor on the final redemption payment. Sovereign debt predominates and corporate linkers constitute only a small portion of the market.

Aside from diversification benefits, the reason for holding these bonds is that they provide arguably the only true hedge against (unanticipated) inflation. They are especially attractive to UK taxpayers since the gain arising from the inflation uplift on the principal value is generally not taxed – in addition, whilst interest received is taxable, inflation-linked bonds are low coupon instruments. Institutions also enjoy an advantage in that an inflation tax relief is granted based on the inflation experienced between tax year-ends (this relief is deducted from the total return).

In terms of the bigger picture, it is estimated that around 90% of the market is owned by pension and insurance companies, matching real annuity obligations and pension fund obligations that have been 'bought-out'. This demand is unlikely to diminish given the present regulatory and accounting environment – not least the fact that a UK company pension scheme now sits on the balance sheet. Given that their liabilities are very long-term in nature, it is no surprise that pension funds have a preference for long-dated inflation-linked bonds; this fact has been recognised by the Debt Management Office (DMO) which has skewed issuance towards this sector in recent years. The net result is that the average maturity of the market is now close to 17 years, compared to 13 years for conventional gilts.

Whilst increasing government issuance on the back of the worsening fiscal outlook is clearly a concern for the gilt market in its entirety, we suspect that the issuance of inflation-linked bonds will be capped at around £30-£40 billion over the next few fiscal years. This number is broadly flat versus the fiscal year 2009 - 2010 and maintains linker supply at 15-20% of total issuance. It would make sense for the government to limit liabilities linked to inflation whilst it is elsewhere pursuing expansionary policies with an inflationary bias. The obvious conclusion is that the structural demand should be more than sufficient to take down this supply. In any event, we do not envisage the government using the inflation-linked market in any form of future quantitative easing.

Looking ahead, it seems reasonable to assume that inflation has peaked and will decelerate throughout the rest of the year. In this respect, there is nothing to suggest that the direct effect of the short-run factors will be anything but temporary, and there is no evidence that medium-term inflation expectations have become



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unhinged. Meanwhile, the sustained weakness in nominal spending has created a substantial margin of spare capacity within the economy, which is likely to bear down on inflationary pressures over time; pay growth is likely to remain subdued. It is also noticeable that core goods prices have surprised to the downside over recent months. The latest GDP growth numbers highlight the fragility of the economic situation and this would be bad news for inflation-linked bonds.

On the other hand, there is an argument that the real concern should be high future inflation. Whilst the economic downturn has indeed been severe, the policy response has been aggressive – interest rates stand at unprecedented lows, the government has increased central bank reserves to the order of £200 billion, fiscal policy remains expansionary, government borrowing is at record levels and sterling has fallen by over 25% (in trade weighted terms) over the past three years – a characteristic of the UK economy is that the degree of pass-through from exchange rate moves to imported manufactured goods prices is high. Once the recovery is assured, this will require a quick withdrawal of current policy stimuli; any perceived delay from the authorities and inflation-linked bonds will perform very strongly.

As to the level of valuations, most statistical models suggest that long-term real rates are in the order of 2%. This implies that today's rates are below sustainable levels. Despite high issuance from the DMO, this is likely to remain the case whilst the structural demand from the pension funds persists. For other investors, the ability to buy inflation-protection is clearly of benefit in an uncertain world.

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