

C A M B R I D G E   A S S O C I A T E S   L L C

## EUROPEAN MARKET COMMENT

### ARE LINKERS RICH?

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## Are Linkers Rich?

Are U.K. linkers overpriced? On the evidence, it certainly appears so: real yields are not only close to all-time lows, but well below their average of 3.17% since they were introduced in May of 1981 (Table A). While it is true that the linker market has somewhat unique supply-demand issues (pension funds and life assurance companies hold roughly 90% of outstanding issues), linkers seem an expensive inflation hedge given real yields of 1.74%.

Still, linkers remain slightly attractive relative to nominal U.K. bonds, which continue to price in quite low inflation expectations. Indeed, since U.K. nominal yields peaked last May, global yields have fallen across the board, with nominal yields generally falling more than real yields (Table B). As a result, break-even spreads have tightened everywhere except Australia. Within the United Kingdom, the bond market is pricing in inflation expectations of 2.79% over the next ten years. Thus, ten-year linkers will outperform nominal gilts if inflation comes in higher over the next decade, which seems quite likely based on historical standards: over rolling ten-year periods since 1957, U.K. RPI has exceeded 2.79% in every period but five, or 87% of the time. We would note, however, that virtually all of this history occurred before the Bank of England became independent in 1997, and thus one could argue that it has an upward bias unlikely to recur in the future.

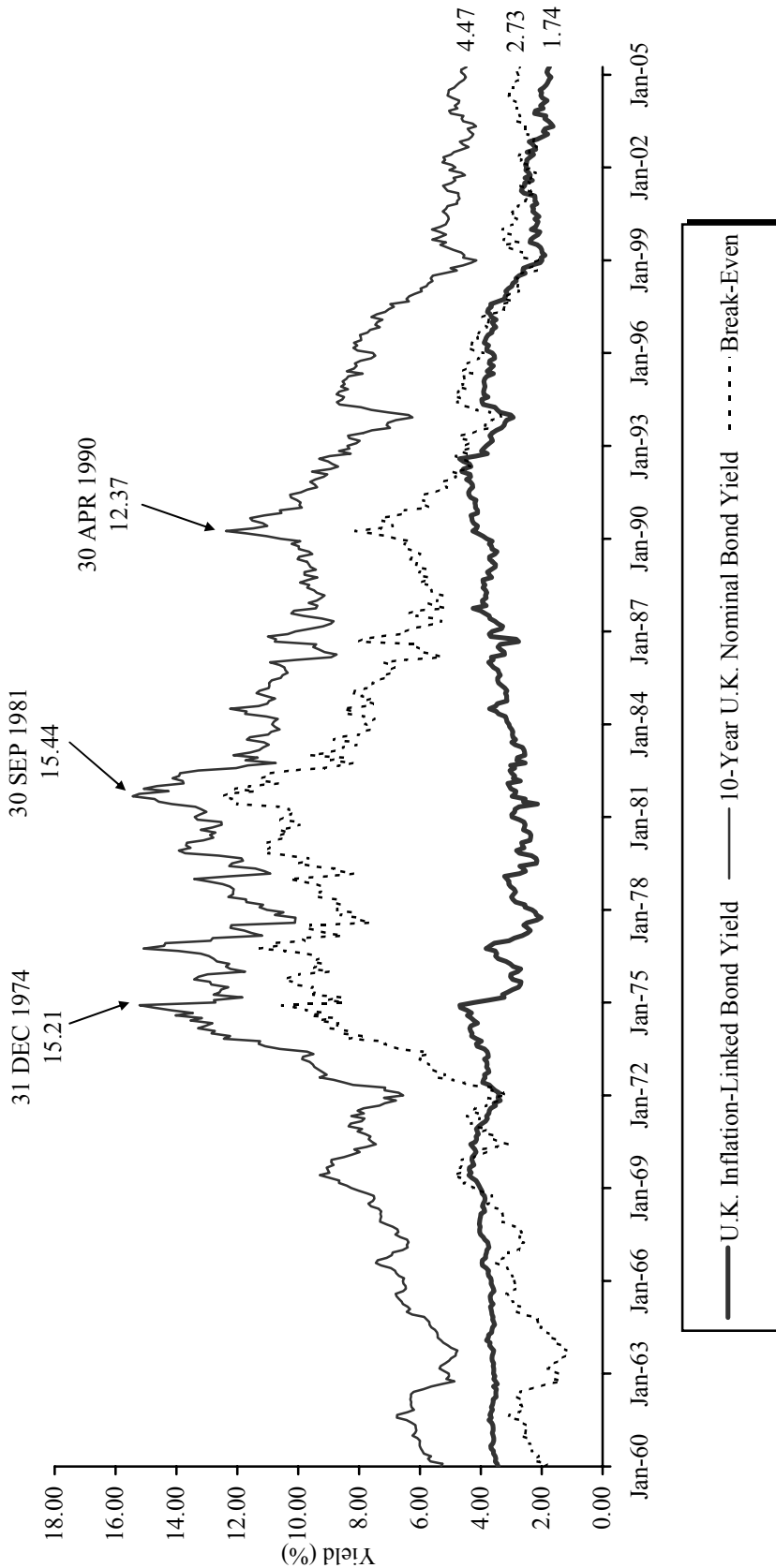
Any discussion of linkers must, of course, address the potential that U.K. pension funds may at some point move en masse out of equities and into fixed income, in order to improve asset and liability management and comply with regulatory changes. While this is certainly a compelling story line, the data have yet to support it, as recent moves by pensions have been fairly minor in scope (Table C). Further, pensions have lately shown a preference for long-dated nominal bonds over linkers (Table D), although the expected introduction of a 50-year linker in July may change this. Barclay's Capital recently compared predictions of a massive asset allocation shift to the fable of the boy who cried wolf. "When writing about the investment behavior of U.K. pension funds," the firm noted, "we sometimes feel we risk taking on the role of the shepherd boy."

The case against linkers, however, is not open and shut. To begin with, while real yields of approximately 2.0% are low relative to linkers' yields over their 24-year history, they are not significantly low relative to most analysts' estimates of average long-term historical real yields. Further, for some investors, the overall benefits of linkers outweigh short-term pricing discrepancies, as they offer a unique blend of inflation protection, diversification, and liquidity. Indeed, the sheer size of pension investors is such that any significant move into linkers could indefinitely depress yields below any reasonable estimate of fair value. While this has yet to happen, it remains a possibility.

Table A

U.K. TREASURY YIELDS

1 January 1960 - 30 April 2005



Sources: Bridgewater Associates and Global Financial Data.

Note: The Bridgewater 10-Year U.K. Inflation-Linked Bond Yield is simulated from 1960-80 and is live from May 1981 to present.

Table B

## GLOBAL REAL YIELDS AND BREAK-EVEN INFLATION

	As of 31 May 2004			
	<b>10-Year Nominal Yields</b>	<b>10-Year Inflation-Linked Yields</b>	<b>Break-Even Inflation</b>	<b>YoY Inflation</b>
United States	4.66	2.00	2.66	3.05
United Kingdom	5.15	2.10	3.05	2.75
Canada	4.78	2.31	2.47	2.46
Sweden	4.69	2.08	2.61	0.57
France	4.32	1.80	2.52	2.60
Australia	5.97	3.30	2.67	2.48 <sup>1</sup>
	As of 30 April 2005			
	<b>10-Year Nominal Yields</b>	<b>10-Year Inflation-Linked Yields</b>	<b>Break-Even Inflation</b>	<b>YoY<sup>2</sup> Inflation</b>
United States	4.21	1.61	2.60	3.15
United Kingdom	4.52	1.73	2.79	3.20
Canada	4.14	1.90	2.24	2.35
Sweden	3.39	1.55	1.84	0.14
France	3.43	1.44	1.99	1.91
Australia	5.42	2.69	2.73	2.36
	Basis-Point Change (bps)			
	<b>10-Year Nominal Yields</b>	<b>10-Year Inflation-Linked Yields</b>	<b>Break-Even Inflation</b>	<b>YoY Inflation</b>
United States	-45	-39	-6	10
United Kingdom	-63	-37	-26	44
Canada	-64	-41	-23	-11
Sweden	-130	-53	-77	-43
France	-89	-36	-53	-69
Australia	-55	-61	6	-12

Sources: Barclay's Capital Research, Bureau of Labor Statistics, Global Financial Data, and Thomson Datastream.

Note: Inflation-linked yield data for Sweden, France, and Australia for 30 April 2005 are represented by the relevant Barclay's Capital Inflation-Linked indices.

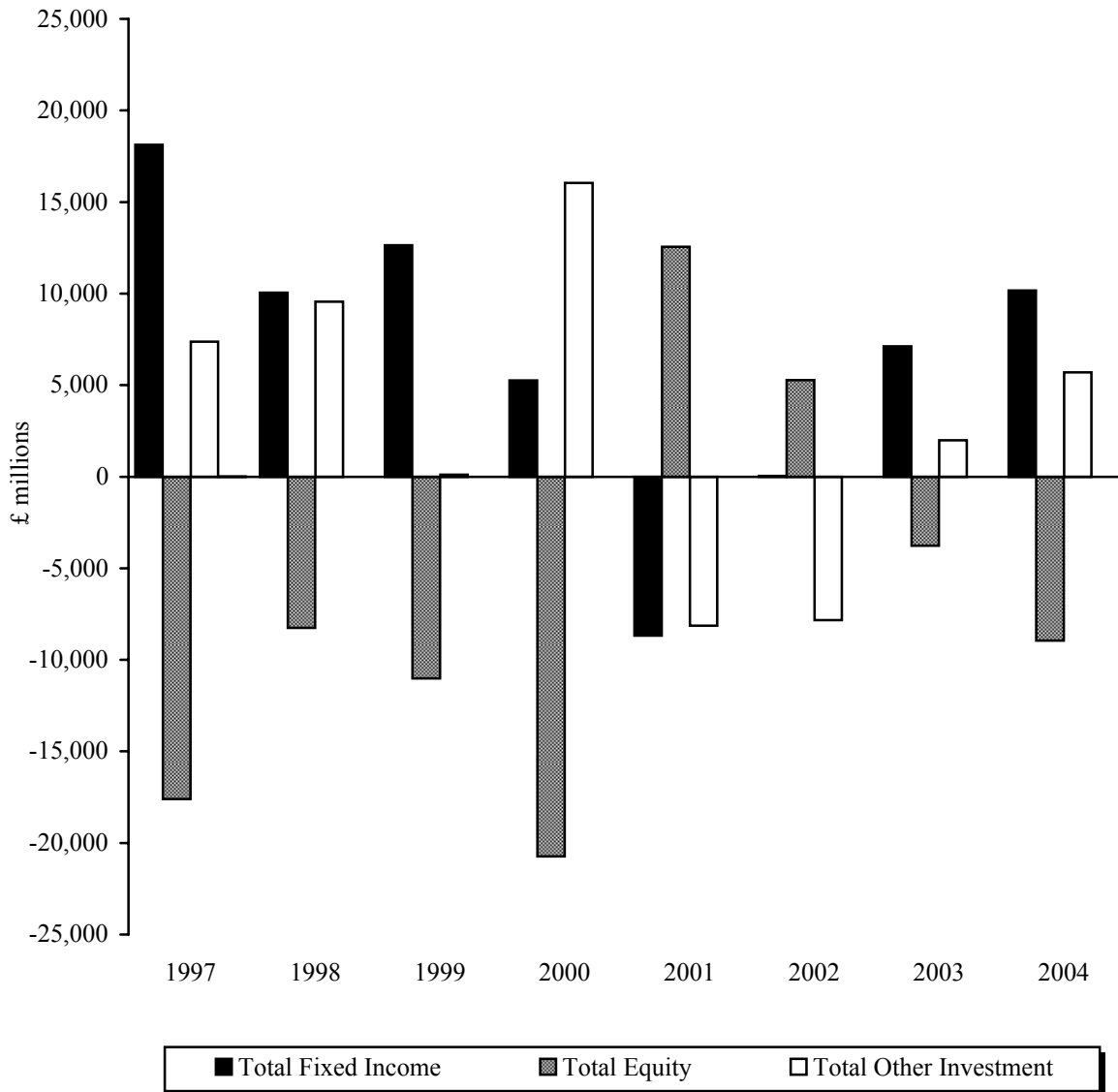
<sup>1</sup> The year-over-year inflation data for Australia is as of 30 June 2004.

<sup>2</sup> The year-over-year inflation data are as of 31 March 2005.

Table C

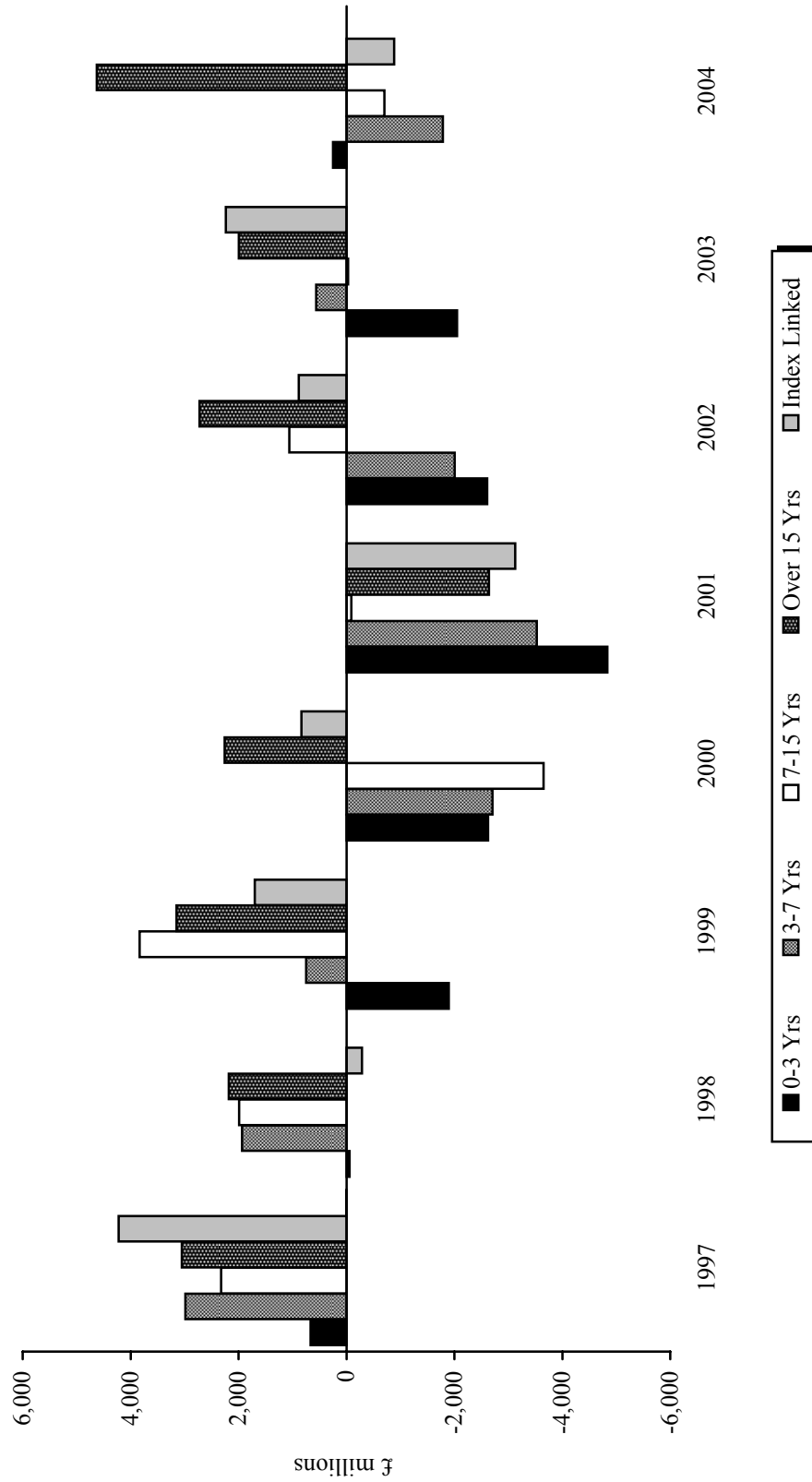
## NET INVESTMENT BY U.K. PENSION FUNDS BY ASSET CLASS

1997-2004



Source: National Statistics.

**Table D**  
**U.K. PENSION FUND GILT INVESTMENT BY TYPE AND MATURITY**  
**1997-2004**



Source: National Statistics.