C | A

CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENT

GERMANY JOINS THE INFLATION-INDEXED PARTY

June 2004

Eric Winig
Rowan Harmer

Germany Joins the Inflation-Indexed Party

Germany's recently announced intention to enter the inflation-indexed (I/I) bond market, along with Switzerland's widely expected plans to do the same, will further broaden and deepen a market that has gone from curiosity to global asset class in less than a decade, even as inflation rates have remained at generational lows. The German announcement, which represents an about-face from the country's decision *not* to issue I/I securities late last year, apparently stemmed from intense investor demand for the bonds. Germany provides the latest example of how governments' perspectives have changed with regard to issuing I/I securities: while officials used to feel a need to justify their decision to issue I/I bonds, now they feel the decision *not* to issue demands some sort of explanation.

Indeed, perhaps the most pressing worry among observers is that Germany's announcement will spur demand faster than issuers can put out supply,[1] as institutions and individuals, particularly those on the Continent, continue to gravitate to the perceived certainty of inflation protected returns. Some market observers, however, expect European issuers to take advantage of the interest generated by the German announcement by moving up their own issuance dates. Barclays Capital, for example, speculates that France, Italy, and Greece may be tempted to issue new supply—particularly in longer-dated maturities that will likely compete with the forthcoming German issues—before the end of 2004.

The global I/I market has expanded at a breakneck pace, more than doubling in size in less than five years. From year-end 1999 to today, the global I/I market has increased from roughly US$250 billion (representing 34 outstanding issues from six countries), to US$550 billion (nearly 50 outstanding issues from nine countries). The addition of Germany and Switzerland will bring the number of issuers to 11, and Bridgewater Associates estimates the global I/I market will top US$820 billion by year-end 2005, a significant increase over their US$650 billion forecast made last time we visited this issue in November 2003.

Still, for all the furor over I/I bonds, debt markets today look much the same as they did seven months ago: While real yields have generally fallen and breakeven inflation spreads widened, the moves have been quite small. (See table.) The largest move in real yields, for example, has been in Canada, where yields fell 69 basis points (bps); the second biggest move was in Australia, which saw a drop of 30 bps.

Within Europe, real yields for ten-year I/I bonds are low, ranging from 2.10% in the United Kingdom to 2.17% in France. Still, while we consider European I/I bonds to be overvalued, real yields of approximately 2.0% are not significantly low relative to most analysts' estimates of average long-term historical real yields. *Recent* real yields, however, have been somewhat higher: since the introduction of U.K. ten-year linkers in 1983, for example, real yields have averaged 3.23% and are currently near their all-time lows.

[1] While Germany has yet to commit to an issuance schedule or even to specific maturities, it is expected to issue roughly €10 billion (about 5% of the country's funding needs) in 2005, in maturities of ten years or more. The issues will likely be linked to the HICP ex tobacco index, as are similar bonds issued by France, Italy, and Greece.

European I/I bonds continue to be attractive *relative* to nominal bonds, given the low inflation expectations priced into nominal bonds. For example, since November the spread between linkers and ten-year gilts has widened a quite unremarkable 26 bps to 3.05%, still well below the inflation experienced over historical ten-year periods: over rolling ten-year periods since 1957, U.K. inflation has exceeded 3.05% in every period but six, or 84% of the time. Thus, we continue to view European I/I bonds as attractive relative to nominal bonds, but somewhat overvalued on an absolute basis.

GLOBAL REAL YIELDS AND BREAKEVEN INFLATION

	As of 31 October 2003		
	10-Year Nominal Yields	10-Year Inflation-Linked Yields	Break-Even Inflation
United States	4.33	1.93	2.40
United Kingdom	5.00	2.21	2.79
Canada	4.83	3.00	1.83
Sweden	4.93	2.35	2.58
France	4.36	2.03	2.33
Australia	5.76	3.57	2.20

	As of 31 May 2004		
	10-Year Nominal Yields	10-Year Inflation-Linked Yields	Break-Even Inflation
United States	4.66	2.00	2.66
United Kingdom	5.15	2.10	3.05
Canada	4.78	2.31	2.47
Sweden	4.69	2.08	2.61
France	4.32	2.17*	2.15
Australia	5.97	3.27*	2.70

	Basis Point Change (bps)		
	10-Year Nominal Yields	10-Year Inflation-Linked Yields	Break-Even Inflation
United States	33	7	26
United Kingdom	15	-11	26
Canada	-5	-69	64
Sweden	-24	-27	3
France	-4	14	-18
Australia	21	-30	51

Sources: Barclay's Capital Research, Global Financial Data, and Thomson Datastream.

* Inflation-linked yield data for France and Australia for 31 May 2004 are represented by the relevant Barclays Capital Inflation-Linked indices.