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EUROPEAN MARKET COMMENT

THE LURE OF INFLATION-INDEXED BONDS

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The Lure of Inflation-Indexed Bonds

Is the inflation-indexed (I/I) bond train finally leaving the station? While I/I bonds have been around for quite some time, most observers date the modern market to the United Kingdom's issuance in 1981; even the United States resisted issuing them until 1997. Yet a number of European countries have lately jumped into the fray: France and Italy have recently issued their own I/I bonds, with Germany and Switzerland likely to follow. The share of such bonds issued as a percentage of total government debt, meanwhile, continues to rise, while investor demand has increased. Institutional and retail investors alike seem to have warmed to the concept of inflation-protected returns.

Future growth in the I/I market, meanwhile, seems virtually assured, with many European governments running budget deficits and I/I securities increasingly seen as an attractive way to finance them. Currently, the European market consists of roughly $55 billion in issues, spread between France ($47 billion) and Italy ($8 billion). While Europe ex U.K. represents only 13.25% of the $415 billion global market, its share is likely to grow quickly. Bridgewater Associates projects the global I/I market will reach $650 billion in 2005, with more than 20.31%, or $132 billion, representing Europe ex U.K. issues. This would represent a 140% increase in the size of the European I/I market in just two years. Furthermore, while the U.K. I/I market is now more than twice the size of the continental market, the Europe ex U.K. market is growing far faster and will likely overtake its U.K. counterpart within the next few years.

In fact, the European I/I market already offers investors a number of choices. France has issued both ten- and 30-year inflation-linked bonds, while Italy recently entered the market with a five-year note. Both France and Italy's bonds, meanwhile, are euro-denominated, which means they are identical in all respects except for the maturity dates and the identity of the creditor.[1] Both are linked to the Eurozone Harmonized Index of Consumer Prices (HICP) ex tobacco, and both are prohibited from falling below par in the case of deflation. We would expect Germany to adopt these relatively standard features if and when they issue their own I/I bonds. (Switzerland would likely issue I/I bonds denominated in francs and pegged to Swiss inflation.)

While the market is broadening and liquidity improving, I/I bonds do not currently provide much in the way of yield. Still, due to rock-bottom nominal bond yields, breakeven levels of inflation (i.e., the level at which I/I bonds returns would equal those of nominal bonds of comparable maturity assuming income is reinvested at current yields) are themselves quite low. In the United Kingdom, for example, ten-year linkers currently yield 2.21% while ten-year gilts yield 5.03%. Investors, therefore, will be better off with linkers if annual inflation averages more than 2.82% over the next decade. While current inflation measures are right around this level, this degree of inflation is low by historical standards. Over rolling ten-year periods since 1957, ten-year inflation has exceeded 2.82% in every period but three, or 92% of the time.

Conditions in Europe ex U.K. are similar, with real yields low but breakeven inflation levels low as well. We therefore view European I/I issues much as we do U.S. TIPS—overvalued in absolute terms but undervalued relative to nominal bonds. European I/I bonds, in other words, look a sight better than nominal bonds. But neither looks a compelling value.

[1] France also has I/I issues that are linked to French inflation, but these were issued in 1998 and 1999, when the Eurozone HICP was new and untested, and potentially subject to revision risk. France now seems to prefer I/I bonds linked to Eurozone inflation. While any European country could of course issue I/I bonds linked to local inflation, this seems unlikely; bonds linked to Eurozone inflation provide far greater liquidity as they appeal to a larger pool of investors.