

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:
U.K. INDEXED-LINKED SECURITIES:
CHEAP OR DEAR?

August 2002

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U.K. Indexed-Linked Securities Cheap or Dear?

Real yields on ten-year U.K. inflation-indexed bonds have been fairly stable since their issuance in 1981 (see the exhibit that follows): in their first 12 years, yields gradually rose from 2.60% to 4.70%, and in the subsequent ten years they have slid back to their current level of 2.49%. This is below both the average of 3.32% since 1981 and the 43-year average of estimated historical real yields of 3.43%. More recently, since the fourth quarter of 1998, real yields have remained in a trading range between 1.89% and 2.67%, the lowest levels since 1960. All this would seem to suggest that real yields have nowhere to go but up and that ten-year Linkers are relatively expensive by historical standards.

Relative to nominal ten-year gilts, however, Linkers look cheap. The current break-even point between the two is 2.52% (ten-year nominal U.K. Treasury gilt yields of 5.01% minus ten-year Linker yields of 2.49%), which represents the average inflation rate that would have to occur over the life of the bonds for the index-linked security to generate the same nominal return as the conventional bond. If the premium provided by nominal bonds over inflation-linked bonds does not adequately compensate investors for their inflation expectations, inflation-linked bonds represent a better value. Therefore, investors who believe U.K. inflation will exceed 2.52%, over the next ten years should regard Linkers as offering better value than nominal bonds.

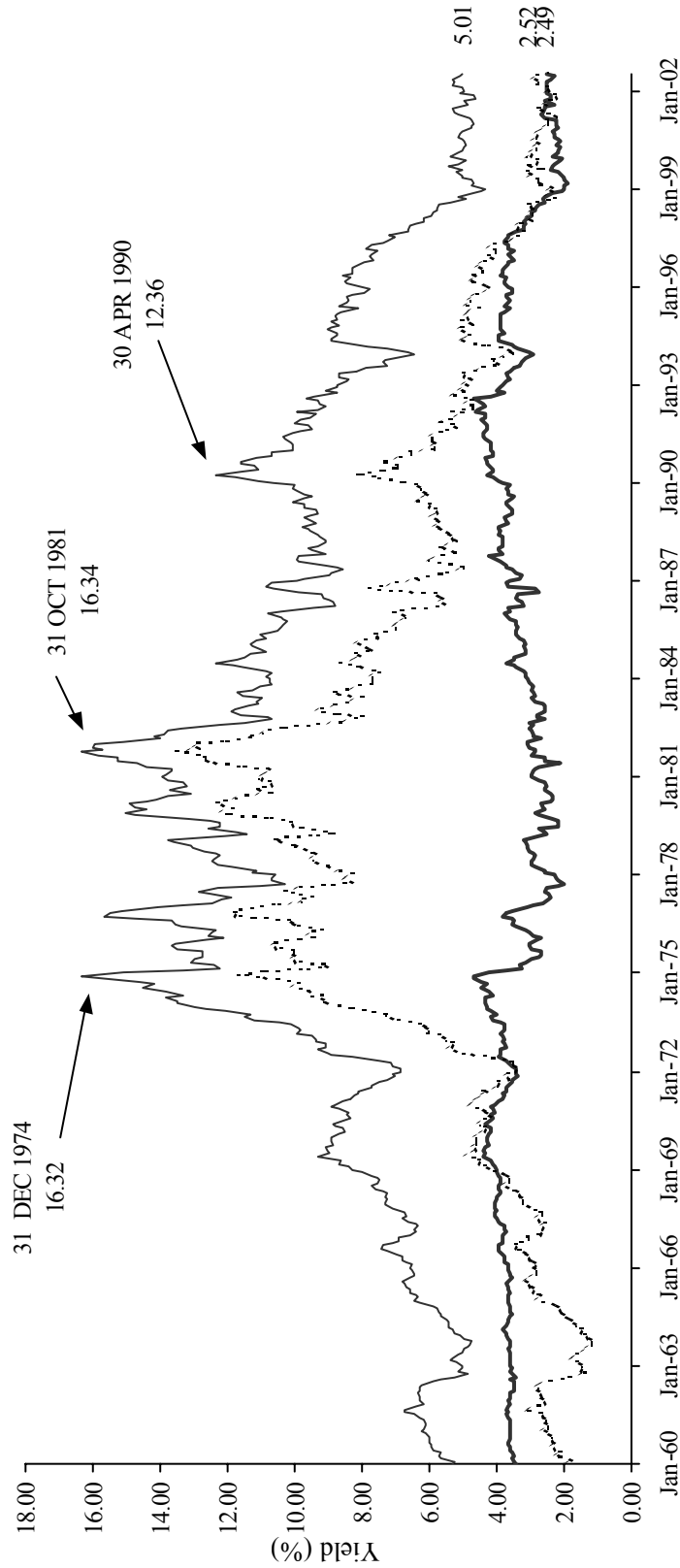
It is worth noting that inflation of only 2.52% is low by historical standards. Over the last 43 years, the break-even point between ten-year gilts and Linkers has averaged 5.64%, while the current break-even point is only slightly above its post-1981 low of 2.24% reached in March 2001. To find lower levels, one must go back to 1964. In fact, for *every* rolling ten-year period since the decade ending in 1966 inflation has averaged 7.20%. Inflation has exceeded 2.52% in every rolling ten-year period other than 2001. These data suggest that Linkers offer great value compared to nominal gilts.

Nevertheless, we would caution investors against regarding Linkers as a bargain. First, the break-even point vis-à-vis nominal gilts may be artificially depressed by the Minimum Funding Requirement for U.K. pension funds. This has spurred the demand for long-dated gilts at a time when the Treasury has significantly reduced the supply of gilts outstanding. As a result, prices are higher (and yields lower) than they would be otherwise, which has the side-effect of reducing the break-even level with Linkers.

In addition, the anti-inflation stance of the Bank of England and the European Central Bank suggests that today's relatively low levels of inflation may be more typical of the future than are the much higher inflation rates that prevailed from 1945-90. If the very high, "abnormal" inflation decades of the 1970s and 1980s are excised from the historical record, the current spread between Linkers and nominal bonds does not seem particularly narrow, nor Linkers particularly cheap.

U.K. TREASURY YIELDS

1 January 1960 - 31 July 2002



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 1981-2002.