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Impact of European sovereign credit crisis on inflation-linked bonds

Recent developments in the European sovereign credit crisis have eroded the effectiveness of European inflation-linked bonds as 'risk-free' hedging tools against inflation, making a portfolio of global inflation-linked securities a better, diversified choice for investors.

A true risk-free asset

Inflation-linked bonds (ILBs), particularly those issued with an embedded deflation par floor, are arguably a true 'risk-free' asset class. They offer the full faith and credit of the respective sovereign issuer and deflation protection, they also protect investors against a loss of purchasing power, as their principals grow with inflation. Even though ILBs may still fall short of being a 'safe-haven', as the liquidity of their nominal comparators is still superior, ILBs are no doubt efficient, high-quality instruments for hedging against unexpected rises in inflation.

Declining sovereign credit quality of European ILBs

Volatility in European sovereign markets and rising concerns over the fiscal sustainability of debt-laden European countries have inevitably dulled some of the lustre of European ILBs as an effective inflation-hedging tool. In an extreme case, the two Greek ILBs fell out of the most popular ILB indices in December 2009 and the inflation outlook no longer plays a part in their valuations.

That leaves Germany, France and Italy as the main issuers in European ILB markets. The average sovereign credit quality of a European ILB index has been hit by Italy's credit downgrades, making them less palatable to investors looking for high quality instruments.

Impact of restructuring risks on breakeven inflation

While investors demand a substantial yield pick-up (or discount) to own Italian nominal debt against German nominal debt to compensate them for the differential in sovereign credit risks, the discounts they are demanding on Italian ILBs over German ILBs are even bigger. In other words, breakeven inflation (BEI) spreads (nominal rates minus real rates) on Italian ILBs are trading at much lower levels than those on German ILBs, even though the bonds are referenced to the same Euro HICP ex Tobacco index. As at end October, 10-year German BEI was at 1.73%, versus Italian BEI at 1.13%.

The structure of ILBs – where their principals grow proportionately to the rate of inflation – introduces additional risks to investors should a restructuring or default arise. The 3-year Italian ILB BTPEi 2014, for example, was issued seven years ago and has accreted 16.9% of inflation uplift on its principal. In a hypothetical restructuring, with a haircut of 40% for example, it is unclear whether investors would get 60% of the inflation up-rated principal (116.9%) or just 60% of the unadjusted real principal (100%). The added uncertainty over the true recovery value

suggests that Italian ILBs, after adjusting for sovereign credit quality differentials, should trade cheaply relative to German or French ILBs, and indicates why Italian BEI should be lower than German or French BEI.

Index rules and the ECB's intervention

It is worth noting that the inclusion criteria of the most widely followed government ILB indices are stricter than those of the nominal government bonds. Most nominal government bond indices require a minimum credit rating of triple-B, but the Barclays World Government ILB Index requires a minimum rating of single-A. That means Italian ILBs will fall out of investors' relevant portfolio benchmarks quicker than their nominal comparators, making ILBs more vulnerable to index selling.

At the same time, while the ECB is providing liquidity support to Italian sovereign debt through the Securities Markets Programme, Italian ILBs are excluded from the purchases, as the ECB prefers to invest in nominal debt to reduce Italy's refinancing costs, than in ILBs which account for only a small part of the Italian bond market.

Investment solutions

Declining sovereign credit quality, the impact of restructuring risks on BEI, the vulnerability to index selling and the lack of ECB support suggest that European ILB investors would be better diversifying their holdings into a portfolio of global ILBs.

ILBs issued by the UK, Sweden, Canada and Australia are rated AAA. These countries' central banks are also more willing than the ECB to look beyond transitory rises in inflation and keep monetary policy accommodative in view of the shaky global economic backdrop, creating a more favourable environment for their domestic ILBs. For US TIPS, although their AAA-status was recently challenged by S&P's downgrade, the US Treasury's predictable, consistent issuance of TIPS (vs. the opportunistic nature of European issuance) and the Fed's inclusion of TIPS in their asset purchase programmes make TIPS more attractive relative to European ILBs.