Inflation-Linked Bonds

Protecting against deflation

The price of buying protection from the appearance of either much higher inflation or actual deflation is rather attractive for investors.

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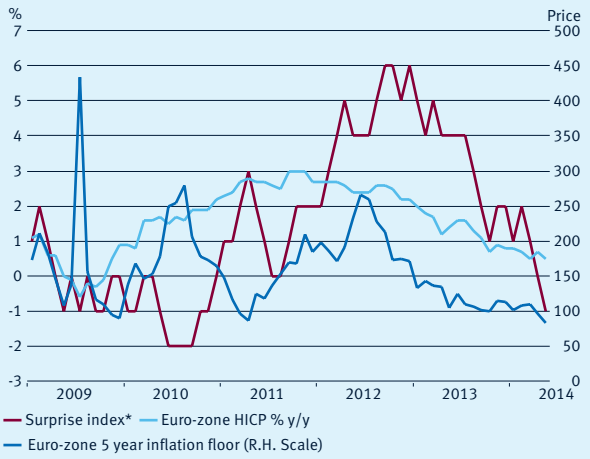
Chart 1
Belief that deflation can be prevented



* calculated by adding 1 to the index when inflation beats consensus forecasts, and subtracting 1 when it misses.

Source: Bloomberg, Standard Life Investments (as of 31 May 2014)

Inflation declining

In recent months, consumer price inflation (CPI) has started to surprise on the downside in most Western economies. Indeed, in some countries, especially in Europe and the US, inflation rates have dropped much more quickly than markets expected.

Europe has perhaps seen the most precipitous fall, to 0.5% per annum (p.a), therefore perilously close to deflation. This has finally engendered a strong response from the ECB, with the recent announcements of negative deposit rates and further unconventional monetary stimulus measures. The US probably saw the most consistent run of undershoots in CPI versus the market's expectations, until some surprises in the recent past. Even in the UK, which went through a prolonged period of upside surprises, CPI has fallen back rapidly and is below target.

With such a noticeable deceleration in inflation, it is perfectly understandable that some investors have begun to question whether deflation, i.e. actual price declines, might arise. In Europe, this subject has been very much on the agenda, particularly as the ECB was intransigent until very recently. As investors cover or hedge against this risk, some people might think that deflation protection would be more expensive now than in previous times. Yet the evidence seems to show a strong confidence that central banks, even the ECB, will deliver low but positive rates of inflation over time. Chart 1 shows Euro-zone harmonised CPI data alongside an index of inflation surprises. The downward momentum in the series and the run of low misses is abundantly clear since the end of 2012. The chart also shows the cost of buying a five-year deflation floor, which would protect the buyer against a falling level in each of its constituent years. This price is at a five-year low; hence any investor who decides that the ECB can save EMU from deflation should be buying such a floor.

This situation is reflected in the US and UK as well, where floor prices remain depressed. Furthermore, in all three countries, inflation caps (the antitheses of floors) are also cheap, implying that the market consensus is for positive but very low inflation, with a high conviction. Believers in non-consensual outcomes should therefore consider buying both instruments.

These prices indicate a belief in low future volatility of inflation as well as a low level. Indeed, inflation expectations implied by markets have seen very little volatility in the major countries so far this year. US 10-year breakeven inflation rates have traded in a broadly 0.2% range in 2014, hardly enough to get investors excited in either direction. Most breakeven rates have been a little soft this year, which is quite normal as inflation expectations tend to move in the same direction as current inflation – perhaps demonstrating the short-term horizons of many investors.

Falling yields

More widely, real bond yields have fallen this year, as indeed have nominal yields, confounding one of the strongest consensus views in recent memory. This has resulted in strong returns for these markets in an environment where few assets have done badly. Real and nominal yields are now low across all the major economies, probably none more than the UK. We expect them to rise a little over the next year or two but, without proper signs of cyclical inflation pressure leading to rapid stimulus withdrawal from central banks, it is hard to see a rampant bear market.

Inflation pressures are clearly few and far between. It is wages that are crucial for policy and markets, as most other factors will likely be seen as transitory or one-offs. Of course, exogenous events such as a major geopolitical shock could damage this view but, until real wage growth moves up and stays positive for a period, markets will likely remain relaxed about inflation risks.

Ultimately, whether that attitude is justified will be decided by how well the US and UK authorities navigate their way back to normal policy settings. This will take time, especially as the ECB is driving in the other direction entirely. In this environment, markets will attempt to price in a normalisation route, but investors should think carefully about risk premia. A disorderly exit path could lead to unforeseen outcomes, and cheap protection against untoward events should be bought.

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