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Private issuance: recent trends in the mature markets

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The theoretical case for corporate inflation issuance/paying…

…closely maps the argument for government issuance. If investment is all about risk and return, then borrowing is all about risk and cost:

- Risk reduction
  - A company's assets and revenues are real, so its liabilities should be too
  - A cyclical hedge - 'P&L smoothing'
  - Liability diversification

- Cost saving
  - Exploit high inflation expectations, if not shared by issuer
  - Save a risk premium (if it can be isolated)
  - Maximising reach – Offering different products to meet the different needs (or market views) of different investors, thereby reducing total expected financing costs

If inflation-linked issuance truly is a lower risk liability than nominal issuance, then a corporate should be able to tolerate higher leverage for a given credit rating using this financing route

The current reality

- Corporate inflation-linked issuance/paying confined to…
- … quasi-governmental issuers, …
- … a regulated asset base of utilities and project-related borrowers, …
- … and a retailer or two…
- … with explicit or semi-explicit future inflation linked revenue streams

- And the “visible” market – i.e. the non-government inflation-linked bond market – is small
- Market capitalisation of euro area non-government market c. EUR11bn; sterling market c. £12bn (tiny amounts, relative to outstanding government issuance)

UK Example: RPI-linked assets and liabilities – potential balance?

Government Stock = £120bn

PFI, Water, Gas, Electricity, Rail and others in the "regulated asset base"

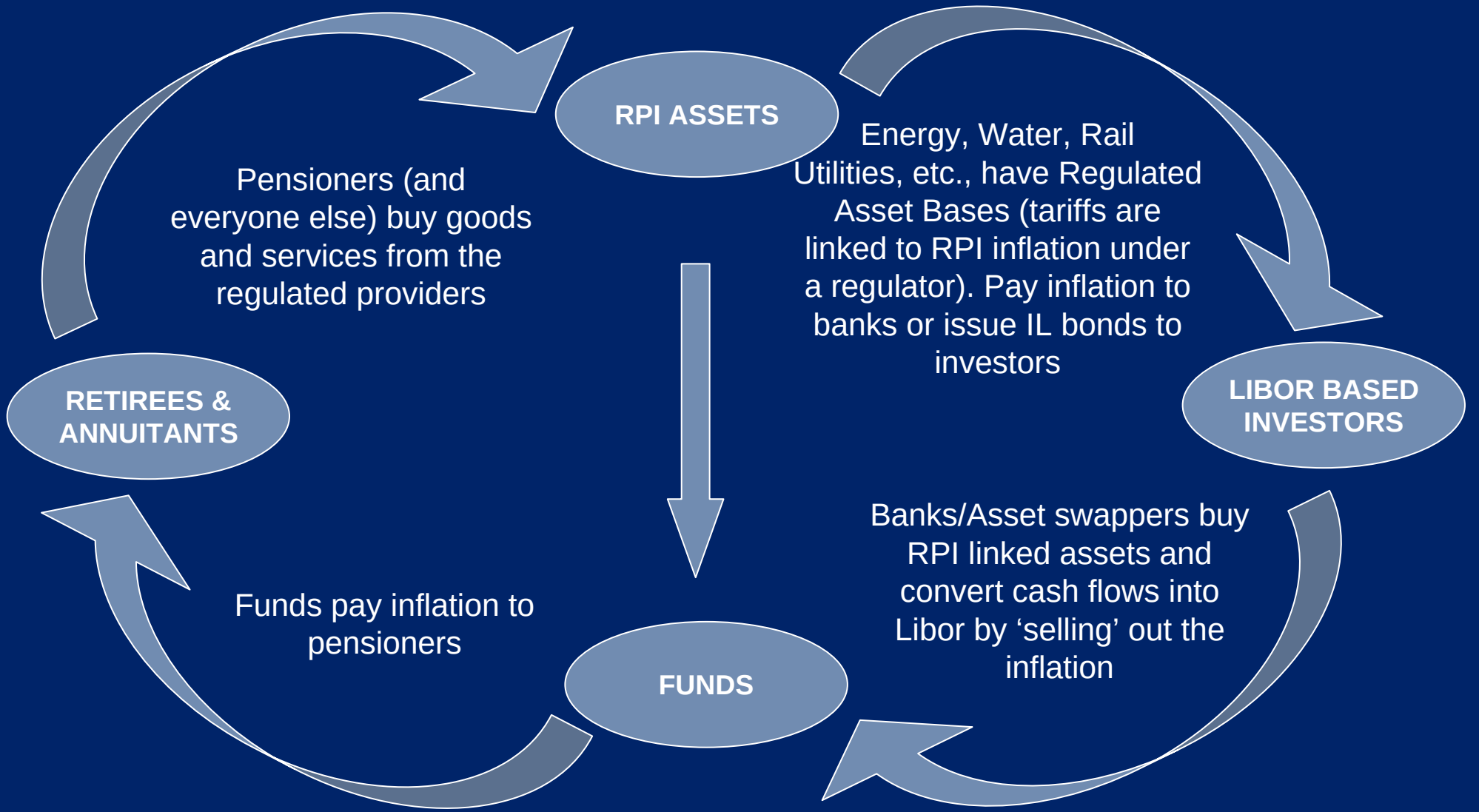
£800bn? (Est.)

=

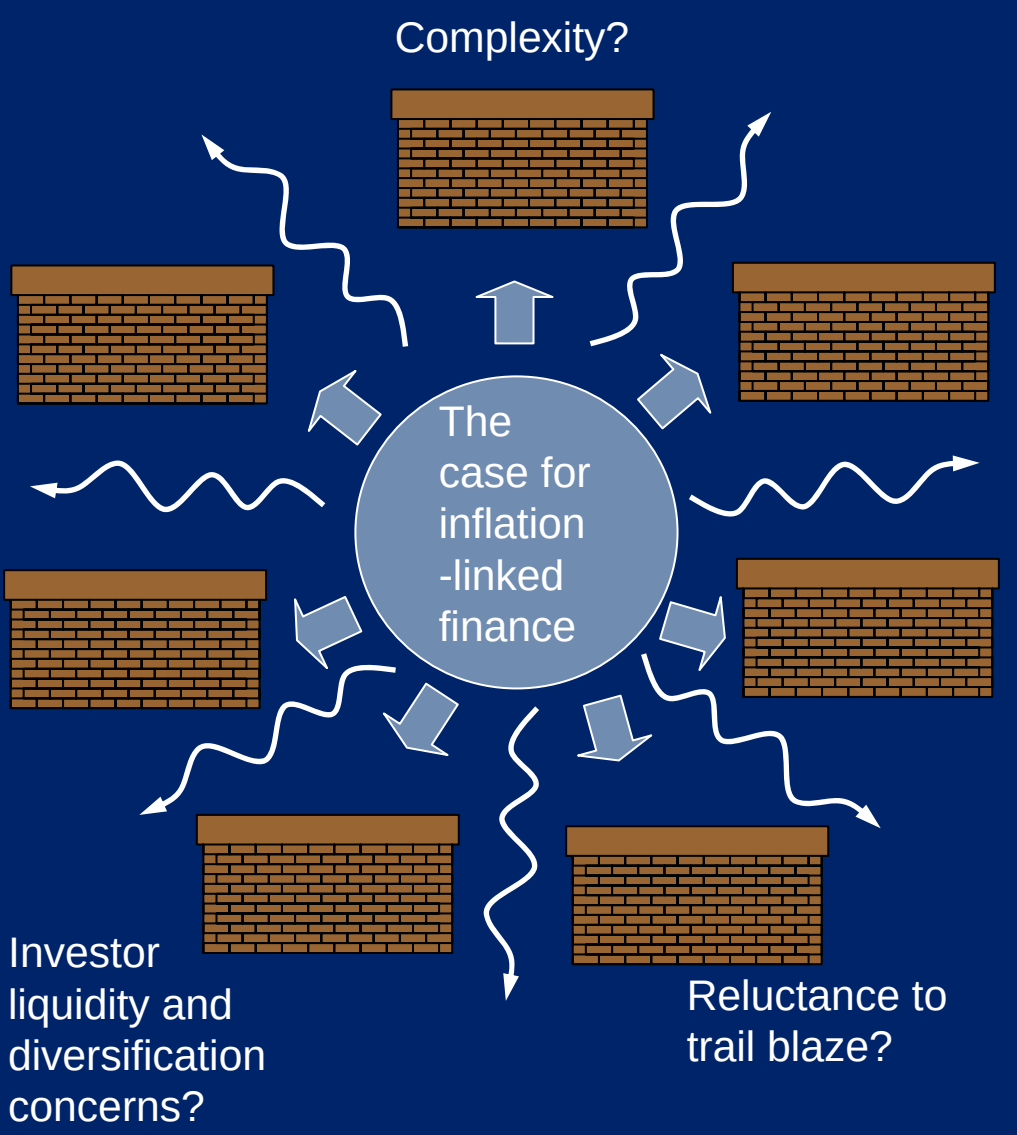
Pension Funds' RPI-linked Liabilities
= £800-900bn (Est.)

So what's the problem???

The UK ‘circle of assets and liabilities’



The blockages to greater private inflation-linked supply



Corporate inflation paying – not just for explicit inflation receivers

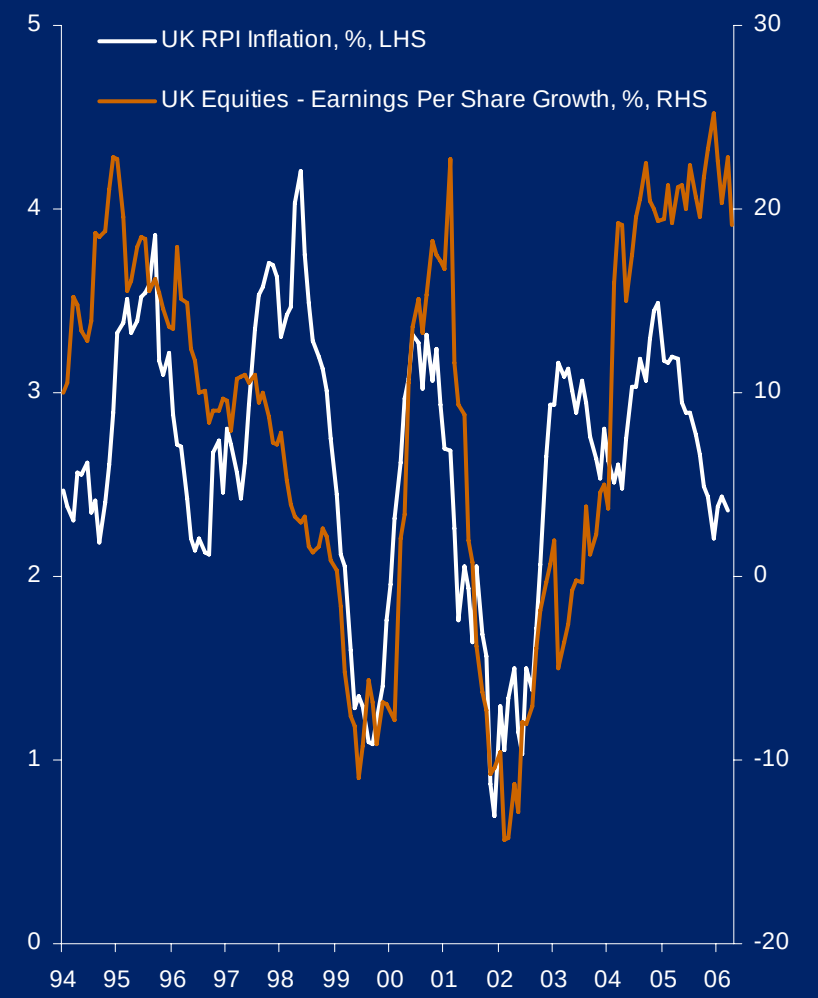
So you question the theory that inflation-linked liabilities confer "P&L smoothing"?

Here's the evidence – earnings per share growth is well-correlated with inflation

US – equity EPS growth & inflation

Source: ***RBS, Datastream***

UK – equity EPS growth & inflation



Source: ***RBS, Datastream***

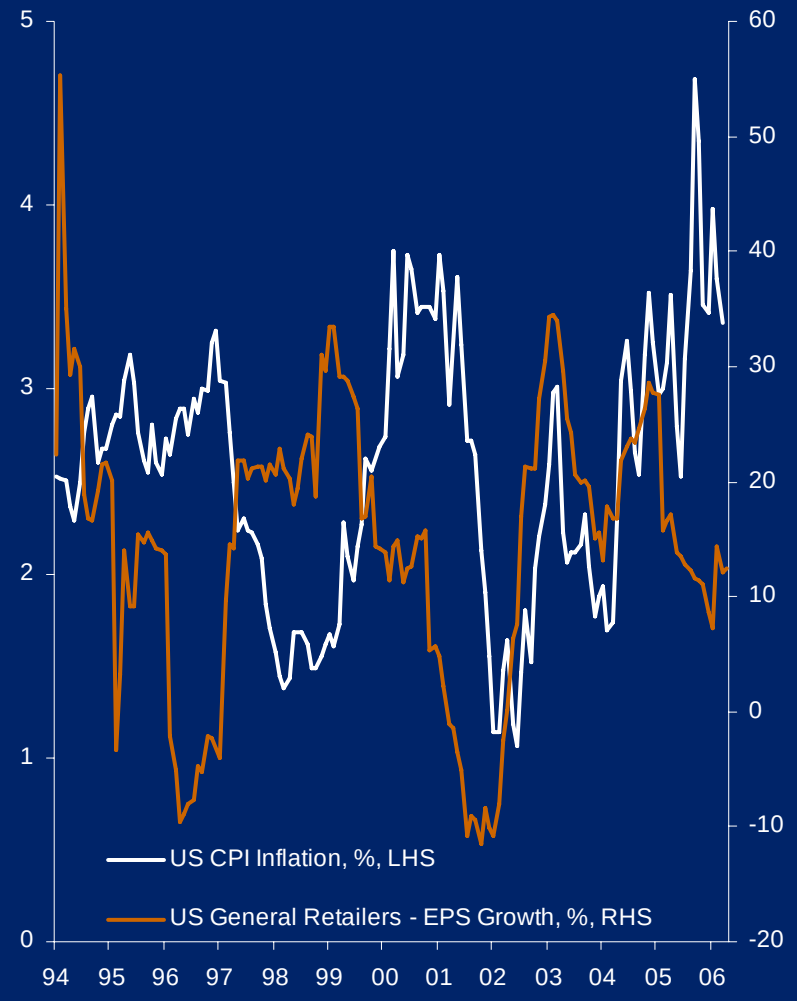
Profits in some sectors/economies more inflation-sensitive than others

However, care is needed – "P&L smoothing" is stronger for some sectors than others…

…and there are no global generalities – UK retailers have strong positive EPS/inflation correlation,…

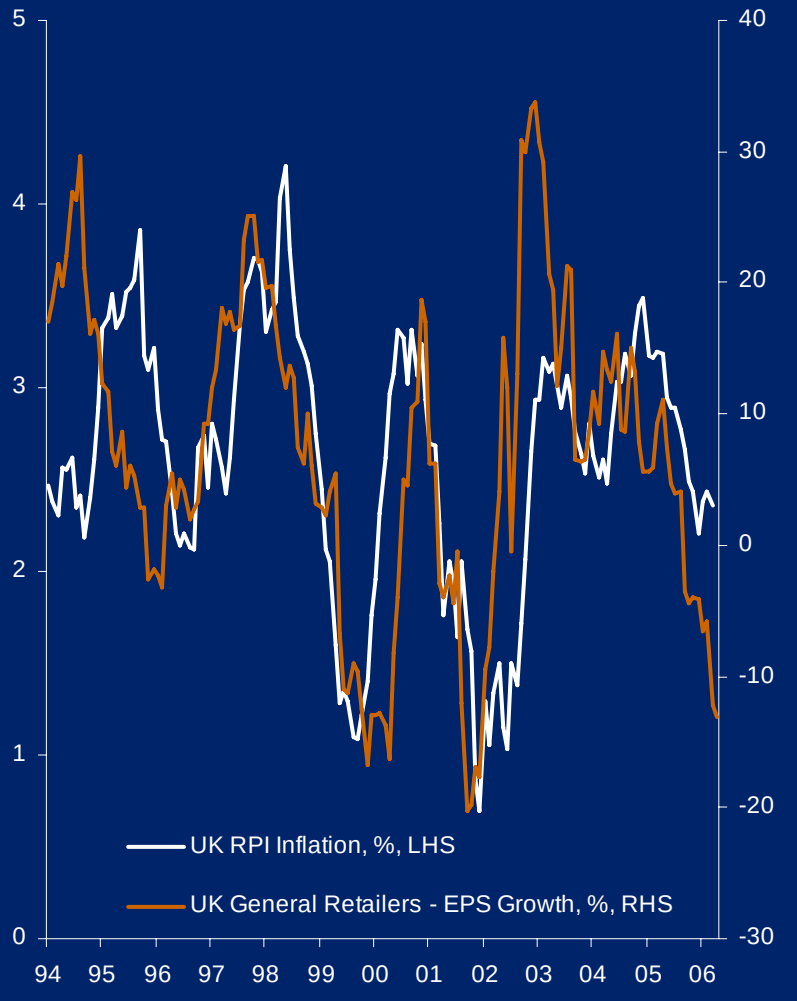
…while for US retailers, the correlation seems to be negative

US gen'r'l retailer EPS growth & inflation



Source: ***RBS, Datastream***

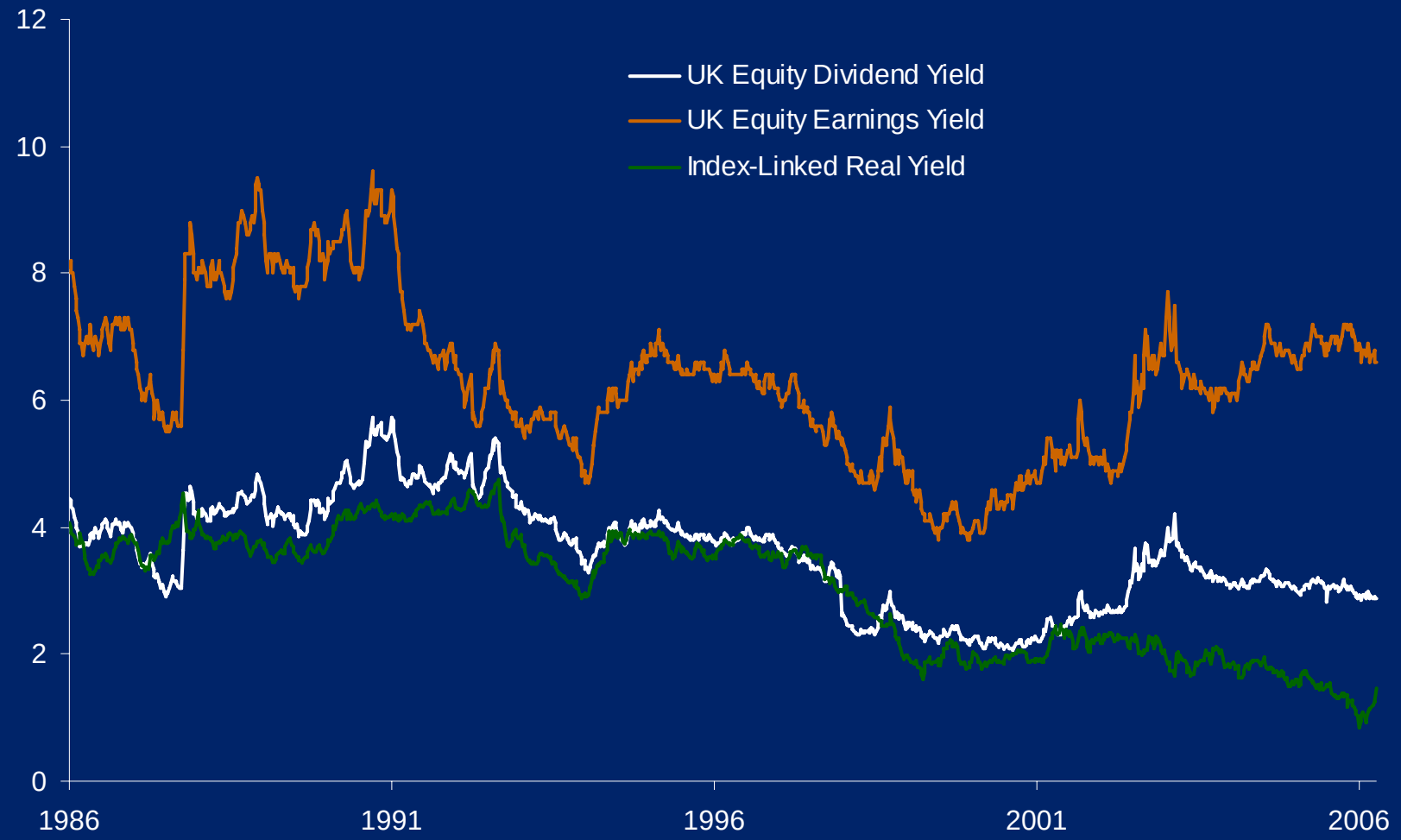
UK gen'r'l retailer EPS growth & inflation



Source: ***RBS, Datastream***

Cost of inflation linked finance cheap versus equity capital

UK linker real yields plus equity earnings and dividend yields



Source: *RBS, Datastream*

Now adjust the real yield gap for tax and real EPS growth…

- Expected prospective *real after-tax* cost of equity finance, before any risk-adjustment:

  = Earnings yield + expected long-term future *real* earnings growth

- For the FT All Share:

  = 7% + 3% (?) = 10% (?) net real

- Expected prospective *real after-tax* cost of inflation-linked finance:

  = [ILG real yield + credit spread + future inflation] x (1-Tax Rate)- future inflation *

  = [1% + 1%(?) + 3%(?)] x (1 - 0.3) - 3% (?) = 0.5% (?) net real

How debt-averse do you have to be for the switch to be unattractive?

* You need to add inflation to work out tax relief on uplift, then deduct it later to get a real net cost

Meanwhile, the carry advantage of floating finance is disappearing fast

"Real" 3-month libor rates rising, reducing the relative attraction of floating borrowings

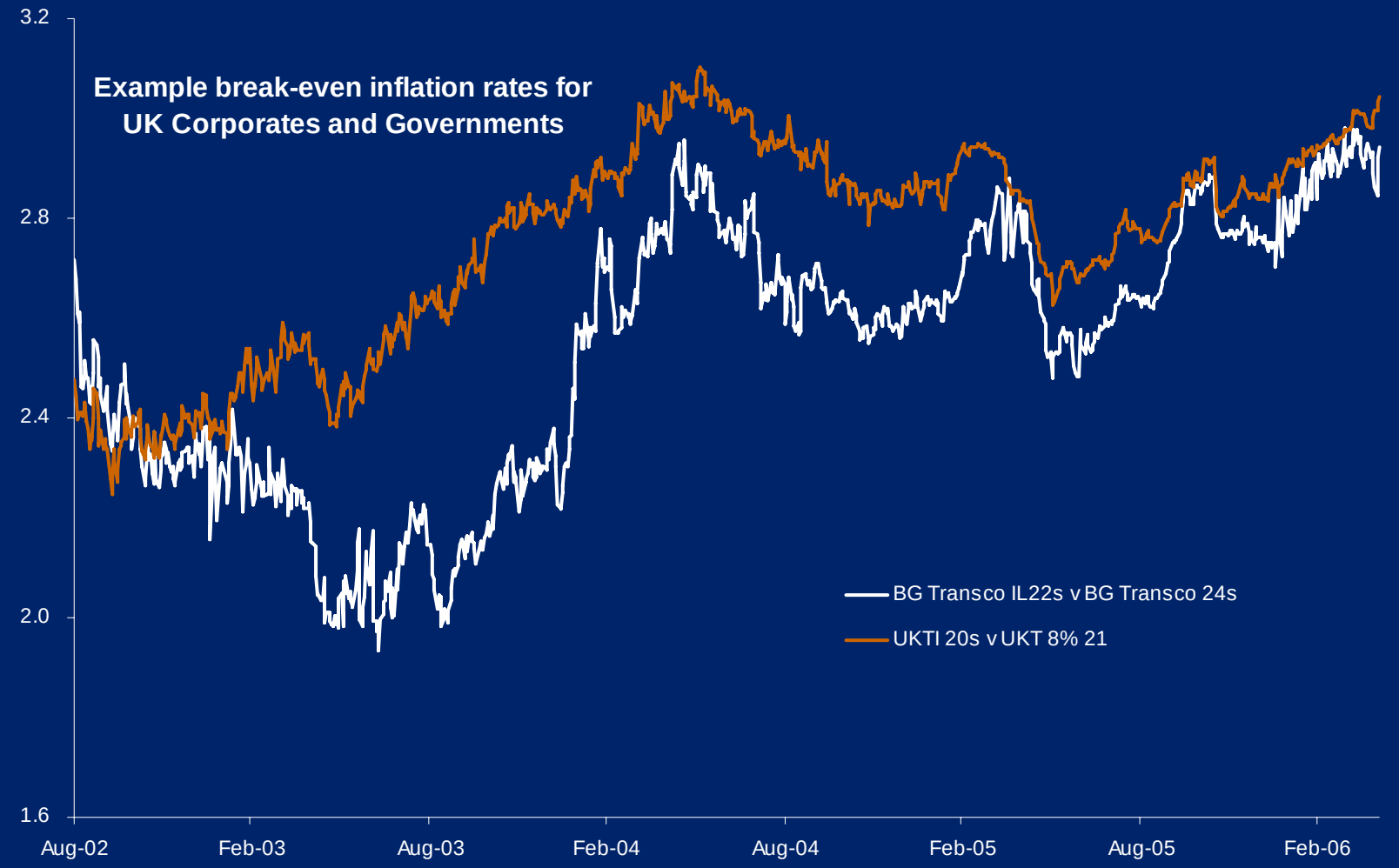
Source: *RBS, Bloomberg*

The chicken and the duck

- There has always been a “chicken and egg” problem in the development of a non-government inflation-linked market
- Investors want credit diversification and liquidity…
- …so the heavy concentration of bonds for project finance and utilities companies, and a “buy and hold market”, create disincentives
- That shouldn’t matter – investors increasingly want to receive inflation via swaps, while borrowers would – in principle – be happy to issue nominal bonds and swap the liability into a real one
- However, an index-linked bond liability is typically accounted for at book cost (like a nominal bond)…
- …but if a nominal bond is turned into a real liability using an inflation swap, the swap might have to be marked to market
- The old premise that “if it looks like a duck, walks like a duck and quacks like a duck, then it is probably a duck” doesn’t necessarily apply
- Companies are still prepared to issue inflation-linked bonds because they want a real liability, …
- …and a “negative basis” market has developed – packaging up and swapping these bonds, perhaps with the credit hedged in the CDS market

The “negative basis” versus nominal financing

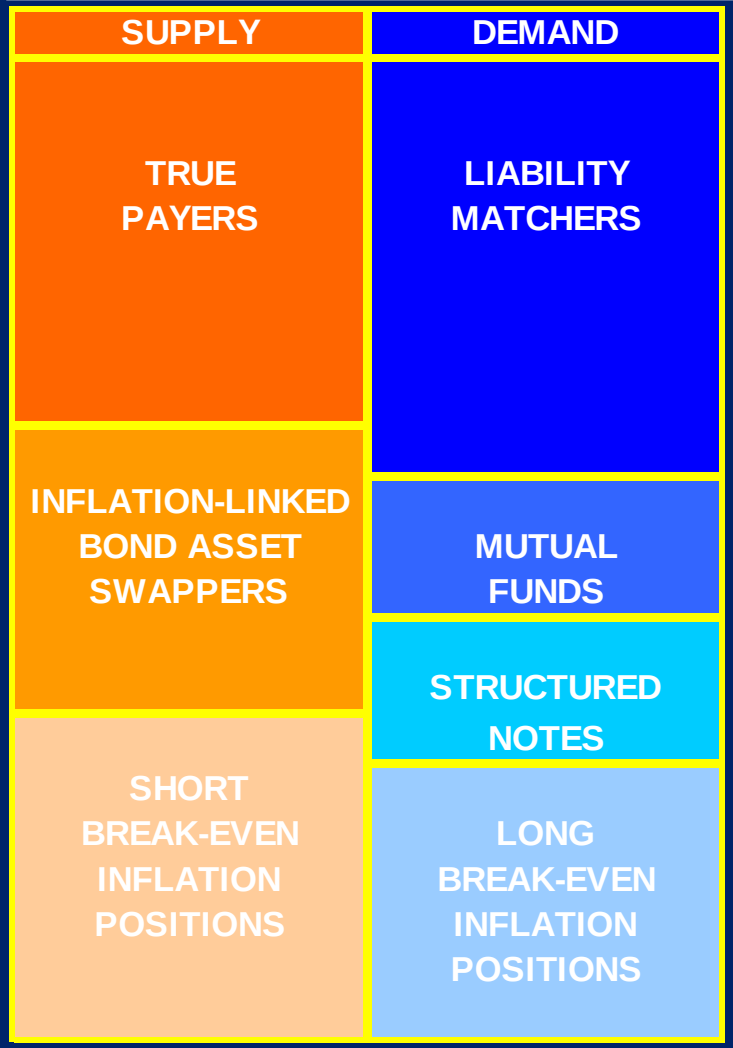
Linker funding’s libor disadvantage compared to nominals is not what it was



Source: *RBS, Bloomberg*

Private supply in the inflation swaps market

The supply and demand composition



Source: ***RBS***

- For the inflation-linked market to grow at its fastest possible pace, there needs to be a mixture of "true" payers and receivers…
- …who have a structural need …
- …and liquidity providers, drawn in by, say, asset swap spread differences between nominal and inflation-linked bonds
- Ideally, the degree of discretion on the and demand sides should not be too different. For instance, …
- … market development would be curbed (and potentially unstable) if all inflation paying was by "asset swappers" holding inflation-linked governments, and all receiving is by ALM "lock-aways" – what if asset swappers want to close their trades?

So where are we now?

- All US TIPS issues trade much cheaper to libor than nominals

  Conclusion: An unbalanced market with an absence of true inflation payers

  Tell-tale sign: most visible inflation derivative prices are TIPS asset swap spreads

- Short-dated euro area linkers trade cheap to libor compared to nominals, the reverse is true at the long end

  Conclusion: heavy demand for receiving inflation via swaps and repackaging it in short-dated structured notes, but little ALM need for long-dated inflation (yet)

  Tell-tale signs: a very flat break-even curve; 233 different Italian non-government inflation-linked “bonds” listed on Bloomberg

- Long-dated UK linkers cheap to libor versus nominals, reverse true at short end (i.e. the opposite situation to the euro area)

  Conclusions: Heavy long end pension fund demand for receiving inflation and a preference to do so via swaps rather than bonds; at the short end, taxed investors have more influence, and index-linked gilts enjoy tax privileges that swaps do not

  Tell-tale signs: a break-even inflation curve that is steeper than elsewhere, even though the nominal curve is more inverted than elsewhere

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