Liquid Insight

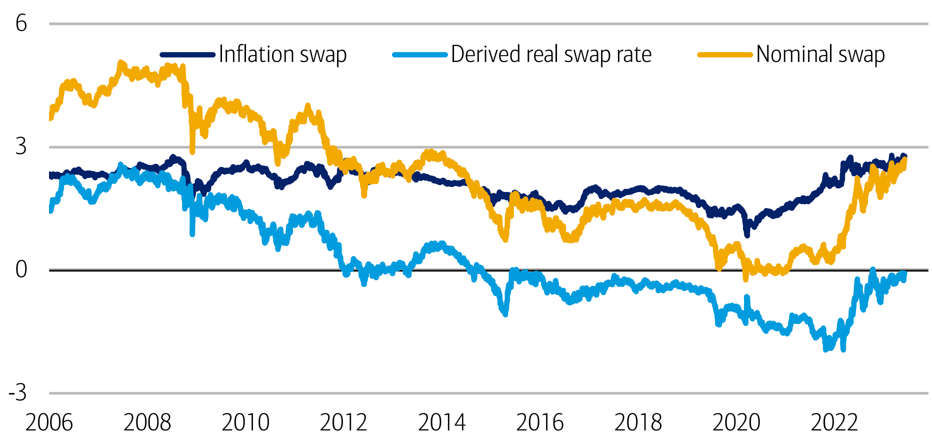
Is inflation an existential threat to the inflation-linked market?

Key takeaways

- The budget cost of inflation-linked has been heavy for issuers, on an accruals basis. The "fiscal hedge" is being questioned.
- But it has worked, especially if the issuer uses ESA standards and properly marks its bond liabilities to market.
- The main inflation risk for borrowers now is the treatment not the condition; the linker market is the wrong place to look.

By Mark Capleton

Chart of the day: 30y Euro inflation, nominal and real swap rates, %
Stubborn long-term inflation is priced, but not the real policy rates to tackle it.



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The bigger elephant in the room

Governments are anxious about how much inflation-linked liabilities are costing them. But the fiscal hedge isn't dead, if you consider debt/GDP ratios, because nominal GDP growth incorporates higher inflation. More importantly, like the rest of the financial world, governments should mark-to-market their liabilities and "take the win". Be happy that linkers were issued at materially lower real yields than would be available today. Duration has eclipsed inflation.

The biggest threat to a government's finances from inflation, if it proves persistent, is not via inflation-linked debt, it's from the cure – the debt servicing costs on its floating rate obligations from tighter real policy rates. This is especially true after central banks have transformed so much of their bond market into bank reserves.

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When theory confronts reality

You save in order to defer consumption, for yourself and for your dependents. So, your prime concern - perhaps your only concern - should be what you'll be able to buy with your savings in the future. An inflation-linked government bond (a bond with its cash flows tied to a price index), maturing at your expected future consumption date, is therefore your risk-free asset. A 3mth Treasury Bill is not, no matter what your textbook might say.

There are qualifiers and complications, of course: you might have nominal obligations to meet (e.g., a mortgage), you don't know precisely when you'll want to consume your savings, and there is 'personal basis risk' – your consumption basket will differ from that of the linking index. But these do not undermine the broad premise.

Important, if secondary, benefits of "linkers" for the investor include their unique behavioural characteristics (making them a diversifying asset), and the opportunity to express views about future inflation and real policy rates explicitly, rather than by proxy with other instruments.

That's all great for the investor, but what about the borrower? The main argument for a government issuing inflation-linked debt is the fiscal hedge: a government's assets – land and buildings – are real, and its revenues – income, consumption and corporate tax – are real (not precisely, but more real than nominal). So its liabilities should be real.

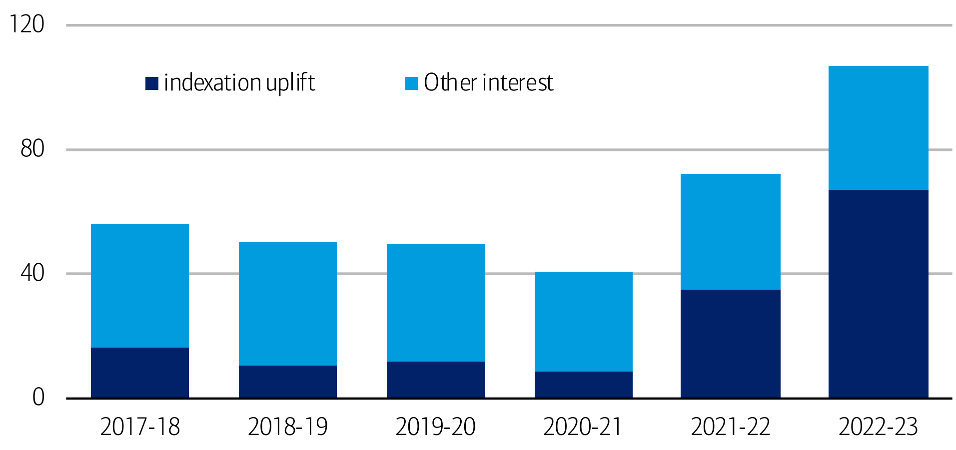
There are potential secondary benefits for the borrower. If you issue different instruments to suit different buyers, this should lower overall debt servicing costs, and you might be able to save a so-called "risk premium". If investors are willing to pay extra for real value certainty, then inflation-linked debt is a lower expected cost liability than nominal debt. And there might be a "credibility feedback" benefit, by reducing issuers' ability to inflate away their liabilities, giving them skin in the game to keep inflation low.

The live reading of inflation expectations that inflation-linked instruments "gift" to central banks and market participants is seen as a positive externality. But it might be more than that. To the extent that it illuminates why nominal bond yields are where they are, this greater understanding might enhance market stability and thereby lower (nominal) bond yields.

That all sounds amazing (or at least it should) – something that extinguishes risk for both borrower and investor.

But then this happened...

Exhibit 1: UK government debt interest bill per fiscal year, separating out indexation costs, £bn
Under ESA 2010, indexation uplift charged to interest as it occurs in the national accounts.



Source: ONS, BofA Global Research

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The witness for the prosecution

Exhibit 1 Shows the contribution to the UK's debt interest costs from the indexation uplift of its inflation-linked bond liabilities. We've used the UK as an example because it is the most dramatic: the UK has the largest inflation-linked share of the national debt among the major developed issuers (with the longest duration) and has had perhaps the most uncomfortable mix of very high inflation and weak growth recently.

The picture is disturbing. In the 2022-23 fiscal year that finished in March, the indexation uplift charge to interest was £67 billion, and this doesn't even include the actual coupons paid on the linkers (which are part of the "other interest" component in the chart). The debt servicing costs of the UK's linker liability, which represents about a quarter of the national debt, made up about two thirds of the total interest bill, equivalent to about 3% of GDP.

This brings us onto the case against inflation-linked liabilities. As with the arguments in favour, there are arguments against that have long been understood, but the main one seems worth reiterating now: there are times when inflation-linked liabilities are a poor fiscal hedge. The example that has been commonly used over time is that of an oil price shock that simultaneously lifts inflation but cuts growth, but now we have the experiences of a pandemic and war in Ukraine that appear to consider.

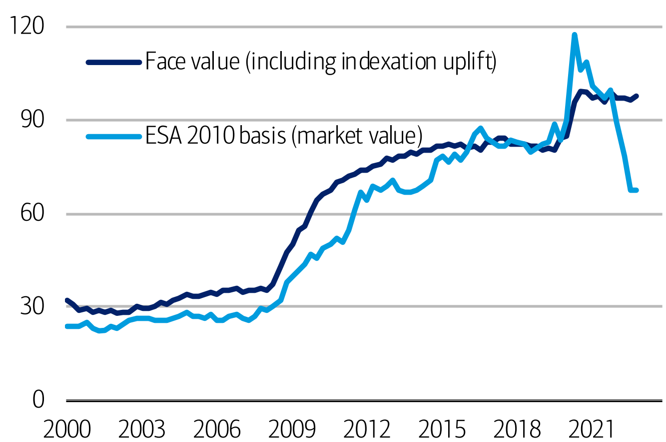
Other concerns expressed about inflation-linked liabilities include: the fact that governments have a lot of other real liabilities already (e.g. pensions); the possibility that the indexation of debts, contracts, wages, etc., might normalise inflation; and the risk that fragmentation of issuance might "cannibalize" the debt market, reducing issue size and thereby the liquidity in nominals. Perhaps the most practical concern is that issuers might not get value for money due to lack of demand, illiquidity, or product complexity.

For the sake of completeness, we would nervously add the possibility that governments might want to issue only nominal debt in order to retain the option to erode the value of their debts with inflation.

Thinking differently about debt/GDP ratios

The accruals accounting impact of the recent high inflation indexation on budget deficits, although ugly, doesn't undermine the fiscal hedge argument.

Exhibit 2: UK debt/GDP ratio shown two ways, %
Moving sideways in notional terms, collapsing in market value terms.



Source: BofA Global Research, ONS, Refinitiv

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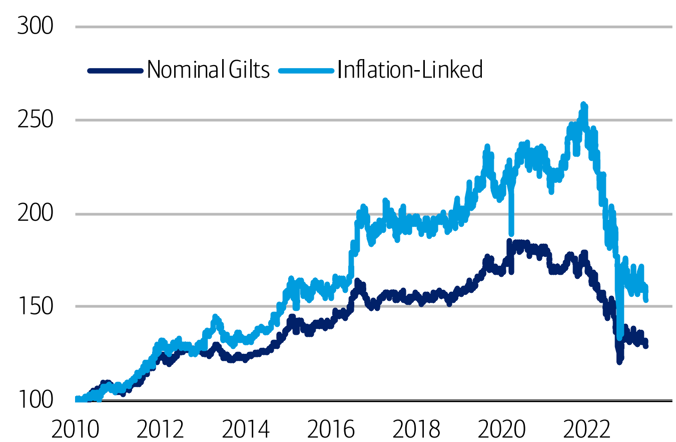
Exhibit 3: Nominal and index-linked Gilt total return indices, rebased
Despite high inflation, UK linkers have done badly for the investor.



Source: BofA Global Research, Refinitiv

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Inflation linked liabilities of governments have been uplifted a lot, but so has nominal GDP. While it is true that GDP deflators have lagged linking indices a little, differences haven't been material. When it comes to debt/GDP ratios everywhere, the numerators have gone up and so have the denominators – this is the fiscal hedge in action.

But there is a bigger issue in play here. Despite the fact that the financial world has come to accept that assets and liabilities should be marked to market, when it comes to government indebtedness and debt to GDP ratios, the reporting convention and the way we all think about them is in terms of notional amounts, or original "face" values (uplifted by index ratios in the case of linkers).

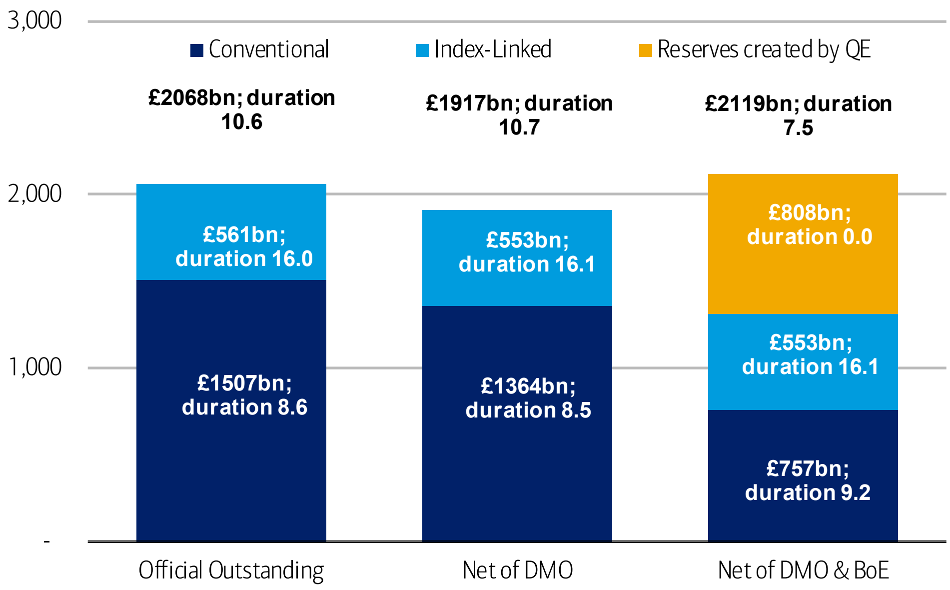
There is any number of simple ways to demonstrate that this is wrong. For instance, consider two (nominal) French 2y issues. France has a 1% OAT maturing in November 2025 (an old 10y) and a 6% OAT maturing a month earlier (an old 30y). They obviously have very different prices because the latter is far more valuable to the investor. It is also, thereby, a far more onerous obligation for the borrower, and should be valued accordingly. The way to do this is to mark-to-market public debt obligations. Indeed, that is what the European System of Accounts (ESA) tells us to do.

This changes the perspective dramatically, as Exhibit 2 shows for the case of the UK. It goes from: "haven't our inflation-linked liabilities been costly?", to: "didn't we do well to issue so many linkers at very negative real yields, over such a long period, now that they are positive?". As ever, the situation for the UK is even more extreme than for others. Exhibit 3 shows how the UK linker market has underperformed nominals dramatically through this high inflation episode, because of the former's much higher average duration. Duration eclipsed indexation for investors (and also for borrowers, if a mark-to-market premise is accepted). Borrowers should fret less about past indexation costs on linker liabilities and "take the win".

Bigger threat to borrowers from inflation is the treatment, not the condition

Our Chart of the Day shows what we would regard as a "macro inconsistency" in the Eurozone. 30y inflation swap rates, at 2.78%, are higher than those prevailing in the years preceding the global financial crisis (GFC). But 30y nominal rates are much lower, so 30y real swap rates are still negative, when they traded in the region of 2% pre-GFC. Yes, there are "special factors", but the market is pricing inflation persistence, and not the monetary policy tightness that would have been deployed in the past to tackle it.

Exhibit 4: UK national debt shown three ways (market values, TBills and NS&I excluded, £bn)
More than a third now represented by reserves paying Bank rate.



Source: BofA Global Research, DMO, BoE, Bloomberg

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Markets had forgotten that floating rate liabilities, like TBills, are loosely inflation-linked, after years at the lower bound. Policy rates go up and down with inflation. Central banks have converted fixed rate obligations of the state into reserves paying the policy rate (or something close to it). You don't have to believe that we will see a return to the eye-watering real policy rates of the Volcker era to accept that the greater threat to debt servicing costs from inflation (if it proves stubborn) will not be the inflation itself but the likely policy response.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- At some point we have to land, **Global FX Weekly**, 02 June 2023
- Hop, skip & a supply jump **Global Rates Weekly**, 02 June 2023
- China pessimism & US debt limit hopes and fears, **Liquid Cross Border Flows**, 22 May 2023

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Global FX Weekly: At some point we have to land 02 June 2023

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