

# Market Commentary

# NZFUNDS

## INFLATION-LINKED BONDS SET TO SOAR AFTER TREASURY RAISES INFLATIONARY FORECASTS

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Transpower's recently issued inflation-linked bonds are set to return in excess of 10% pa as a result of the upcoming hike in goods and services tax, protecting investors from the rising inflationary environment.

Inflation-linked bonds tend to have relatively low interest rates but this is compensated by their capital value being linked to rises in the Consumer Price Index.

Transpower, the state-owned enterprise behind New Zealand's electricity grid, issued at least NZ\$75 million of inflation-linked bonds in March. The bonds, which pay interest at 4.1% and mature in 2020, compensate investors for rises in the Consumer Price Index (CPI). The Treasury is forecasting the CPI to jump 5.9% for the year ending March 2011.

"If you combine the bonds' running yield of 4.1% pa with inflation projections for the first year of the bond of around 5.9% pa you are looking at double-digit returns," said Michael Lang, Chief Investment Officer at New Zealand Funds Management.

Lang has been an advocate of inflation-linked bonds since July 2009 when he urged Treasury to consider renewing its 2016 issue of New Zealand's only inflation-linked government bond. New Zealand Government inflation-linked bonds were last issued in 1999. In the Budget last week, Treasury announced it was considering issuing a new inflation-linked bond.

Lang says in New Zealand's low interest rate environment, some investors have chosen to invest in lower quality bonds such as subordinated notes or perpetual bonds which offer higher rates of interest. But in doing so, Lang believes they risk a permanent loss of capital.

"High yielding bond default rates are still unacceptably high, but New Zealanders continue to support lower quality bond issues. This is a decision I believe they will rue".

In contrast, Government or quasi-government bonds can offer superior returns with significantly less risk. We are consistently finding overlooked corners of the market including inflation linked bonds which offer our investors superior risk-adjusted returns, rather than the heavily promoted bond issues of late."

Over the past 12 months, New Zealand Funds Management has been accumulating stakes in both the recently issued Transpower bond and New Zealand Government inflation-linked bonds with a view to profiting should inflation rates rise.

"This strategy now looks set to pay off with rising inflation rates set to boost returns of inflation linked bonds."

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