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Investors Switching to Inflation Protected Assets

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US investors are rushing to buy inflation protected securities as fears grow that the Government's efforts to prevent a prolonged global recession will instead spark inflation when the global economy recovers, says NZ Funds.

Michael Lang, Chief Investment Officer at NZ Funds says since the advent of the global financial crisis in September 2007, New Zealanders have been at more risk of experiencing deflation as investment markets and house prices have declined in value. "As a result investors have shied away from investing in assets which grow with inflation and have preferred the safe haven provided by bank deposits, government bonds and corporate bonds. Yet if US investors are worried about inflation, it should also be a concern for New Zealand investors."

Rising inflation erodes the value of returns on fixed rate securities such as bank deposits, Government bonds and corporate bonds. Lang says a recent study published in the [Bank of Canada Review](#), 2009 (vol. 2009, issue Spring, pages 45-52) showed the main winners of unexpected inflation were young, middle-income households who are holders of fixed-rate mortgage debt. Inflation effectively reduces the real burden of their debt. The losers are high-income households with no debt and investors who in provisioning for retirement hold long-term fixed rate bonds or pension investments whose payouts are not linked to inflation.

Last week the US Federal Reserve made their six weekly decision on their equivalent of the Official Cash Rate – the Federal Funds Rate. As expected they kept the Federal Funds rate unchanged at between 0% and 0.25% and stated that 'economic conditions are likely to warrant exceptionally low levels of the Federal Funds Rate for some time'. Lang says the interesting part is that they adjusted their commentary on the likely outlook for inflation. "In April they stated that 'inflation could persist for a time below rates that best foster economic growth and price stability longer term' – clearly highlighting the risk of deflation when prices actually fall rather than rise. In their latest statement however they just state that 'inflation will remain subdued for some time'".

In changing their commentary the Federal Reserve no longer appears concerned about the threat of

deflation. But should they be more concerned about the threat of inflation? Lang believes so. “Over the last few months we have seen a remarkable increase in the inflationary expectations of US investors. The US Federal Reserve has been printing money to restore the financial system and there is a risk that the side effect of this medicine is inflation.”

Inflation protected assets include Treasury inflation protected bonds (TIPS), commodities, property and equities, says Lang. “In each case, it is very important to pick the right investment. Over time equities remain a good way to generate inflation beating returns, but the key is to pick the right stocks. Companies with pricing power and low debt levels can pass on rising costs to consumers so their earnings are likely to grow at the same pace as inflation over time. Companies that typically do well in an inflationary environment are those that are linked to commodities. Property investments that are funded with a mortgage tend to offer better inflation beating returns than those funded with cash, but it is also very important to select the right property investment.”

At the beginning of this year, 10 year US Treasury inflation protected bonds (TIPS) were trading at the same yield as 10 year nominal bonds. Lang says this implied that investors believed inflation would average zero percent over the next 10 years. “Recently this implied yield has risen to 2% as US investors have shied away from nominal bonds and purchased inflation protected bonds instead.”

Unlike the more commonly issued nominal bonds, which pay a fixed coupon till maturity, TIPS are designed to compensate investors for inflation by paying an increased coupon inline with inflation rates. In addition at maturity instead of receiving back only the original principal, the investor receives the principal adjusted for the change in the consumer price index. The yield investors receive on TIPS is therefore lower than on nominal bonds as this yield is a real yield which is an inflation adjusted yield.

Lang who oversees approximately \$1 billion in assets at NZ Funds, has seen a sharp increase in interest for NZ Funds inflation protected portfolio strategy. “A couple of years ago we began developing an investment strategy designed specifically to protect investors’ purchasing power from the impact of a prolonged period of higher inflation. It’s been hard to find the right assets as the New Zealand Government last issued an inflation linked bond in 1999. However recently we have been able to access a number of international inflation linked bonds such as those issued by the US Treasury and the United Kingdom at attractive prices and we’re now seeing renewed interest in the strategy as part of diversified financial plan”.

On 25 June the yield on the US 10-year note closed UP 0.03% at 3.7%, while US 10-year TIPS last traded at 1.88% flat on the day. The New Zealand Dec 2017 year issued government bond traded at 6.05% up 0.05%, while the New Zealand 2016 year TIPS was unchanged at 3.36%.

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