

KING & SHAXSON

International Inflation Bond Research

10 August 2010

The jury is still out as to whether the markets are going to experience a deflationary spiral or an inflationary bubble. There is no doubt that we have been going through some nervous times of late, and the deflationists have been extremely vocal, particularly with the continuing worries over the sustainability of the global recovery. We nailed our colours to the mast some time ago. We have always maintained that in time, QE would provoke more general asset price inflation. As we can see from the breakeven levels below, inflation expectations are higher in the UK than most other world markets.

Using 7-10 year BEIRs:

Eurozone : 1.59% (see attached graph)

US : 1.72%

UK : 2.50%

This shows that UK index linked gilts are pricing in a higher level of inflation than most of the developed world. The market is clearly telling us that the UK faces the greatest inflation threat. We have considered at length that due to the fear of the double dip, the UK authorities will keep their foot on the throttle longer than is probably necessary. Relative to the size of the UK economy, the Bank of England must be one of the most committed central banks to QE. The likelihood of them getting behind the curve is high. In fact, this might well be their intention. No central bank could fail to manufacture inflation if it really wanted to.

The problems of massive public debt, precarious bank balance sheets, an overstretched consumer and unemployment have not gone away. Despite this, UK inflation remains stubbornly high. In part, this is probably due to sterling's slight depreciation over the last year. Also, as the government tries to grapple with rebuilding the public finances, there has been an increase in indirect taxes and duties. If it weren't for these, headline inflation might be a lot lower and probably more in-line with the US and eurozone. With concerns rising over the failure of the BoE to foresee recent rises in inflation (today's FT), we reiterate that we strongly recommend buying UK breakevens.

French Index Linked Breakeven



Source: Bloomberg

	UK		US		FR		FRei	IT		SWE		CAN	AUS	NZ
	10Y	30Y	10Y	30Y	10Y	30Y	10Y	10Y	30Y	5Y	30Y	30Y	5Y	7Y
IL BOND	2.5%20	2%35	2.125%19	3.375%32	1.0%17	3.15%32	1.6%15	2.1%17	2.35%35	3.5%15	3.5%28	3%36	4%15	4.5%16
REAL YIELD	0.88	0.89	0.84	1.74	0.60	1.27	0.45	1.69	2.26	0.77	1.32	1.46	2.34	2.35
RPI/CPI	5.00	5.00	1.10	1.10	1.40	1.40	1.30	1.30	1.30	0.90	0.90	1.40	2.90	1.80
TOTAL RETURN	5.88	5.89	1.94	2.84	2.00	2.67	1.75	2.99	3.56	1.67	2.22	2.86	5.24	4.15
12MTH HEDGE			0.20	0.20	0.09	0.09	0.09	0.09	0.09	-0.41	-0.41	-0.54	-4.46	-3.27
TOT.RET. £	5.88	5.89	2.14	3.04	2.09	2.76	1.84	3.08	3.65	1.26	1.81	2.32	0.78	0.88
CONV BOND	4T20	4.25%36	2.75%19	5.375%31	3.75%17	5.75%32	5%16	5.25%17	5%34	3.75%17		5%37	6.25%15	6%17
YIELD	3.38	4.23	2.56	3.80	2.19	3.40	2.07	3.11	4.68	2.33		3.68	4.81	5.11
SIMPLE BEIR	2.50	3.33	1.72	2.06	1.59	2.13	1.62	1.42	2.43	1.55		2.22	2.47	2.76

Note : All yields have been annualised.

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