



# The global inflation-linked markets

## Supply-demand imbalances

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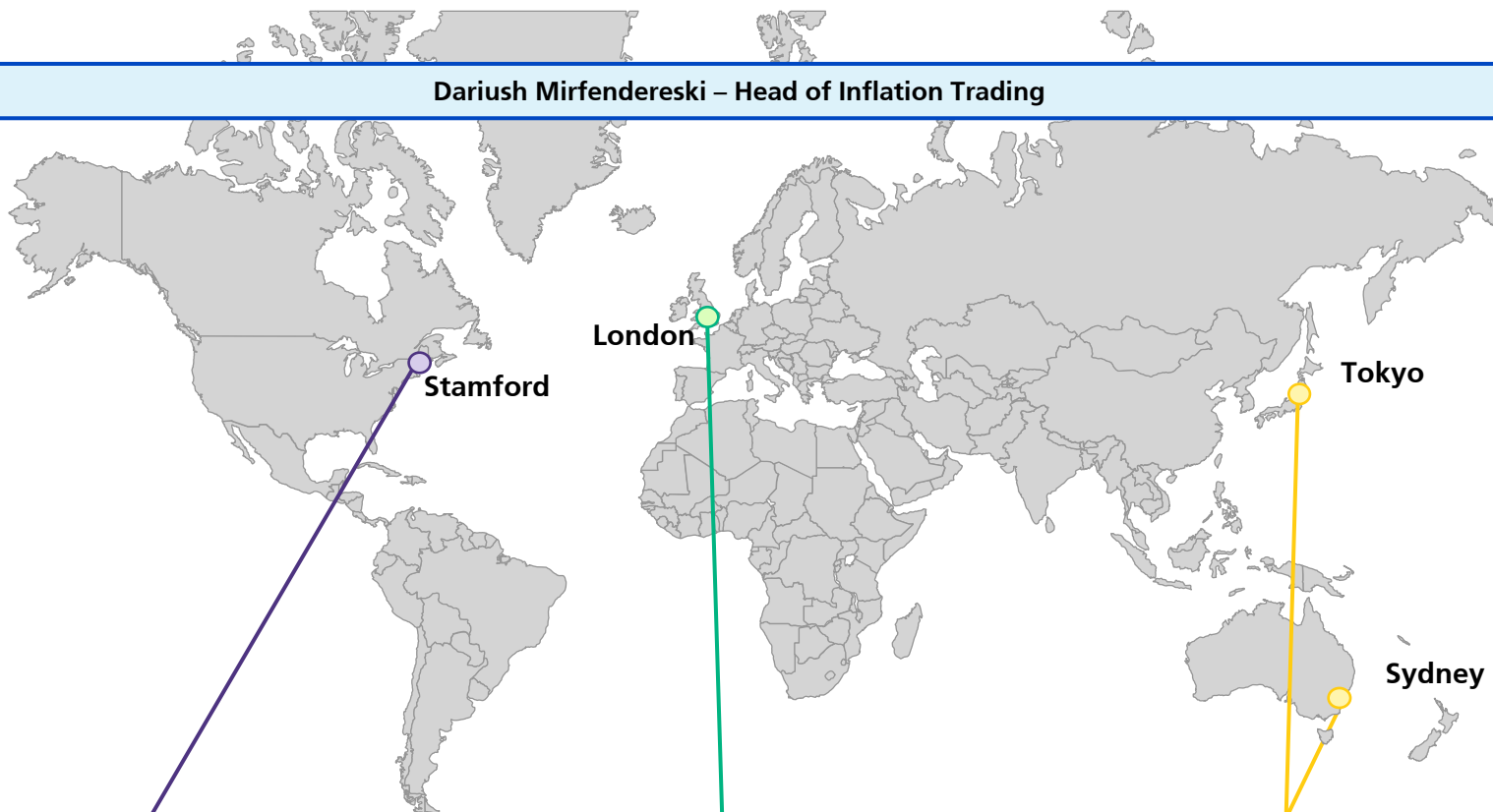
SECTION 1

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## UBS's inflation trading team and inflation linked bond credentials

# UBS Global Inflation Trading Desk

**Dariusz Mirfendereski – Head of Inflation Trading**



## **Stamford Inflation Trading Desk**

Joseph Simpson, Executive Director

## **London Inflation Trading Desk**

Dariusz Mirfendereski, Managing Director  
Antonio Giampaolo, Executive Director  
Mark Button, Executive Director  
Adam Pasztor, Associate Director  
John Baker, Associate Director  
Pierre Lalanne, Associate Director

## **Tokyo Inflation Trading Desk**

Takahiro Tajima, Executive Director

## **Sydney Inflation Trading Desk**

Andrew Barnet, Executive Director

# UBS's credentials—sovereign inflation-linked mandates (2005 to date)



**United Kingdom**

£1.25bn 1.25% IL due 2055  
September 2005



**United Kingdom**

£5bn 0.50% IL due 2050  
September 2009



**United Kingdom**

£3.5bn 0.625% IL due 2040  
January 2010



**Republic of Italy**

€5bn 0.95% IL due 2010  
January 2005



**Republic of Italy**

€4bn 2.1% IL due 2017  
June 2006



**Republic of Italy**

€4bn 2.35% IL due 2019  
May 2008



*Liberté • Égalité • Fraternité*  
RÉPUBLIQUE FRANÇAISE

**Republic of France**

€4bn 1.8% IL due 2040  
March 2007



**Australian Gov't (AOFM)**

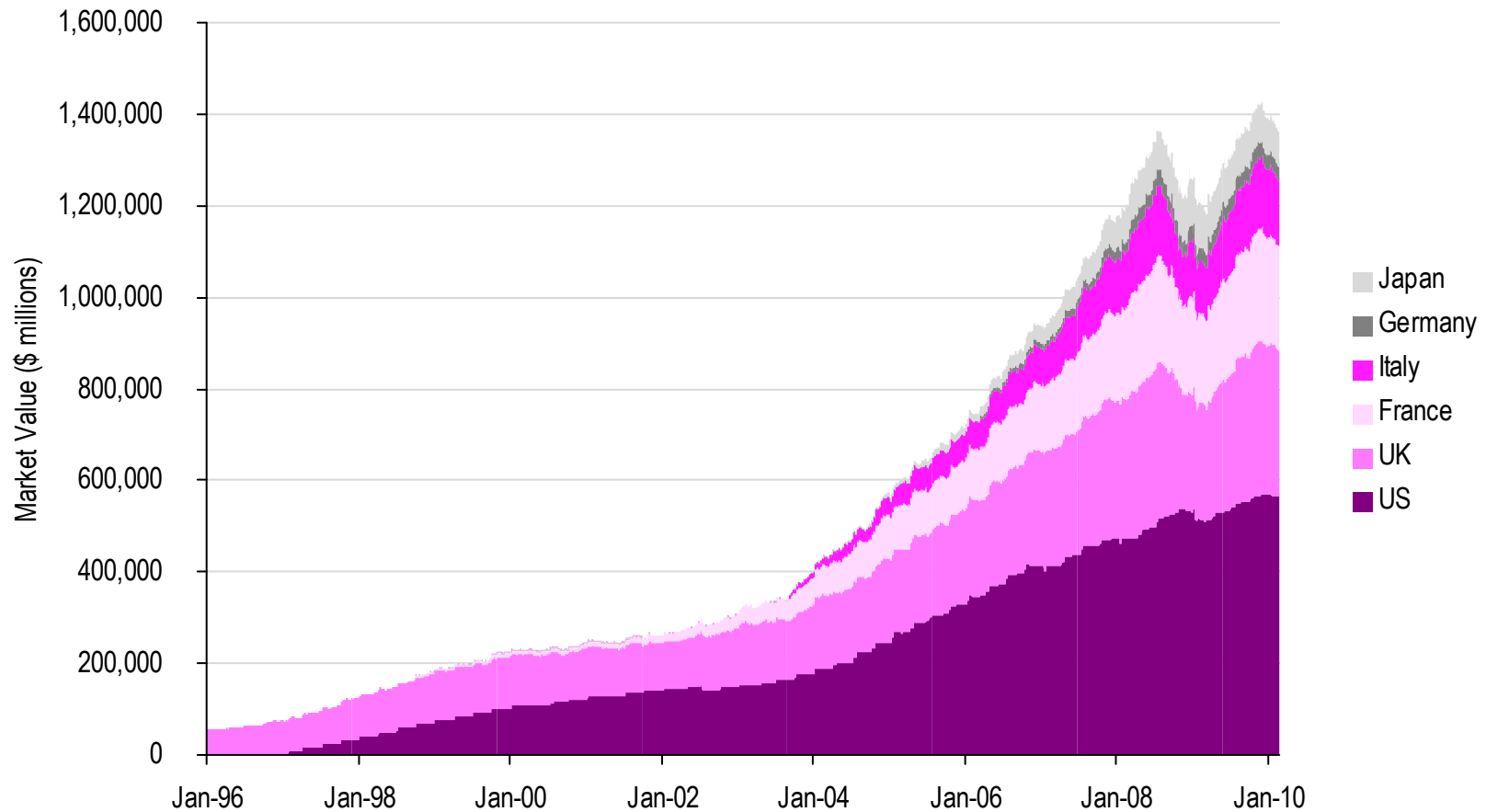
AUD 4bn 3% IL due 2025  
September 2009

SECTION 2

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## The major global inflation markets

# Historical market capitalization of global linkers: A \$1.4 trillion market

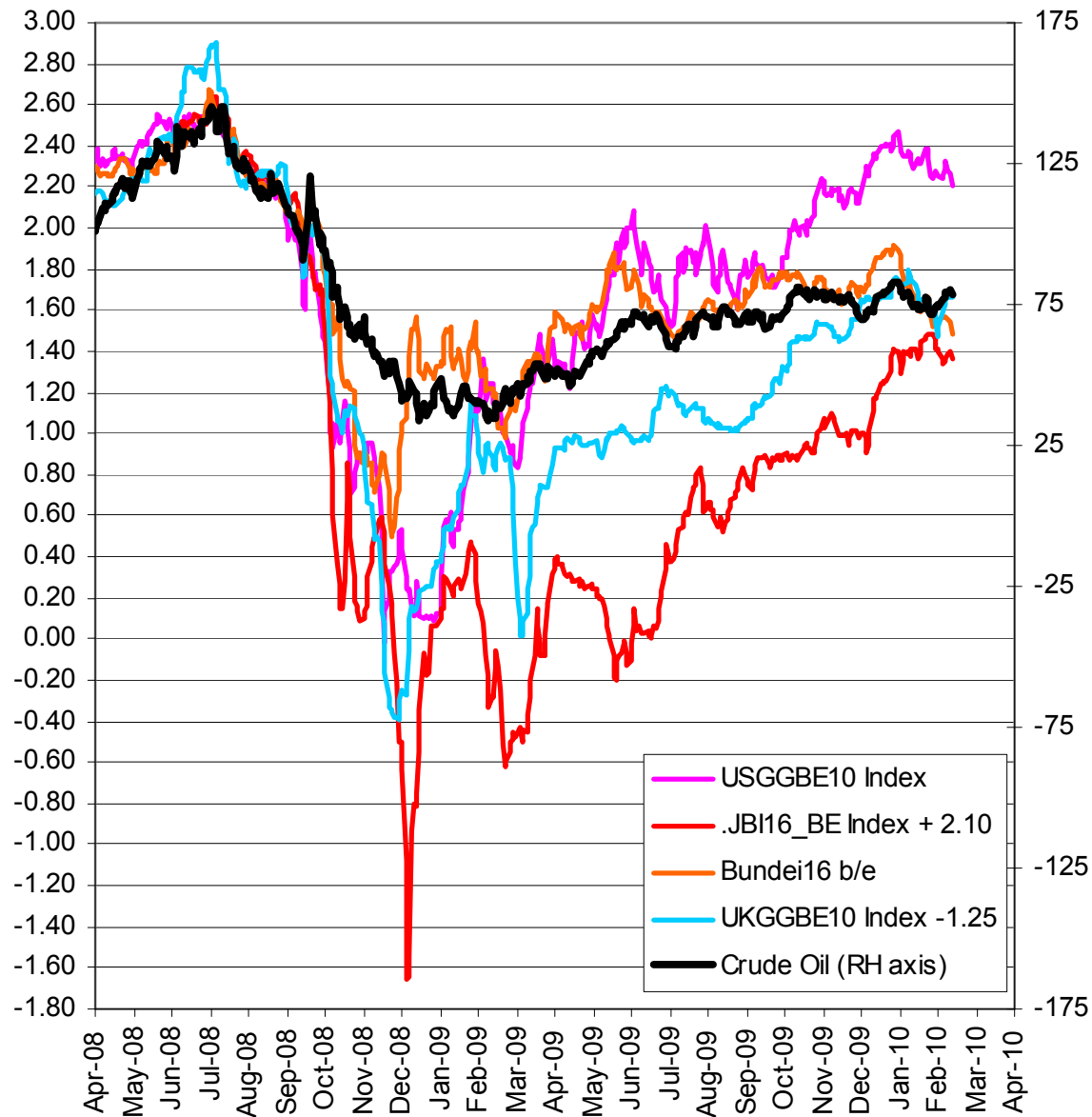


## SECTION 3

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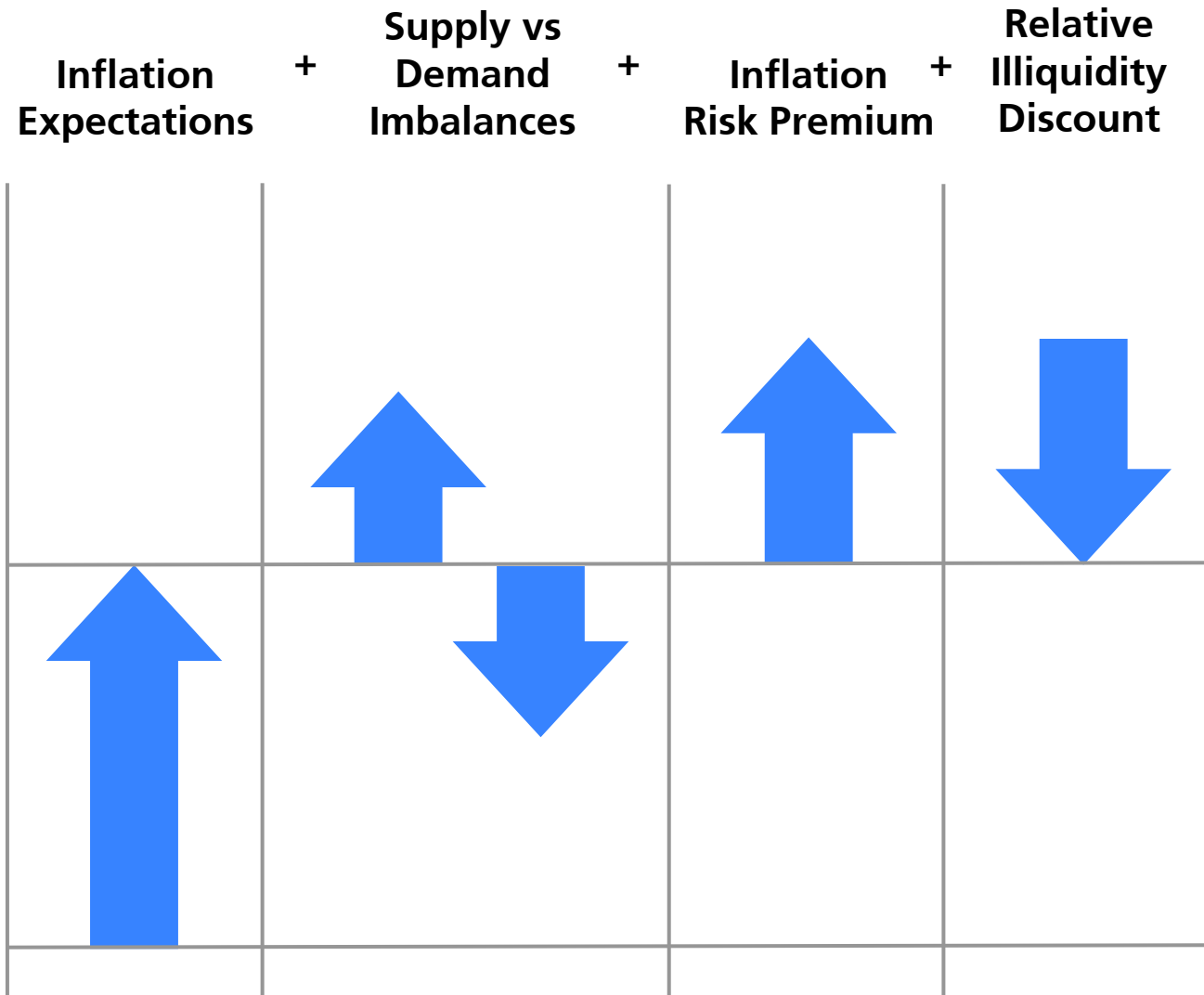
# A few snapshots of the global inflation markets

# 10y Global Breakevens and Crude Oil Prices: Apr-08 to Feb-10

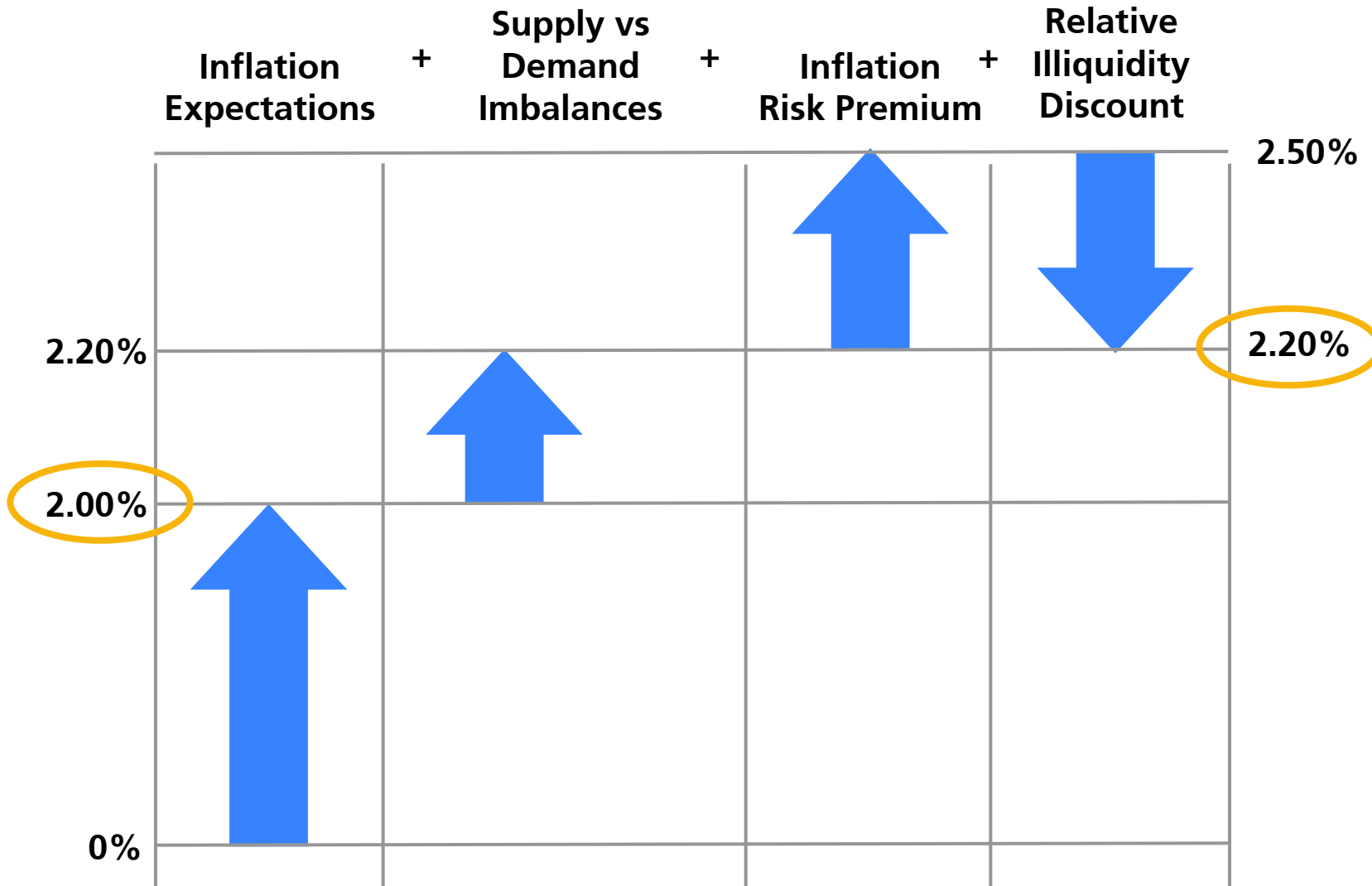


# Inflation breakevens: what is it made up of?

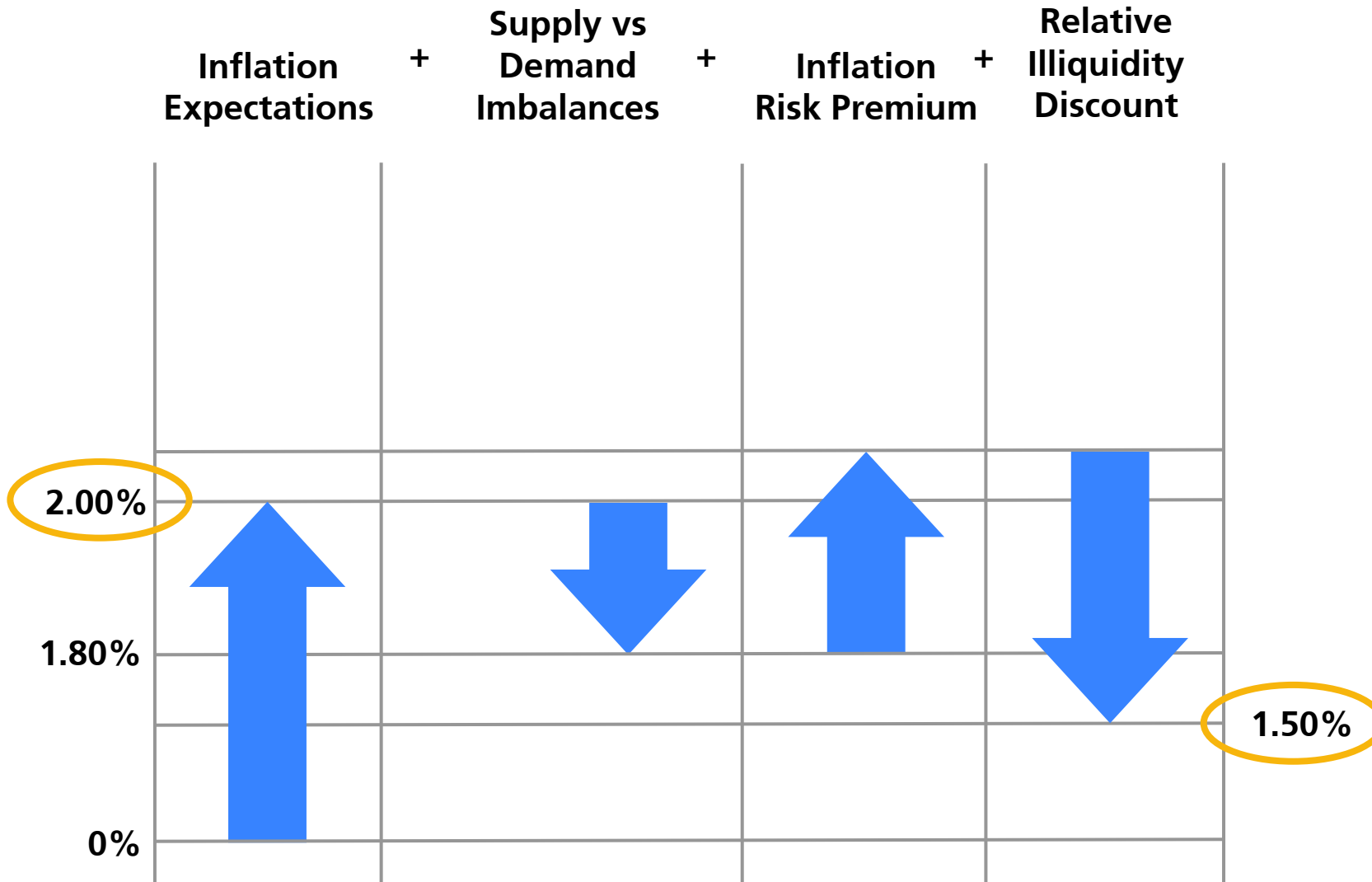
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# Inflation breakevens: typical market example

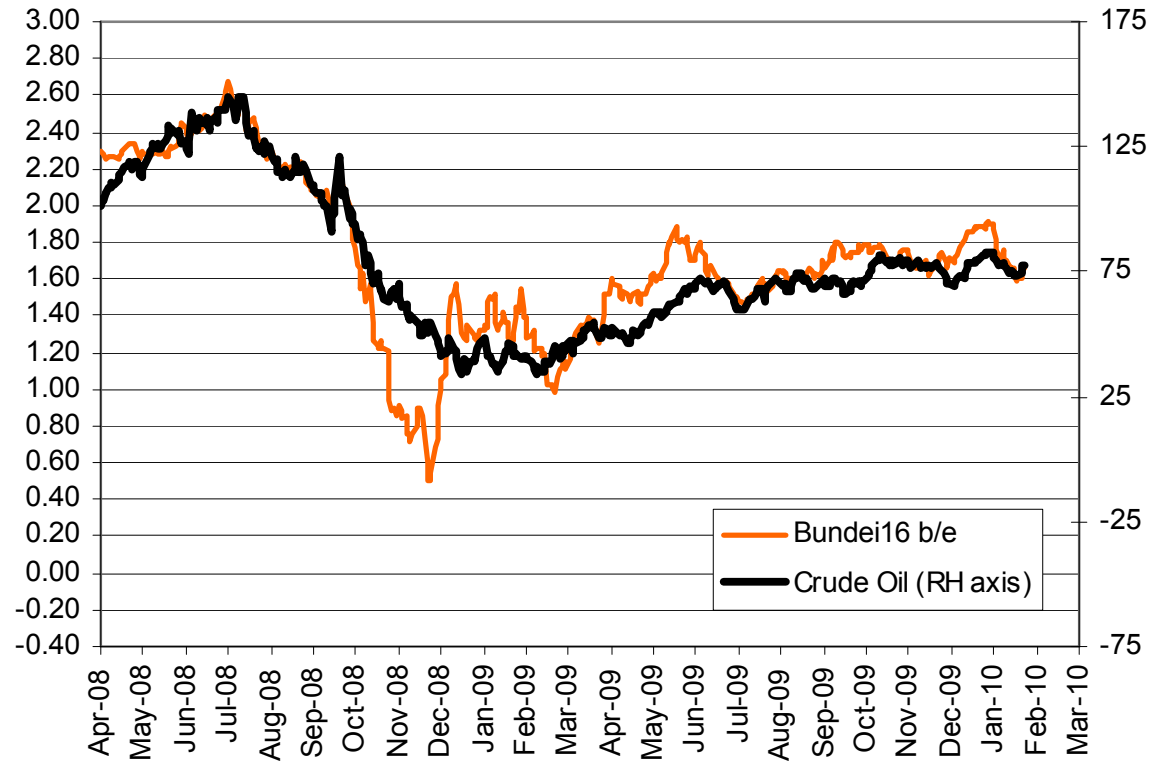


# Inflation breakevens: unusual, but not unrealistic, market example



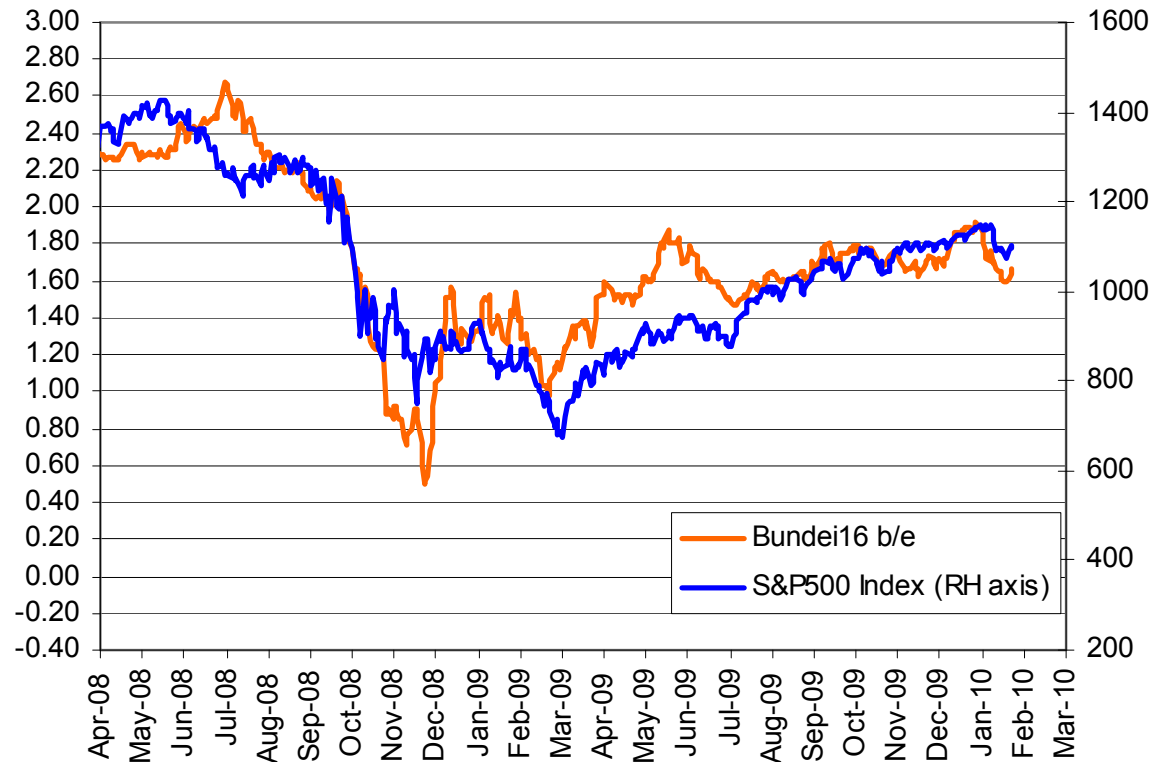
# Breakevens vs crude oil

## DBRi16 breakevens and crude oil prices



# Breakevens vs. equity markets

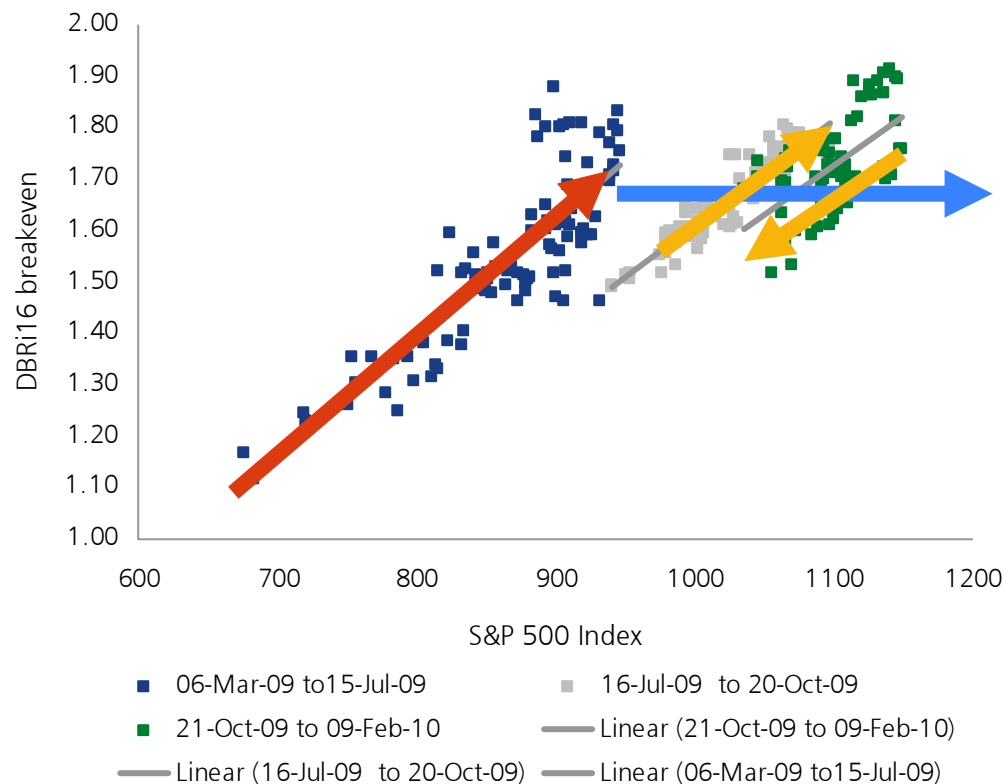
## DBRi16 breakevens and equity prices



... but is this really how things should continue?

# Breakevens vs. equity markets: return to normality

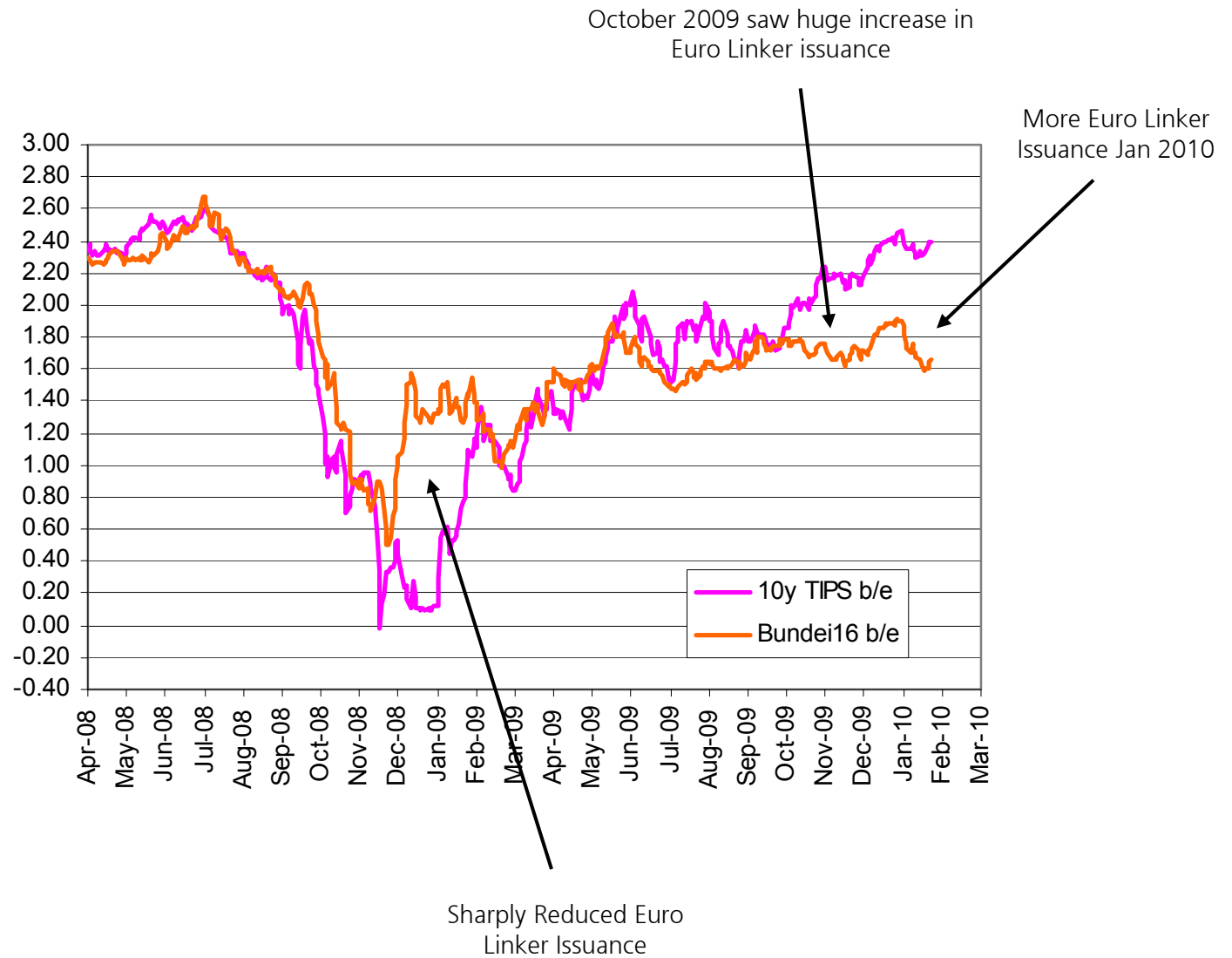
## DBRi16 breakevens and equity prices



- ◆ There is a high correlation between breakevens and equity prices from the start of the equity market rally in March 2009 until mid July 2009
- ◆ During this period, breakevens recovered to reach levels that we have largely maintained (i.e. 1.80 to 2.00 range)
- ◆ As equity market indices should be a long-term up-trending quantity and breakevens should be mean reverting,
  - Disruption of the correlated trend is a positive signal for the inflation market, i.e. indicating a certain return to normality post Q4 2008
- ◆ The inflation markets continue to be wary of weakness in equities and correlate well with downturns in the equity markets, as well as bounces following drops as indicated by the two periods shown in the graph for Q3 and Q4 2009 and into 2010

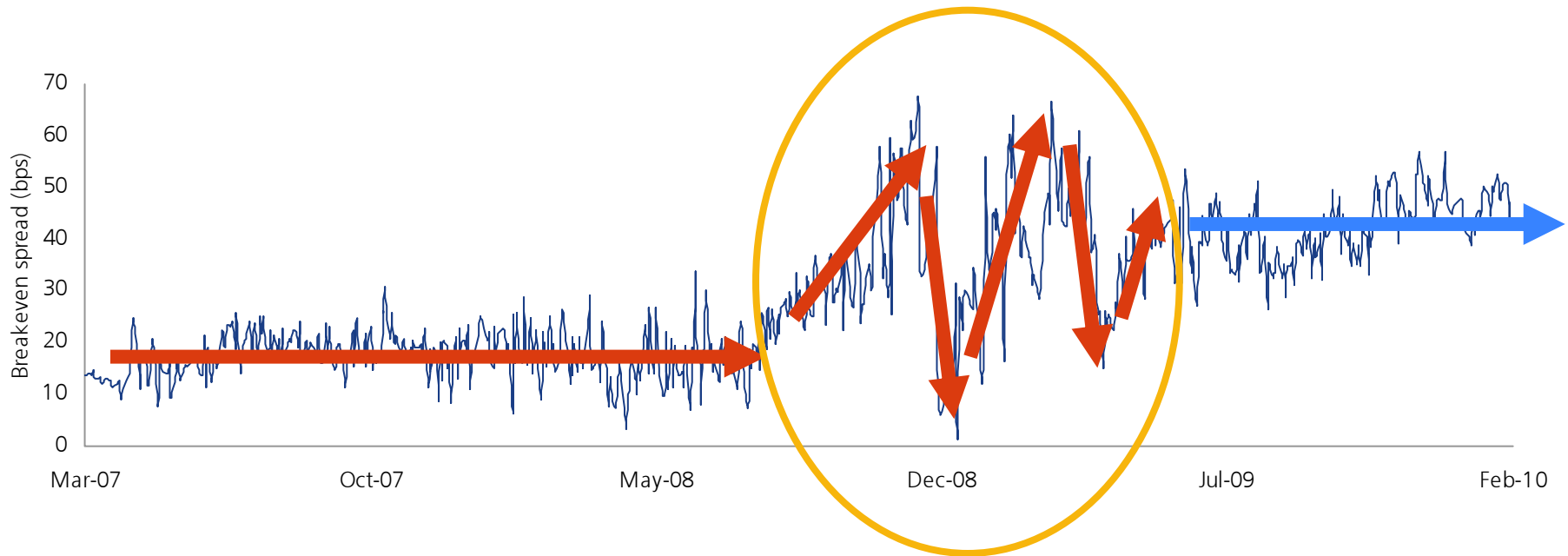
# Breakevens: cross-market comparison

## DBRi16 and TIPS 10-year breakevens



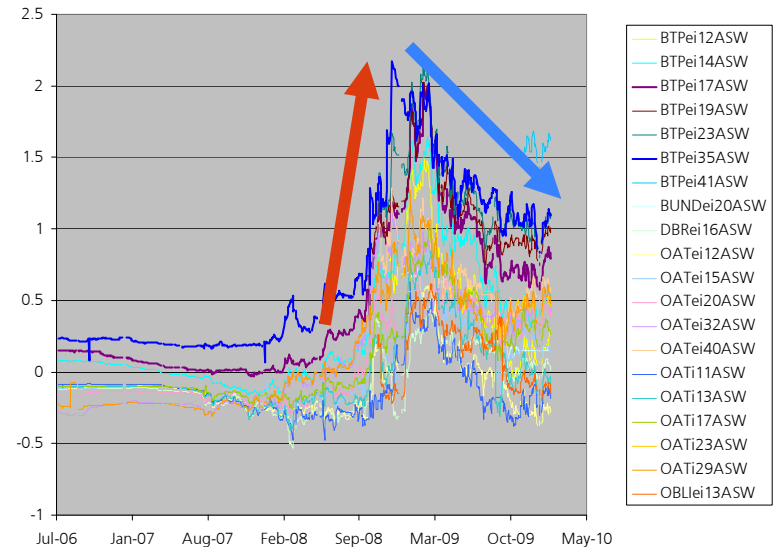
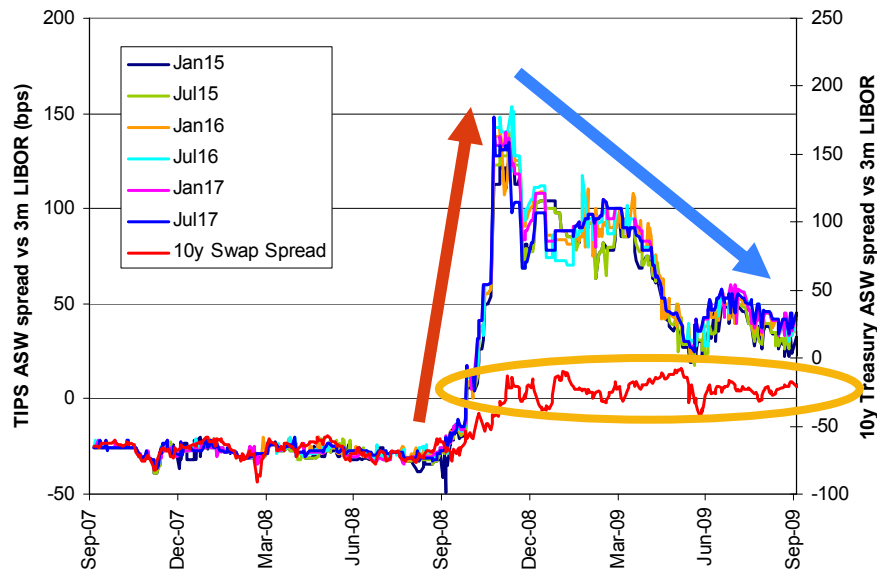
# Breakevens: 10y vs 30y

## French 10-year – 30-year breakeven spread analysis



- ◆ French 10-year – 30-year breakeven spreads were stable at or just below +20 basis points until September 2008
  - We have used France as an example here in the absence of a German 30-year inflation-linked issue
- ◆ Post Lehman, short-end underperformance due to low inflation and / or deflation concerns widened this spread
- ◆ The spread remained volatile and started to contract as equity markets, oil and 10-year breakevens started to recover strongly from March 2009
- ◆ The 10-year – 30-year breakeven spreads have stabilised in the +40 to +50 basis points range for the French ei curve, much wider than the pre-Lehman period as the market is more correctly pricing in inflation risk premiums for long maturity inflation-linked bonds
- ◆ **For issuers, one of the attractions of linker issuance is the savings made from not paying the inflation risk premium**
- ◆ **This makes long-dated euro inflation linked issuance very attractive on a relative value basis**

# Global linker asset swap history—a glimpse into derivatives:



**Inflation bond market illiquidity & inflation swap supply constraints were the problem ...**

**... inflation swap supply/demand issues continue**

## Prospects for 2010 ... part I

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- ◆ **We should continue seeing correlation of 10y breakevens with global equity markets**
  - ◆ **Once the recovery is seen as sustainable, we will see a decoupling of breakevens and equity market performance—already visible in some markets**
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- ◆ **We see potential for rising breakevens on the back of rising nominal yields in the UK post QE: any replacement (e.g. requiring clearing banks to hold more gilts, or QE II) will likely fall short of what QE did in 2009**
  - ◆ **The LDI-driven flows will mean ‘cheaper’ real yields will find buyers and will therefore lag the rise in nominal yields in the above environment**
- 
- ◆ **We believe that the pressure of more supply in the Euro-zone would mean 10-15y area Euro breakevens will continue to underperform other markets**
  - ◆ **Euro-zone 10s30s breakeven curve steepness to stay with us—long end demand, esp from Dutch Pension Funds will continue, unless we get a sustained equity market collapse**

## Prospects for 2010 ... part II

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- ◆ **We believe 10y US breakevens are rich relative to the wings and the 10s30s breakeven curve should steepen**
- ◆ **The re-introduction of the 30-year TIPS program will bring in more demand in the long end, driven mainly by real rate demand rather than any breakeven RV**

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- ◆ **The Aussie market will continue to act as a proxy for Asian market growth and inflationary pressures**

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- ◆ **The Japanese market may well see floored JGBi's and an extension of the curve beyond 10 years**

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- ◆ **An improved credit environment should allow more non-sovereign inflation-linked issuance routes in the usual markets**

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