Why Inflation-Indexed Bonds Are a Bad Deal for Corporate Investors

by Robert G. Smith

In January 1997, when politicians and policymakers decided to issue index-linked Treasury notes, Treasury officials' reason for implementing the inflation-indexed financing program was to achieve a lower cost of federal funding while expanding the market for U.S. debt securities. Interest savings are based on the assumption that the Treasury can capture most of an inflation risk premium embedded in nominal bond yields and will benefit from a further decline in inflation. But given the disinflation of recent years and a stable monetary policy recognized by bond market participants, the inflation portion of the overall bond yield risk premium looks minimal and near-full recoupment could prove elusive. This is evident given the index rebenchmarking risk that the CPI measurement could be adjusted to reduce the measured rate of inflation. (Returns on inflation-indexed bonds are adjusted in response to fluctuations in the CPI.)

Furthermore, the returns on inflation-indexed bonds are likely to prove sensitive to monetary policy. If the Federal Reserve maintains a vigorous anti-inflation stance that keeps it in check — as Chairman Greenspan appears determined to continue — the return on these securities will be depressed. Of course, if the Fed becomes passive or lax, allowing inflation to rise, indexed issues will outperform nominal bonds.

Given the current low inflation expectations, the likelihood of a favorable outcome for these issues is limited. As the fanfare over their introduction continues to wane, investors may demand some extra yield to compensate for what is beginning to look like a relatively illiquid secondary market.

Dr. Smith is president of Smith Affiliated Capital Corp., an investment advisory firm based in New York, NY. He is a member of the New York Financial Control Board, the New York State Comptrollers' Investment Advisory Committee for state pension funds and the Baruch School of Business Advisory Council.

POLITICAL UNDERPINNING

The Clinton Administration continues to pursue an aggressive program of shortening the average maturity of Treasury debt to reduce current interest costs. By shifting issuance into shorter maturities and taking advantage of the steep yield curve, the Treasury made significant reductions in interest expense. This, in turn, permitted the administration to present budgets showing continuous deficit reductions while sparing favored domestic spending programs from severe cuts.

If the Federal Reserve maintains a vigorous anti-inflation stance, the return on these securities will be depressed.

However, the Treasury recognizes that shifting borrowing into shorter notes and bills has practical limits. This is especially true because the market has displayed periodic bouts of indigestion from the sharp increase in short-term issuance. By issuing inflation-indexed securities, the Treasury can alleviate the supply glut at the front end, shifting back to longer notes and bonds without having to pay the higher yields that investors expect from longer-duration issues.

The first issuance of the 10-year inflation-indexed notes had a coupon of 3.45 percent and soon trended lower, after an enthusiastic initial response dissipated. In June of 1997, the notes tumbled almost a point ($10 per $1,000 face amount). What was worse, during a two-week period that month, the indexed bonds climbed 7 basis points to 3.65 percent while regular 10-year bonds surged, driving yields down 21 points to 6.42 percent. In rapid response, individual and corporate investors holding the notes began dumping them.

To date, more than $15 billion of the 10-year indexed bonds and $8 million of 5-year bonds have been issued. Plans are for an additional auction of another 10-year issue and a 30-year issue in 1998. The government now faces the prospect of a secondary market flooded with sell orders by disenchanted investors.

But will there be much of a market for the new securities? As long as inflation remains quelled, investors have little reason to purchase securities that penalize investment returns at the cost of unnecessary inflation defense.

A PHILOSOPHICAL PERSPECTIVE

If large numbers of investors are sheltered from the adverse effects of inflation, they gradually become indifferent to it. This in turn makes it more difficult for government to retain a consensus when tough-minded measures are necessary to maintain price stability. By issuing inflation-hedged bonds, our leaders seem to be telling us they cannot or will not control themselves, that they will fail in controlling inflation. They tell us they need a special insurance policy against government irresponsibility.

Foreign monies have been pouring into our Treasury securities in recent years because of the low rate of inflation, the falling budget deficit and the strengthened dollar. Introducing this "gimmick" bond, which was needed only in high-inflation economies, sends the wrong message to foreign investors, who closely monitor our government's debt-management policies and practices.

Inflation is — first, last and foremost — a monetary phenomenon. Since money and credit is created in Washington, so is inflation. It is the government's responsibility to promote price stability by resisting inflation rate increases. This is something it cannot accomplish without institutional investors actively participating in the effort.

Bond-indexing advocates downplay these concerns. They counter that only a few of these obligations will be issued and they will never represent a significant portion of U.S. government debt. But this argument seems to acknowledge that the exercise is a gimmick. It is hardly a vote of confidence to suggest to business investors that we not worry, since it won't amount to much.

SO WHAT ABOUT PERFORMANCE?

Both the coupon payment and the accretion of the principal that occurs each coupon date for inflation-indexed bonds will be treated as income for tax purposes. So for taxable accounts, the taxes owed could exceed the coupon payment when inflation is high. For this reason, indexed securities are largely targeted to accounts that defer or are not subject to income taxes.

For indexed bonds to provide a true inflation hedge, government should tax only the real return on these bonds. If taxes are levied on the inflation adjustment, then the return on the bond is reduced by the amount of the tax — and the higher the inflation rate, the lower the after-tax return.

Inflation-indexed bonds are a less volatile form of nominal bonds because the real value of their income flow is more stable and their valuation is less volatile. As such, they are best suited to corporate situations where stable real cash flows are highly valued and yield is relatively less important, since the portfolio is almost certain to pay a premium to acquire the inflation protection. In more aggressive equity-dominated balanced portfolios, the usefulness of inflation-indexed bonds is severely limited by the implied loss of return and the modest impact on overall risk. And equities as claims on real earning streams already have some built-in inflation protection to last over extended horizons.

The key issues for financial executives assessing inflation-indexed bonds are the willingness to forego returns and the degree to which the covered obligations are actually inflation-indexed. In Canada, most pension plan sponsors have rate-of-return targets expressed in real, rather than nominal, terms because the plans contain either an explicit indexing provision or the plan sponsor intends to grant future inflation-based improvements on an ad hoc basis. The inflation-linked obligations make appropriate a similar type asset. The inflation-indexed bonds are especially attractive to a pension plan when the real yield meets or exceeds the plan's real return objective.

Inflation-indexed bonds may have significant reinvestment risk. Investors often assume that real interest rates are stable over time, at least beyond cyclical volatility, but empirical evidence does not validate that. Real interest rates have varied considerably over time and have moved up or down by hundreds of basis points. While inflation-indexed bonds are hedges against inflationary monetary policy, they are equally vulnerable to anti-inflationary policy. ✧