

Non-Treasury Inflation-Linked Bonds - A Review

Given the popularity of TIPS, we have begun to see some corporate and agency issuers test the inflation-linked waters. The results have been pretty interesting. Year-to-date, we've seen ~ \$1.5 billion in non-Treasury inflation-linked bond issuance. The preponderance of this issuance came from Fannie Mae, which issued a \$750 million 5 year in February and re-opened the issue for another \$250 million in May. Below are a couple of the higher profile issues and their structures:

Issuer	Coupon	Maturity	Index	Size	Floor	Cap
FNMA	CPI + 1.14	2/17/2009	YoY CPI-U	\$750 MM	-	-
MER	2*(CPI) -.0035	2/3/2014	YoY CPI-U	\$24 MM	0	8.8%

Like TIPS, the non Treasury issues to date, all pay inflation based upon changes in the same index, the NSA CPI-U. However, there are some nuances to the non Treasury structures. For example most non Treasury issues have a floating coupon versus the fixed coupon and floating principal structure of TIPS. This difference is meaningful for taxable investors who owe income taxes on the principal accruals but receive no cash flow until maturity. Additionally, non Treasury issues have been paying on year-over-year (YoY) changes in CPI-U versus month-over-month (MoM) changes like TIPS. Given the tendency for inflation to rise over any 12 month period, the YoY structure helps to smooth out cash flows for an investor. Over the last 34 years, there have been no months in which the YoY structure would have produced negative inflation carry; however, there were 24 months in which the MoM structure would have produced a negative inflation carry for investors.

From a relative value perspective, the first FNMA issue was reasonably priced, offering 42 basis points over 5 year TIPS.

January 30, 2004

Issuer	Issue Yield	Maturity	Comparator Yield	Spread to Comparator
FNMA	1.14	5 year	.72	.42

However, the re-opening was another story. Investors who purchased in the re-opening picked-up only 4 basis points to Treasuries, a reflection of the appetite for inflation protection.

May 2004 re-open

Issuer	Issue Yield	Maturity	Comparator Yield	Spread to Comparator
FNMA	1.14	5 year	1.10	.04

The MER floater which pays $2*(CPI) - .35$ and has an 8.8% inflation cap is a little more difficult to decipher. However, MER issued a 10 bullet around the time it issued the floater.

Issuer	Issue Yield	Maturity
MER	$2*CPI - .35$	10 year
MER	5.035	10 year

At the time the 10 Year Inflation Swap was priced at 2.68%. Using swaps we can get a pretty good comparison:

MER CPI Floater + Pay CPI SWAP			MER 10 Year Bullet + Receive CPI Swap		
Receive	Pay	Net	Receive	Pay	Net
$2*CPI + 2.68$	$-(CPI + 0.35)$	$CPI + 2.33$	$5.032 + CPI$	-2.68	$CPI + 2.35$

From this analysis it appears that the CPI floater was rich versus the 10 year bullet. From a credit standpoint, the issue is in-line (2.33 vs. 2.35), however, investors were clearly not being compensated for the coupon cap (CPI level of 4.575%), which clearly has economic value.

There is no question that investor demand for inflation protection remains strong. Given the demand, we expect to see continued issuance by non Treasury entities. As investors, we are underwhelmed with these structures and will continue to look for cheaper ways to access the exposures we want.