Agenda

A deep dive into the **drivers** of inflation linked bond and swap markets

**Disentangling** the impact of inflation expectations from risk premia and technical factors
Introduction

HICP 10Y (Market) vs HICP 10Y (Model)

Coefs Model 10y (norm)

<table>
<thead>
<tr>
<th>Coef</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mid Brent</td>
<td>Coefficient of Brent Mid</td>
</tr>
<tr>
<td>Last SX5E</td>
<td>Coefficient of SX5E Last</td>
</tr>
<tr>
<td>Mid EURUSD</td>
<td>Coefficient of EURUSD Mid</td>
</tr>
<tr>
<td>Mid Bund</td>
<td>Coefficient of Bund Mid</td>
</tr>
<tr>
<td>Mid GAZ</td>
<td>Coefficient of GAZ Mid</td>
</tr>
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</table>

Regression Statistics

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Value</th>
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</thead>
<tbody>
<tr>
<td>Multiple R</td>
<td>0.9774423</td>
</tr>
<tr>
<td>R Square</td>
<td>0.9553934</td>
</tr>
<tr>
<td>Adjusted R Square</td>
<td>0.9552775</td>
</tr>
<tr>
<td>Standard Error</td>
<td>0.1202774</td>
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<tr>
<td>Observations</td>
<td>1931</td>
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</tbody>
</table>

Segmentation

- **Short end**
  - 0y – 3y sector
  - Dominated by Hedge funds & couple of dealers
  - Thin liquidity & higher volatility give sensitivity to Macro events & shocks
  - Distortions are frequent but corrections are quick as economic data/models and fundamental approach prevails

- **Belly**
  - 3y – 10y sector
  - All player are active
  - Most liquid part of the curve
  - Limited volatility and distortions. Reaction to shocks is less violent except in case of an important headline
  - Premium is frequent but repricing is relatively prompt

- **Long End**
  - 10y – 50y sector
  - Real Money client with large liabilities and more uniform/stable views
  - Trades often with larger premium as dealers offers tend to be too elastic given no natural supply
  - Main driver are depth of the demand (for real yields for example)

Source: HSBC
Inflation Linked Bonds Market

- Inflation linked bonds are probably a less accurate measure of Inflation expectations
- Inflation assumptions can be determined by numerous factors associated with bond market

Differential of liquidity between ILB and Nominal Bond

Issuer credit

Supply / demand dynamics and mismatches (Auctions, Syndications, or large buying programs that don’t coincide with DMO supply events or sizes)

Balance Sheet Constraints, Positioning, as well as bonds dropping out of Indexes

Convexity, risk off/risk on. The iota operates as an arbitrage metric used mostly by RV desks (HF mainly)

Pure Real Yield demand and buying programs
Swaps market reflects a purer pricing of inflation expectations theoretically; liquidity premium is to be taken into account though.

The liquidity differential between IRS and ILS is not an issue, because it is its own instrument.

But there is a structural issue of supply/demand mismatch, that can skew the levels to be too high most often, as there is no natural supply for inflation swaps, and only natural demand.

The inflation supply is created “synthetically” via Asset Swap buying by investors. But even those flows are dependent on the outright level of Asset Swaps, as well as the level of lotas.
Can the debate about the cost of Linkers segment for the tax payer, and the potential reduction of ILB issuance from the DMOs increase this risk and liquidity premium due to the growing demand/supply mismatch?

Is it possible to accurately calculate the risk premium that is embedded in Inflation forwards?

What about the role of the growing influence of CTA accounts, and their momentum driven models that can push these risk premia higher?
Opening up a world of opportunity