GILT-EDGED

Budget deficit may scare off foreign investors

The election was a watershed for the market in gilts. Sizable pent-up demand from domestic and foreign investors has been unleashed. Currency risk and fears of temporarily higher interest rates have been replaced by expectations of a firm anti-inflationary policy, including a move to ERM narrow bands.

Monetary union (EMU) remains the main driving force behind European bond markets, forcing convergence of bond yields. The key measure for gilts is the spread over Bunds. There has been a dramatic reversal since the election, with the spread of ten-year gilts over ten-year Bunds narrowing from a peak of 203 to 123 basis points. With sterling appreciating, the immediate outlook for gilts is positive and the spread over Bunds should narrow further.

There is, however, too much optimism about the prospects for EMU. The economic convergence criteria for EMU are extremely tough and, judging from the recent deterioration in budgetary positions throughout Europe, may take longer to achieve than envisaged. Furthermore, the trade-off for monetary union is likely to be continued tight monetary policies, leading to permanently high unemployment throughout Europe. This is already leading to political tensions elsewhere, increasing the likelihood of an ERM realignment and possibly leading to a delay in the monetary union process.

UK political stability should, thus, give gilts a boost relative to other European bond markets, particularly in the run-up to monetary union. Longer dated gilts are likely to benefit from the policy stance resulting from the election. I expect policy to remain tight for some time. This is because there will be a need to reduce inflation and the budget deficit. Government policy will also be heavily influenced by the need to move the economic and political cycles back into synchronisation. After the 1987 election the government relaxed policy prematurely and it will not want to repeat that mistake.

The removal of political uncertainty will lead to a rebound in confidence, but the factors that led to the recession remain, namely high real interest rates and a debt overhang. A lesson may be seen from America last year, when a rebound in consumer confidence after the Gulf war was interpreted as an end to recession. In fact, the factors that caused the recession remained in place, and the economy weakened further.

Although an early UK rate cut cannot be ruled out, sustained recovery is unlikely until real interest rates are significantly lower. However, inflation figures suggest the government will not lower rates aggressively. Retail price inflation excluding mortgage interest payments remains high, at an annual rate of 5.7 per cent in March. Service sector inflation is particularly high. Furthermore, producer output prices, excluding food, drink and tobacco, rose by a monthly rate of 0.4 per cent in February and March, highlighting the risk that any rebound in the economy could prompt producers and retailers to rebuild profit margins.

The trouble is that unless interest rates fall and there is a steady recovery, the budget deficit is likely to deteriorate. Already, the scale of the fiscal problem points to the likelihood of significant restraint in government spending in this year's autumn statement.

Bank of England figures show that last year foreign investors bought a net £5.4 billion of gilts, compared with total net official sales of £9.2 billion.

They are expected to increase their holdings this year. If the problem on the budget deficit is not addressed, however, this will overshadow all the present good news for gilts and foreign demand could dwindle.

GERARD LYONS
DKB International

WALL STREET

HIGHER interest rates, sell programmes and a rout in secondary issues derailed Wall Street's record-setting

The Nasdaq composite index, battered by a sell-off in technology and medical-related stocks, sank 15 points to 577.