The good news, the bad and the great unknown

The good, the bad and the unknown. The gilt market will face all three in the next year. The good news will be on inflation, particularly in the next few months. Despite market fears that the economy is about to overheat, there is no evidence of this.

Core producer output price inflation has eased from 3.4 per cent to 1.3 per cent in the past six months and is set to reach zero soon, as competitive pressures persist. The Government's targeted measure of retail price inflation has stuck stubbornly around 2.8 per cent this year but will soon fall below the Government's 2.5 per cent target, as good news on producer prices feeds through.

Inflation risks must be watched closely, given the UK's poor record. But this recovery has been very different. Inflation has stayed low, in spite of sterling's ERM exit and four years of economic growth. The economy may be able to grow more strongly than the market believes before inflation intrudes. Firms have used existing capacity and labour more efficiently in this recovery. There are no signs of supply bottlenecks, in spite of the UK's low rate of investment. The trade deficit remains well behaved and has not even begun to act as a safety valve for inflation pressures. There is no evidence of wage pressures, in spite of the fall in unemployment.

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Consumers remain resistant to price rises, forcing retailers to keep prices down. Such price resistance will be crucial in restraining service sector inflation. As growth gains momentum next year, the gilt market may doubt that this favourable inflation trend will last, but it should, particularly if wage rises are contained.

The bad news remains the budget deficit. Stronger growth will ease the public sector borrowing requirement, but this cyclical impact will not be huge. The deficit's high level suggests that hard choices on spending are still being avoided.

The Chancellor's Budget may not be such a giveaway as many expect. Tax cuts may be modest, and will be paid for by cuts in spending. Similarly, any rise in state spending in future years would require tax increases. The big budget deficit should not stop gilt yields from falling, but may result in a relatively steep yield curve.

The unknown factor is Labour. At this week's conference, the party may portray itself as radical, but the market wants to know whether it is as conservative as Tony Blair usually suggests. By the time of the general election, the gap between the two main parties will have narrowed sharply. Economic recovery should boost the Conservatives' chances and Labour policies will be put increasingly under the spotlight. Although Labour remains favourite to win, a closer race will encourage it to advocate a cautious economic policy.

Mr Blair is appealing now to floating voters, positioning Labour in the middle of the political spectrum. After the election, he aims to appeal to the financial markets, being tough on inflation. The unknown factor is at what stage Labour will appeal to its own voters, who want higher spending on health, education and other areas. And will Labour be able to control public sector pay?

The euphoria of victory may delay Labour voters' calls for higher public spending. Mr Blair hopes a "growth dividend" will save Labour, allowing more spending without upsetting the markets. But it may not. The risk premium on gilts would also decrease if Labour took a pro-Monetary Union stance, but it may not be able to, because of the constraints this would put on fiscal policy. Continued good inflation news suggests that gilt yields are still attractive. Stronger economic growth in the next year may ease bad news on the budget. So, provided the political unknown doesn't turn out ugly, gilt yields should fall sharply.

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