GILT-EDGED

Why UK yields fail to attract on world view

The outlook for the gilts market is negative. A declining Budget surplus, rising inflationary pressures, imbalanced growth and a deteriorating trade deficit all point to eventual downward pressure on sterling and an extremely large rise in gilt yields.

In view of the poor economic fundamentals, the rally in gilts can be viewed only as a short-term phenomenon. This rally has been based on an overreaction to speculation about the possible entry of sterling into the exchange rate mechanism (ERM).

First, the strength of domestic demand and the rising trend of inflation mean the pre-conditions for ERM entry do not exist.

Secondly, sterling needs to enter the ERM at a credible and sustainable level. This means a lower level than at present and one which is consistent with an improvement in the trade deficit — DM2.60 for example. To neutralize the inflationary impact and to prevent the domestic economy from overheating, fiscal policy would then have to be tightened, but this is unlikely before the next election.

Thirdly, if sterling membership of the ERM occurs too soon, falling interest rates could reignite inflationary pressures and boost imports.

Finally, sterling's membership of the ERM is unlikely to lead to an improvement in the structural problems facing Britain.

Once it is realized that early ERM entry contains risks, gilt yields should rise, particularly for longer maturities. In fact, the poor underlying structure of the economy and the *ad hoc* nature of policy means that the risks attached to holding gilts are higher than in other government bond markets.

From an international perspective, gilts have been supported by the combination of political stability and a budget surplus. These market supports are crumbling.

The political risk premium attached to gilts is high. There is the chance of a change in government at the next election. Furthermore, for the Conservatives to close the gap in the opinion polls it is likely that an expansionary policy stance will be implemented before the election.

The combination of lax controls on expenditure and an expected slowdown in revenue growth will lead to a falling budget surplus. Thus, even taking into account a possible increase in the take-up of national savings, gilt yields will have to rise as the market discounts the chance of new supply next year.

A falling budget surplus will also draw attention to the economy's imbalances. The declining budget surplus means there is a need to boost private sector savings to reduce the current account deficit.

In addition, the present policy stance is not only failing to adequately reduce domestic demand pressures, as the strong growth of retail sales, wages and money supply (M0) testify, but it is also exacerbating the underlying structural economic problems.

The danger signals were clear in last week's manufacturing investment intentions survey. Investment intentions for the next 18 months are poor and indicate that capacity constraints will act as a future limit to growth once demand rises. The lack of capacity is one contributory factor to the persistence of the current account deficit.

The continued resilience of domestic demand means the cyclical component of the deficit has not improved while Britain's inability to produce sufficient high quality goods implies that the structural component of the deficit will continue to deteriorate.

Present policy is not tackling either component adequately. The cyclical component of the deficit will only improve as domestic demand slows. To expect the deficit to decline because of a surge in exports appears optimistic, particularly as sterling's appreciation has led to a loss of competitiveness, and as import penetration, particularly of consumer goods, continues to grow.

Although the current account deficit can be viewed as a safety valve for inflationary pressures, inflation is still rising. The persistence of inflationary pressures means there is little scope for an early cut in interest rates.

Overall, yields on gilts are not attractive from an international perspective. Indeed, the real yield on 10-year gilts is only 2.2 per cent against 3.7 per cent in the US, 6.3 per cent in Germany and 4.5 per cent in Japan. Even allowing for the uncertainty over German monetary union and the possible underestimation of inflationary pressure in Japan, yields on gilts are too low.

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