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What foreigners fear most

GILT-EDGED

Two key issues will dominate the outlook for gilts. First, can inflation remain low, despite sterling's latest fall? Secondly, are gilts a safe haven? The answer to both questions is yes, although foreign investors may take time to be convinced.

During the past year, world bonds have been affected by three main fears: higher inflation, rising official rates and budgetary problems. Even though the UK's fiscal position has been improving, gilts failed to escape the inflation worries that drove world bond markets down last year.

In recent months there has been a general improvement in global inflation views, as the US economy has slowed and commodity prices have peaked. Britain's inflation performance has been good, in spite of the rise in the headline rate. Yet misplaced inflation fears linger, fed initially by concerns over supply bottlenecks and sterling's fall.

Of course, sterling needs to be monitored. Producer input prices are rising by an annual 11.4 per cent and there has been a small rise in output prices. CBI price expectations are high, although they have fallen for the past two months.

After sterling's ERM exit the market wrongly expected devaluation to trigger inflation. Similarly, inflation worries may be overdone now. A difference is that when sterling fell from the ERM the economy was very weak, with ample excess capacity. Now, the economy is stronger, and there is less spare capacity. Even so, continued competitive pressures evident in the UK throughout the past year suggest that rising intermediate prices will not feed through fully into factory gate or retail prices.

The same disinflationary pressures keeping world inflation low will restrain price pressures here. Companies face strong competitive pressures to keep costs down. Subdued wage growth and steady productivity gains point to unit costs remaining low, more than offsetting higher import costs. With wages sluggish, job insecurity high and rate rises adding to debt servicing costs, consumers are price sensitive, limiting the ability of retailers to make higher prices stick.

If there was a strong sustained rebound in domestic demand, then some of sterling's fall could boost inflation. But we are some way from that. There is almost a dual economy in the UK, with export sectors doing well, while domestic demand conditions remain tough. This suggests that base rates do not need to rise, in spite of sterling's weakness.

Higher rates require evidence of a strong rebound in domestic demand as well as sterling's fall. Latest data suggests domestic demand is weakening. In spite of this, I would not be surprised if Bank of England caution triggered a further, final 0.5 per cent rate rise this summer.

A central feature of the favourable global inflation picture is the policy environment. The increasing independence of central banks is allowing them to be more pre-emptive in curbing inflation. Yet there is the danger of overkill throughout Europe.

We are in a disinflationary international environment, suggesting the inflation fears of last year were overdone and the recent bond rally is justified. However, a more genuine fear is that associated with budget deficits. This contributed to the recent flight to quality in global markets and will ensure that it continues.

A number of First World countries, including Canada, Sweden, Italy and Belgium, already face poor fiscal positions that will not be solved by economic recovery and which require tax increases or spending cuts beyond the scope of their Governments. This makes default or inflation in the medium-term a serious possibility. Fortunately, Britain is not part of this group as its fiscal trend is good.

The problem for gilts is that in spite of the underlying inflation and fiscal trend, politics may prevent foreign investors from regarding gilts as a safe haven. The immediate danger is not so much a change in government, however, as a shift towards an easier fiscal policy before the election. And if this was, in turn, offset by further Bank of England tightening, the consequences for gilts would be poor. Politics apart, the outlook for gilts is good.

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