GILT-EDGED

Recovery goes hand in hand with a global revival

Gilt yields have fallen in response to low inflation, the Bank of England's pre-emptive tightening and the prospect of a tight Budget. Having discounted this good news, the spread of gilts over other markets has narrowed, hitting a six-month low against German Bunds before the Federal elections.

But gilt yields will not fall further in isolation because of two risks. First, the UK's poor inflation record. Although labour market flexibility has allowed inflation to ease, investors will remain concerned that the economy is growing above its sustainable rate. The lack of prior investment still points to capacity constraints unless growth slows further.

Second, sterling is still a soft currency. Despite the improvement in the current account deficit, attention should not be diverted from the non-oil trade deficit. This remains high, showing that Britain still has a longer-term trade problem.

A further decline in gilt yields thus requires an improvement in international bond market sentiment. But the immediate outlook for world bonds is poor. World markets continue to discount a strong global recovery, triggering rising inflation and higher official interest rates. The recent sharp rise in commodity prices both reflects this view and adds to inflation concerns. And supply worries persist. Consequently investors who have already had a torrid year are unlikely to commit net new money to bonds.

One lesson this year is that markets in Europe and Japan have not been able to decouple fully from events in the US. A recovery in US bonds is a prerequisite for a better performance elsewhere. But US bonds will not rally until there is concrete evidence of an economic slowdown, dampening inflation expectations and fears of further Fed tightening. This will be some months off, allowing global bond yields to fall when it does.

There is still intense, international competition. This is best seen in the UK and the US, which are both well into their recoveries. Any attempt by producers or retailers, to pass on higher commodity prices has not been successful. Any price rises have not stuck, but have had to be reversed, as the latest US producer price data and UK retail price data has shown.

Sentiment in bond markets must show improvement for yields to decline further

But even if commodity prices are rising, this need not result in higher inflation. Labour costs, which are more important than commodity prices, remain low. With companies in the UK and on the Continent still shedding full-time jobs or using existing workers more efficiently, the phenomenally strong productivity growth that characterised the recovery in the United States could be repeated here and elsewhere.

International pressures still point to downsizing and cost-cutting. Even though South East Asia accounts for a relatively small proportion of world trade, the production there of low-price, high-quality goods is having a significant impact on the behaviour of international companies. As western countries seek inward investment from Asia, this will add to downward pressure on costs. Last year, hourly compensation in the UK's manufacturing sector was $12.82. This was significantly less than the $16.34 medium for industrialised countries and Germany's $25.56 but well in excess of Korea's $5.37 or Taiwan's $5.23.

Global policy stances are adding to disinflationary pressures. Central banks continue to pursue tough anti-inflation policies, while political parties of the left or right are seeking tight fiscal policies. In the UK, this has already resulted in a slowdown in growth as Friday's GDP data showed. A further slowdown is inevitable. Tax increases are in the pipeline and the Bank of England is still set to push base rates towards 7 per cent by the middle of next year.

The global economy may already be shifting from an inflationary era to one of low inflation. This is good news for the longer-end of bond markets, which should recover early next year. Gilts will share in this improved outlook.

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