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THE U.K. GILT-EDGED MARKET

A talk by Gordon Pepper at a Seminar on the Economic and Investment Outlook for 1980, organised by The Society of Investment Analysts on Monday 19th November 1979

Today is a special occasion for me in two ways. It is the first one-day seminar organised by the Society of Investment Analysts - I wish the Society every success with its new venture. Secondly, it is the first time that I have spoken at the same seminar as Dr. Henry Kaufman. I have known Henry for many years. He has had a great influence on my way of thought. I am both honoured and delighted to share the platform with him.

My talk is divided into two. I will start with the extraordinary events of the last few weeks; subsequently I will describe the outlook for 1980.

Chart I shows the monthly changes in sterling M3 as of a month ago. It will be seen that in the four months prior to mid-September, monetary growth had fallen and was continuing to fall. (Allowing for distortions, the picture was not quite so encouraging, as is shown in Chart II for M4). If the data for banking October had been good, the monetary situation would have been encouraging.

It was originally expected that the data for banking October would be good. On 7th September the Bank announced issues of two new gilt-edged stocks. It arranged the calls so that none was due in banking October. The calls, on these and previous issues, in banking September were very large. Two substantial calls were arranged in banking November. But banking October was left void. The Bank would surely have done this only if it had been been confident that monetary growth in banking October would be sluggish. Such confidence at the time was not unreasonable. Indeed, we and many other commentators shared it. We were all wrong. But the Bank's actions after September appear, with the benefit of hindsight, to be very puzzling.

P. G. E. Greenwell
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G. T. Pepper
The Lord Annaly
The Lord Renwick
J. A. Rickards

L. Gooderham
T. Quinn
A. T. Boanas
M. T. Higgins
D. G. Thomson
H. N. Seely
T. G. Wakeley

J. F. R. Hammond
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E. J. Fenton
A. J. Bonner
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R. B. Pomphrett
M. R. F. Wonfor

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O. J. Olcay (U.S.A.)
Graham H. Greenwell

It must be remembered that the Bank has far more up to date information than do market participants. The Bank has daily data for the CGBR, total sales of central government debt and official intervention in the foreign exchange market. There are also official projections for the CGBR. Further, the Bank has weekly data for the money supply, although these data are not available immediately.

Chart III shows the monthly behaviour of the CGBR less sales of central government debt to the non-bank private sector. In banking October it made a record contribution to monetary growth of almost £1,000m. What action did the Bank take, while it was observing that development taking place?

Chart IV shows a long-dated gilt-edged index on which sales of official tap stocks have been superimposed. In banking October, the long dated official tap stock was operative on just one day, 27th September. Subsequently, although the authorities sold various unofficial tap stocks, they appeared to make no move to encourage additional sales, for example by inducing a rise in yields. Further, on the last day of the banking month, we understand that the Government Broker was bid for a substantial amount of the long-dated tap stock at a price that was in line with the market price (marked X) but some three points below the price at which the Government Broker had last supplied stock. The authorities, however, chose not to accept the bid.

As a result of authorities' inaction, official sales of gilt-edged stock in banking October were some £250m. less than redemptions and buying-in of the next maturities.

The banking statistics also indicate that the authorities chose not to make the corset bite, even though bank lending was very buoyant. The banks' IBELs on the October make-up date were lowered by £624m. market loans to the discount market. If the Bank had squeezed the supply of reserve assets, the banks would have had to designate these loans as call money (which qualifies as a reserve asset) and the corset would have been a greater constraint.

The authorities' decision not to respond to the bid for the tap stock on 17th October had a secondary effect. It suggested that the authorities remained confident about monetary growth in banking October. The abolition of exchange controls on 23rd October was interpreted by many, including us, in the same way. We did not think that the

authorities would open the euro-sterling loop-hole in the corset unless monetary growth was under control. For all these reasons the publication on 6th November of bad data for the deposits of the London Clearing Banks and the eligible liabilities of all banks came as a bolt out of the blue.

Another factor made an important contribution to the extent of the market's reaction. It is much more difficult for a market to discount adverse monetary forces than bad news. A monetary squeeze in real terms means more sellers than buyers of securities whilst the squeeze lasts. A continuing flow of transactions anticipating the end of the squeeze is needed to offset the effect of the squeeze.

Some ten years ago the gilt-edged market did not anticipate monetary forces because few people understood them. As people have learnt, the market has anticipated a reversal of monetary forces earlier and earlier, by perhaps six weeks in 1974 and three months in 1976/7. This suggested that the market might look even further ahead at the current turning point. It tried to do so but we now know that the adverse forces, which I will describe in a moment, were too large. The bargain hunters ran out of funds to commit to the market. One reason why I mention this is to indicate that there has been no buyers' strike. Another reason is that it is a vivid reminder for investment analysts that formal analysis should be combined with the intuitive approach. On this occasion the market nose warned that people were running out of money.

Having discussed the events of the last few weeks, I would now like to consider the background for 1980.

When conditions change as rapidly as they have recently, it is wise to return to fundamentals. Excessive monetary growth is caused by too much borrowing (by both the public and private sectors) from banks. In the U.S., Henry Kaufman specialises in analysing the supply and demand for credit. The concept of credit is, perhaps, not so widely appreciated in the U.K. as it is in the U.S. I tend, instead, to use the expressions the demand for finance and the supply of savings. Interest rates rise when the demand for finance in the economy as a whole exceeds the supply of savings. Conversely, they fall when the supply of savings exceeds the demand for finance.

In the U.S. it is possible to build up a comprehensive table showing the components of the supply and demand for credit. The gap in the U.S. statistics usually amounts to only about 10% of the whole. The last time I tried to build a similar table for the U.K. the gap amounted to no less than 60%. This was exceptional even by U.K. standards; the gap is usually about 40%. But the poor coverage of U.K. statistics means that we cannot use the U.S. technique in this country.

A broad-brush technique has to be used instead. The demand for finance comes from the private sector, to finance both real growth and inflation, and from the public sector. Full data are available only quarterly and a long time after the event. Proxy data, however, are available monthly and quite quickly.

The top graph in Chart V shows a proxy for the public sector's demand for finance. It shows the central government borrowing requirement (CGBR) expressed as a percentage of GDP. Running annual totals of monthly data have been plotted in the middle of the period to which they apply.

The second graph shows a proxy for the private sector's demand for funds to finance real economic activity. It shows seasonally adjusted unfilled job vacancies. When these rise, activity and the demand for finance by the private sector are both expanding.

The third graph shows a proxy for the private sector's demand for funds to finance inflation. It shows annual percentage changes in the wholesale output price index, plotted in the middle of the period to which they apply.

The bottom Graph shows the yield on twenty year gilt-edged stock.

It will be seen that when the dominant tendency is for the top three graphs to rise, the bottom graph also rises. If demand for finance from the public and private sectors rise together, yields rise. Conversely, when the top three graphs are tending to fall, so does the bottom one. If the demand for finance from the public and private sectors fall together, yields fall. I will discuss each of the sources of demand for finance in turn.

Firstly, disappointingly high inflation is, of course, an important reason for the recent financial difficulties. Because inflation is currently rising, some people are arguing that monetarism is not working. They do not seem to understand that current control of

the money supply does not control the current rate of inflation; rather it has its effect in one to two years time. The current rate of inflation is a reflection of excessive monetary growth since August 1977. If the growth of the money supply is controlled from now on, inflation will start to fall in due course.

As far as real growth is concerned, in my judgement the graph of unfilled vacancies has passed its cyclical turning point. Paul Nield has just described his economic forecast. A recent run of the London Business School's model produces similar forecasts for GDP. There are, of course, differences of detail but they can wait until the discussion.

The private sector's demand for finance is always very high at the present point of the business cycle. When the economy turns downwards involuntary loan demand rises as profit margins are squeezed and finished goods are left unsold on the shelves.

Turning to the CGBR, Chart VI shows it in more detail (but this time in absolute terms rather than as a percentage of GDP). The dashed and dotted graphs show the six and three month moving averages of seasonally adjusted data. It will be seen that the graph fell in 1976 and the first three quarters of 1977; the last part of the fall was the result of the IMF measures. A major turning point occurred in the autumn of 1977. Since then the graph has been rising, because of four factors.

Firstly, the Labour Government backslid on the IMF measures. In the year before the election, necessary but unpopular action went by default.

Secondly, decisions to curtail the growth of public expenditure take at least six months to have an effect. So the trend inherited from Labour continued after the Conservative Government was elected in May.

Thirdly, the switch in the June Budget from direct to indirect taxation delayed the receipt of revenue by about two months. PAYE is paid about a month in arrears. VAT is paid about three months in arrears.

Fourthly, strikes and other industrial action have delayed the collection of VAT and telephone bills, as the Chancellor said in his statement on Thursday.

As a result of these four factors the public sector's demand for finance has continued to rise. This is why the financial situation became acute. But the situation is forecast to improve, dramatically for the next six months and, in comparison with the recent past, significantly thereafter.

The Chancellor's statement on November 15th included an updating of the Treasury's forecast of the PSBR in 1979/80, namely £9bn. before the policy changes and £8.3bn after them. During the first half of the financial year the PSBR has been in excess of £6bn. on a seasonally adjusted basis. This implies an official forecast for the PSBR in the second half of the fiscal year of less than £3bn. before the policy changes and about £2bn. after them. In short, the seasonally adjusted PSBR in the second half of the current financial year should be about a third of that in the first half.

Turning again to Chart V, the graph of unfilled vacancies is already falling. The graph of the CGBR is forecast to fall sharply in the near future. The two graphs falling together provide the classic conditions for a bull gilt-edged market to start. The CGBR is forecast to rebound somewhat in 1980/81 but the Government will most probably ensure that it is significantly lower than in 1979/80 as a whole on a constant employment basis. The weakness of the real economy and inflation starting to fall will provide the conditions for the bull market to continue.

There are many other current factors relevant for a forecast of interest rates that I have not mentioned - the abolition of exchange controls, overseas interest rates and the situation in Iran. There is not time to discuss them, but they do not alter my main conclusion that classic conditions will exist for a bull market in 1980. The events of the last few weeks have meant the bull market is more rather than less likely, although it has started from a higher yield basis than I expected. Notice the tense. It started on Thursday afternoon.

MONTHLY CHANGE IN STERLING M3 SEASONALLY ADJUSTED : AS REVISED

CHART I

£m.

+2000
+1600
+1200
+800
+400
0
-400
-800
1200

1975 1976 1977 1978 1979

SEP.

MONTHLY CHANGE IN M4

CHART II

£m.

+1600
+1200
+800
+400
0
-400
-800
-1200
-1600

1975 1976 1977 1978 1979

SEP.

MONTHLY CHANGE IN CGBR LESS CENTRAL GOVERNMENT DEBT SALES

CHART III

£m.

+1200

+800

+400

0

-400

-800

-1200

-1600

OCT.

1975 1976 1977 1978 1979

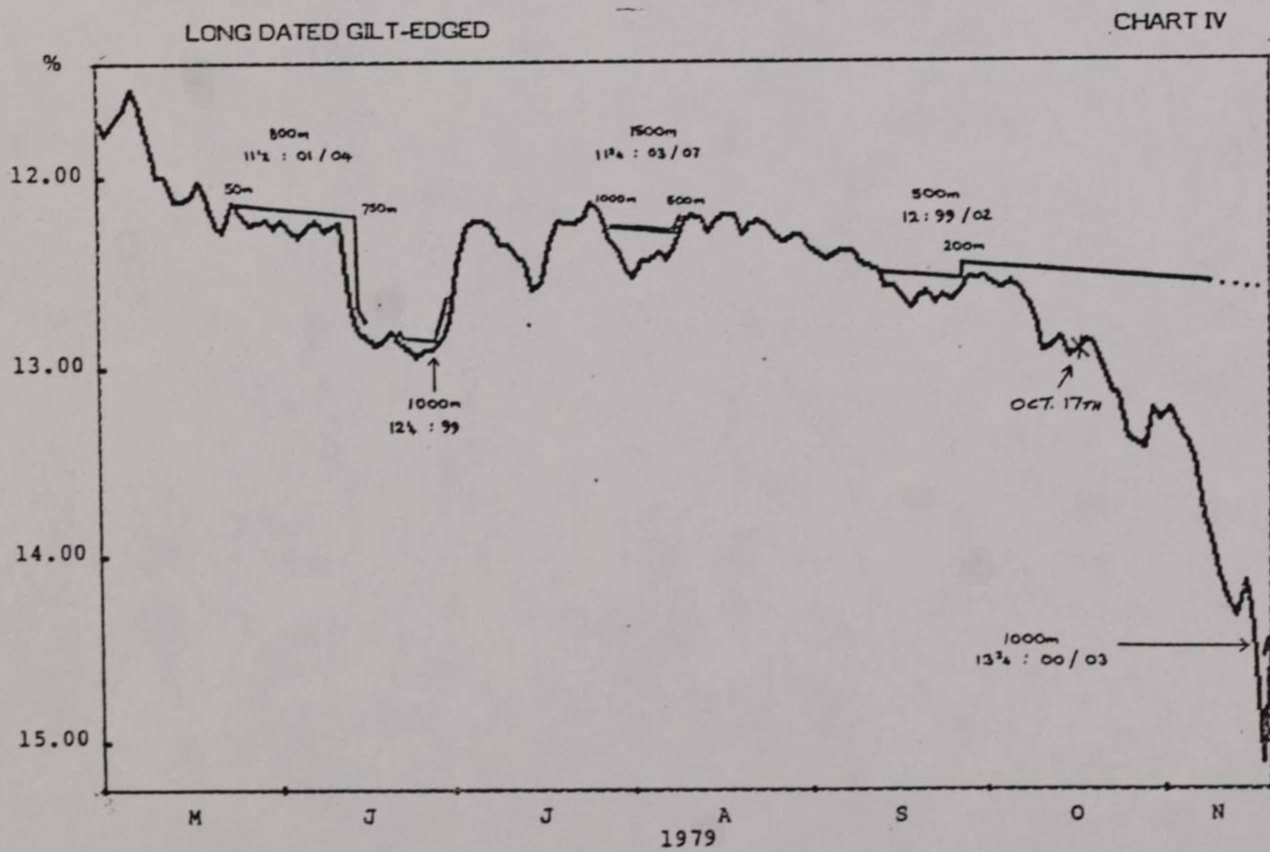

CHART V

CGBR (as % GDP)

Unfilled Vacancies

Wholesale Output Prices

20 Year Gilt-edged Yield

1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979