Lombard Street Research Ltd.

Economic Analysis for the Institutional Investor

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Investment themes 1.

Key points

- Credit stagnation in USA good for bonds

Credit growth seems to have come virtually to a stop in the USA. As a result, the rates of broad money growth have fallen to extremely low levels in nominal terms - and are negative in real terms. In the past this has always preceded periods of weak economic activity and/or outright recessions. US Treasury bonds at yields over 9% are therefore a buy.

- UK slowdown will become recession unless short-term rates are cut

Evidence of the slowdown in the UK is becoming steadily more convincing. As emphasized at our seminars and presentations in late March and early April, domestic demand is probably falling already and ought to drop by at least 1% in 1990. In the second half output will start falling as well. UK short-term rates will have to fall by 2% - 3% over the next six to twelve months if a 1980/81 style recession is to be avoided. But that is not discounted by the money market yield curve.

- Bear market in gilts ought to be over

Gilt yields of 12 1/2% plus have become attractive relative to medium-term inflation prospects. Gilts are therefore no longer a sell. If we are right about UK short-term rates, gilts ought to have a run in late 1990 or early 1991. But we are sceptical that long gilt yields can go much beneath 11 1/2%, because the economy would revive strongly if short rates were to drop significantly beneath 12%. (Nevertheless, a fall in long gilt yields to 11 1/2% in twelve months' time would give a total return of over 20%, which has only been exceeded on three occasions - 1975, 1977 and 1982 - in the last 20 years.)

- Unless overfunding is resumed, which might be good news in other respects anyway

One caveat to the bullish view on gilts is that the authorities may resume overfunding at some point in the next few quarters, as recommended in the May 1990 *Gerrard & National Monthly Economic Review*. If so, the consequences would be positive for short-term rates (because the withdrawal of money would be deflationary) and negative for long yields in the short run (because of the extra supply of stock). But even gilts ought to benefit in the end from lower money growth and inflation.

- Watch out for bond market implications of EMU

The leaders of the 12 EC states are pretending to be serious about EMU and European political union, and therefore about a single European currency.(A single European currency will involve the disappearance of the existing currencies.) If they really are serious, they will have to decide what to do about, a. existing bonds expressed in terms of the national currencies (i.e., are they to be converted? if so, on what terms?), and b. the currency denomination of new issues of government debt. Presumably it would make sense for all new government debt issues in the EC to be in terms of the new single currency.

Tim Congdon **3rd May, 1990**

(***Investment Themes*** will be issued occasionally between our quarterly forecasting seminars, to update Lombard Street Research clients on our latest views. We intend to prepare a more complete *Portfolio Strategy* publication in the next few months.)

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Investment Themes, May 1990

Credit stagnation in the USA

The American financial system appears to have stopped extending credit in recent months, a remarkable development after three decades in which bank executives have seen balance-sheet growth as their first objective. The following figures tell the story:

	Stock of 'loans and leases' at all US commercial banks, $b.	Growth rate of 'loans and leases' in previous year - %
Dec. 83	1,123.9	8.7
" 84	1,321.0	17.5
" 85	1,459.3	10.5
" 86	1,588.4	8.8
" 87	1,708.8	7.6
" 88	1,861.9	9.0
" 89	1,999.2	7.4
June 89	1,937.3	
Oct. 89	2,001.1	
Dec. 89	2,006.1	
Jan. 90	1,999.2	
Annualised growth rate in six months to June 1989		8.3%
Annualised growth rate in six months to December 1989		6.5%
Annualised growth rate in three months to January 1990		0.4%

(Source: US Government Printing Office *Economic Indicators*)

It is clear that since October last year bank's 'loans and leases' - which comprise about 80% of their total assets - have stopped increasing. The explanation seems to be that, following the various debacles in the savings and loans industry, real estate and junk bonds, regulators are interfering to such a degree in the running of financial businesses that new lending has come to an end.

Lending is the principal asset counterpart to deposits on the liabilities side of the banking system's balance sheet. It is therefore hardly surprising that broad money growth has slowed down sharply. On the M3 measure (which tends to receive less attention in the USA than M2) growth has just about come to a complete halt.

% change (on yr. earlier, or annualised growth in last six months for latest months) for:

	M2		M3
Dec. 82	8.8		9.2
" 83	11.8		10.3
" 84	8.3		10.7
" 85	8.5		7.4
" 86	9.5		9.2
" 87	3.5		5.2
" 88		Data revised	
" 89	4.9		3.2
Jun 89	1.9		3.4
Oct	6.0		2.6
Nov	7.5		3.2
Dec	7.7		2.9
Jan 90	6.7		2.2
Feb	7.1		2.8
Mar	6.8		2.5
April (est.)	3.8		3.2

(Source: *Economic Indicators* and *Wall Street Journal*)

The credit slowdown sets up the danger of a downward "debt-deflation" spiral, in which banks' reluctance to extend credit undermines asset values, which undermines the collateral for loans, which reinforces banks' reluctance to extend credit and so on. If that does happen (and Mr. Anthony Harris' column in 30th April *Financial Times* suggests that it is a reasonable description of parts of the USA at present), M2 and M3 growth will decline further. M2 and M3 growth in real terms is already negative. It could go significantly negative - by 5% or over - which would be exceptional by post-1945 standards.

If Lombard Street Research's approach - with its heavy emphasis on credit and broad money - were applied to the USA, the message would have to be that economic activity is about to slow down sharply. With yields at over 9% (which they have never exceeded by much since 1985), Treasury bonds ought to be a strong buy. Indeed, the domestic case for bonds is surely compelling.

The main objection is, of course, the external threat posed by the lack of Japanese interest when Japanese bond yields are over 7%.

UK slowdown will become recession unless interest rates are cut

Last week the *Lex* column of the *FT* referred to the "surprising strength" of UK domestic demand, while in the latest *Independent on Sunday* Mr. Christopher Huhne talked about "the resilience of demand". These commentators have hardly covered themselves with glory in the last few years, but apparently the markets believe them. The money market yield curve - as measured by the short sterling contract - is expecting base rates to be about 14% in March and June next year. This is lower than today, of course, but hardly represents much progress.

Our view - as expressed at our latest seminars - is that base rates will have to be nearer 12% in twelve months' time than 14%. If base rates are still as high as 14% in spring 1991, the economy will be in a deep recession. Various items of evidence have come to hand recently to support our view:

- Construction orders in the three months to February were 14% lower than in the previous three months and are still falling. A slump in residential orders has been under way for some time, but it is now being joined by weakness in the industrial and commercial sectors. (Construction is about 6% of GDP. A fall in orders of 15% will therefore take 1% off GDP, after allowing for lags, etc.)

- Building societies' net new mortgage commitments in March were lower than a year earlier, with mortgage demand being discouraged by the latest rise in mortgage rate. This is the first time for many months that mortgage commitments have been lower than a year earlier. Mortgage loans made by the Committee of London and Scottish Banks (i.e., the clearing banks) were lower in the quarter to March (£1,949m.) than a year earlier (£2,149m.), which in turn was lower than the quarter to March 1988 (£2,565m.) Generalised weakness in mortgage lending is in prospect in the second and third quarters.

- Sales at John Lewis' department stores have been very depressed in the last few weeks. They were lower in money terms (i.e., heavily down in volume terms) in the weeks to 14th and 21st April than in the same weeks last year. There are problems with the timing of Easter, but it should soon be clear that the official February retail sales were freakish.

- The latest CBI survey is consistent with de-stocking by British industry in the next few quarters. Last year stockbuilding was between £3b. and £4b. (The imprecision arises from the official data.) If there is a little de-stocking this year, the change in stockbuilding will subtract 1% from domestic demand.

The drop in housing activity and change in stockbuilding behaviour will themselves deduct 2% from domestic demand in 1990. Although other components of demand (e.g., public capital expenditure, consumer non-durables) will grow, domestic demand as a whole should fall. (This was one of the themes of the December 1989 forecast and we can see no reason to retract it.) Talk of the "surprising strength" of demand, the "resilience of demand" and so on is simply wrong.

It should be emphasized that the peak in the recent cycle came in August 1988 (when base rates were 11%), the slowdown began in earnest in early 1989 (when base rates were 13%) and has subsequently gathered pace (with base rates above 14% since May 1989 and above 15% since October). Another year of base rates at or above 14% will cause a severe recession, with collapsing demand and output.

Bear market in gilts approaching its end

At our December seminar we argued that gilts were "systematically mispriced", because we could not envisaged short-term rates falling much beneath 12% for an extended period in the foreseeable future and - if the yield curve were a "normal" shape - long yields ought to be above short rates. It followed that the gilt market, with long yields at that time under 10%, was too expensive and should be sold.

Gilt yields at the long end are now at about 12 1/2% and are therefore much more realistic in relation to interest rate prospects. Arguably, they are not a great buy at present levels, since - in relation to a "normal" yield curve - they are still rather dear. However, it may be that the existence of a budget surplus means that the yield curve will not return to a normal shape at all. Given our view on short-term rates, we have to conclude that the bear market in gilts is approaching its end.

Indeed, if we are right about US Treasury bonds and international bond sentiment improves, there may be scope for a decline in gilt yields as UK rates decline later this year or early in 1991. But - on fundamentals, with the sustainable floor for short rates at 12% and the medium-term underlying inflation rate in the 6% - 7% area - gilt yields ought not to fall beneath 11 1/2%. If they do reach 11 1/2% sometime in the next twelve months, total return would be about 20% and they would again be a sell.

Recommendation of a change in funding policy

Our research has argued that the main mistakes in British monetary policy in recent years were to end overfunding and scrap broad money targets in 1985. The authorities have now admitted that they made serious mistakes, but they deny that these were of a strategic nature and specifically rule out any change in funding policy.

The May *Gerrard & National Monthly Economic Review* therefore returns to the fray, developing the case for a resumption of overfunding that was first set out in the August 1989 Review ('The case for a resumption of overfunding') and the November 1989 Review ('Mr. Lawson on funding policy'). At some point the authorities may accept this argument, but it does not seem imminent. If they were to accept, the short-run implications for gilts would, of course, be negative. But, in the long run, a return to a well-designed anti-inflationary policy - of the kind conducted in the early 1980s - should be good for all markets.

Watch out for bond market implications of EMU

Bond markets are - probably correctly - not taking much notice of all the high-level international financial diplomacy on European Monetary Union. It is clear that no consensus has emerged about the two key issues,

a. whether the introduction of a "single European currency" (rather than a parallel currency like the ECU) is to mean the disappearance of the existing national currencies, and

b. when and whether the new currency (whatever it is or may be) is to be legal tender in the various EC states.

The problems were discussed in detail in the February *Gerrard & National Monthly Economic Review* and, more polemically, in my 17th April article in *The Times*. Three points for institutional investors should be mentioned:

a. the possible effects on long-term insurance policies and pension contracts if the pound is to disappear,

b. the question of how bonds denominated in national currencies would be converted into the single European currency, and

c. the possibility that at some future date all European governments will stop issuing debt in their national currencies and issue debt only in ECU (or whatever the European currency is to be).

a. and b. are very hypothetical and perhaps not "practical politics". But c. is possible and just the sort of thing European finance ministers would do to persuade people that the whole exercise is not a charade.

Tim Congdon **3rd May, 1990**