Lombard Street Research Ltd.

Economic Analysis for the Institutional Investor

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Investment themes 2.

Key points

- Watch out for the bond market implications of EMU, II

The implications of a single European currency could be the big, new topic for financial markets in the second half of 1990.

It cannot be emphasized too strongly that European leaders are becoming serious about introducing a single European currency in the 1990s. Discussion of the idea, with the aim of reaching a definite agreement, will be the purpose of the Inter-Governmental Conference on European Monetary Union in December. If there is to be a single European currency, high-yielding European bond markets (UK, Italy, Spain) could outperform low-yielding European bond markets (Germany, France, Netherlands) in the next few years, as they have in 1990.

But much depends on conversion terms. Massive contractual uncertainty - with dramatic effects on the profitability of long- term investing institutions - would be opened up by a move to a single European currency or even by an announcement that such a move is possible.

(The July issue of the *Gerrard & National Monthly Economic Review* will be devoted to analysing some implications of a single European currency. The topic will also be discussed at our July seminars.)

- The coming slowdown in lending growth

Recent survey evidence - from the building societies' monthly press release and the list of syndicated credits in Euromoney - indicates that credit demand from both persons and companies is easing. The next few quarters should see reductions in the monthly totals of bank and building society lending, perhaps to about £5b. from the average of £7b. since mid-1988. This fits in with the view expressed in the first issue of ***Investment Themes***, that "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".

- More evidence of increasing slack in the labour market

At the end of last year we warned that pay settlements would be higher in 1990 than in 1989, with an unwelcome message for gilt yields. We were worried that, with unemployment still falling, the labour market was still tightening.

We remained worried early this year that unemployment would not rise enough to curb pay settlements, even in 1991. However, since then convincing survey evidence has become available that the labour market is becoming less tight. This evidence has come from CBI and Building Employers' Confederation surveys, which show that it is much easier to find skilled labour now than it was in late 1988.

Pay settlements will be lower in the next pay round than the current one, a helpful background influence on gilt-market sentiment.

Professor Tim Congdon **4th June, 1990**

(The first issue of our ***Portfolio Strategy*** publication will appear next month. ***Investment Themes*** will continue to be published when there is an important new development and/or change of view.)

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Investment Themes, June 1990

Watch out for bond market implications of EMU, II

The political momentum behind Economic and Monetary Union (EMU) in the European Community is growing, with proposals for a single European currency to the forefront. Influential statesmen like Helmut Schmidt and Valery Giscard d' Estaing, who were largely responsible for the establishment of the European Monetary System, have said that they intend to campaign for a single currency in the early 1990s. There is an outside possibility that member countries of the EC will make a definite commitment to a single currency at the Inter-Governmental Conference in December.

Contrary to market rumour, Mr. John Major's visits to finance ministers in other European capitals are more concerned with expressing British doubts about the single currency than arranging early entry into the ERM. Treasury officials are undoubtedly spending much of their time at present analysing the implications of a single European currency.

It should be emphasized that the phrase, "a single European currency", means what it says. The existing national currencies are to disappear.

This may sound like pie-in-the-sky, but institutional investors - particularly insurance companies - must be aware that high-level international negotiations have been under way for some months and it will now be difficult to prevent something significant happening. The supporters of a single European currency believe that their idea will prove unstoppable. In the first issue of *Investment Themes*, we pointed out there would be drastic consequences for bond markets because of the need to convert existing debt obligations. We spell them out in more detail here.

Clearly, if there is to be a single currency, there must also be a single interest rate and yield curve. The existing differences in bond yields between the various countries of Europe - which, of course, reflect the fact that they have their own currencies - would have to disappear.

There are then two main approaches to conversion of the existing debt obligations, although countless variations could be imagined. The two main approaches are:

i. Convert all national-currency values (i.e., redemption value and coupon payments) on existing debt obligations into ECU at a fixed exchange rate.

ii. Convert only redemption values in national currencies into ECU at a fixed exchange rate, while ignoring the value of coupon payments on the existing debt obligations and replacing them with coupons which reflect a uniform ECU interest rate and yield curve, presumably imposed by the EC (or an affiliated authority).

We will call i. "uniform conversion" and ii. "variable conversion". It is clear that, if uniform conversion is followed,

> ***all bonds issued in existing EC currencies with national-currency yields above ECU yields should achieve capital gains on conversion, and***

> ***all bonds issued in existing EC currencies with national- currency yields beneath ECU yields should suffer capital losses on conversion.***

If EC governments adopt uniform conversion, the market message is to sell deutschemark and guilder bonds and buy UK gilts, Irish gilts, Italian government bonds and Spanish government bonds. (N.B. This is not a recommendation, but simply a statement of an outcome which could well be market gossip ahead of the December IGC. The main surprises to me - in casual discussions I have had with bank economists and officials - have been a. the lack of awareness of this problem, and b. the large number of people who, once they have seen the problem, say that the capital gains and losses are like those resulting from any other economic development. There seems to be little concern that these gains and losses - if they were to happen - would result from revisions to legally-binding contracts.)

There are no clear-cut bond market conclusions if EC governments instead favour variable conversion. But - if that is the route along which EC governments travel - massive financial uncertainty lies ahead. Not only will markets lack a simple criterion for assessing the future value of bond liabilities, but all contractual arrangements between borrowers and lenders will be made insecure. An outcome like the 1997 situation in Hong Kong, where every new contract has the same terminal date, could be imagined. This date would, of course, be that on which the new European currency irrevocably replaced the existing national currencies.

A decision at the December IGC that all future government debt issues will be in ECU would anticipate the difficulty of a future cut-off date for the national currencies. The idea should not be dismissed as ludicrous. (In other words, the British Government stops issuing sterling-denominated gilts, the Frech franc government bonds, and so on. Instead every EC government issues debt only in ECU.)

It is perhaps unnecessary to point out that the terms set out in a variable conversion would have enormous effects on the relative wealth of bondholders and bond issuers, including the profits of life insurance companies. There would be much haggling and debate. All this analysis may prove irrelevant in the end. But institutional investors need to be aware of the opportunities - and dangers.

The Ernst & Young management consultancy firm, with help from the National Institute of Economic and Social Research, has just written a report - on A Strategy for the ECU *- for the Association for the Monetary Union of Europe. This sets out a timetable for the introduction of single European currency. According to this timetable, "a credible announcement" is to be made in 1990 or 1991 that the "ECU will become the single European currency". The process is to culminate in 1996 - to be known as the 'Year of the ECU' - when the ECU "should become legal tender". (The timetable says that in 1992 "ECU life insurance policies should be designed and marketed", without explaining whether insurance companies are to be forced into this step or to decide on it voluntarily.)*

The coming slowdown in lending growth

Bank and building society lending has been so high for so long that commentators have become accustomed to annual growth rates of about 20% as normal, when - from any very long-term historical perspective - they are extraordinary. In the March 1990 Gerrard & National *Monthly*

Economic Review we argued that, "The great 1980s boom in credit growth is over". This message was greeted with some scepticism, notably by the 'Lex' column in the *FT* which continues to talk about "buoyant credit demand". However, there is growing evidence that credit growth is about to slow down quite markedly. The April lending figure - with bank and building society lending down to £3.9b. - was not a flash in the pan.

Two kinds of evidence are relevant, on mortgage demand and the volume of syndicated credits arranged by large companies.

i. Mortgage demand

Data on mortgage demand is readily available, but has become awkward to interpret because of the re-classification of Abbey National (from building society to bank) in mid-1989. To track underlying mortgage demand from building societies' data it is necessary to multiply the crude numbers upwards by 1.2 from July 1989. (Abbey National was about 1/6 of the building society movement.) Even that is not the total picture, because we need to add in mortgages promised by the banks and specialist intermediaries. The clearing banks do publish figures on mortgages approved, the specialist intermediaries do not. The final column in the following table gives the "complete story", insofar as that is possible.

		Building societies' net new mortgage commitments:		Mortgages approved by	Sum of BSA
£m.		Series published by Building Societies' Association	BSA series, X 1.2 after Q2 1989	CLSB banks (i.e., clearers)	adjusted series, and CLSB banks
1985	Q1	6,062		612	6,674
	Q2	6,903		1,185	8,088
	Q3	6,994		1,251	8,245
	Q4	7,804		659	8,463
1986	Q1	7,859		747	8,606
	Q2	11,380		1,518	12,898
	Q3	10,734		1,772	12,506
	Q4	7,877		1,603	9,480
1987	Q1	7,633		1,354	8,987
	Q2	9,654		2,322	11,976
	Q3	9,739		2,379	12,118
	Q4	9,656		2,063	11,719
1988	Q1	13,112		1,960	15,072
	Q2	15,727		3,238	18,965
	Q3	12,892		3,341	16,233
	Q4	9,265		2,413	11,678
1989	Q1	9,944		1,431	11,375
	Q2	13,699		1,537	15,236
	Q3	14,928	12,440	1,498	16,426
	Q4	12,833	10,694	1,317	14,150
1990	Q1	13,231	11,026	1,340	14,571

Sources: Building Societies' Association press releases, CLSB quarterly press release.

Note that the series are not seasonally adjusted and therefore show seasonal peaks in Q2 and Q3.

The main points here are

- the remarkable increases in mortgage commitments from 1985 to 1986 and from 1987 to 1988 (although not from 1986 to 1987),
- the peak in mid-1988 when the housing market was at its most exuberant,
- a dip in late 1988 and early 1989, following the move to higher interest rates, and
- an apparent rise from mid-1989, with mortgage commitments in Q1 1990 higher than in Q1 1989, although lower than in Q1 1988.

However, part of the strength in mortgage commitments in late 1989 reflected building societies' move into the second-mortgage market and the very latest data gives a different story. The last rise in mortgage rate, implemented on 1st March, seems to have been a watershed. BSA net new commitments in the month of April were £3,237 (i.e., £3,884m., after the Abbey National X 1.2 adjustment), lower than the £4,336m. recorded in April 1989. This was only the second time for many months that the BSA figure was lower than a year earlier. Banks' and specialist intermediaries' mortgage lending has been depressed since the beginning of 1989 and remains so.

The central message from this analysis is that - with present interest rates - mortgage lending is set to fall beneath last year's levels. Net mortgage advances in 1989, at £36.3b., were already lower than 1988's peak of £41.3b. Since mortgages usually represent between 35% and 50% of M4 lending, this is clearly a change in the right direction.

ii. Volume of syndicated credits arranged by UK companies

There is no easy way of forecasting loan demand by large UK companies, but a rough guide is given by the total of syndicated credits for UK companies - in both sterling and foreign currencies - listed in *Euromoney*. This indicates how much money companies are preparing to borrow to finance investment programmes, acquisitions and so on. The figures in the last few years and recent months are as follows:

		In sterling £m.	In foreign currencies $m.
1986		9,739	5,820
1987		24,390	14,112
1988		41,189	22.789
1989		45,952	31,774
1989	Q3	6,695	16,267
	Q4	16,532	6,891
1990	Q1	3,112	2,845
1990	Jan	1,306	845
	Feb	687	0
	Mar	1,119	2,000
	Apr	1,904	1,237
	May	832	338

Source: *Euromoney*

These figures appear to indicate peak levels of arranging syndicated credits in the fourth quarter of last year and a sharp drop since. However, the impression is somewhat misleading, since it largely reflects £7,850m. of facilities arranged for the newly-privatized water authorities in December, in order to finance their massive investment programme in the 1990s. (A further £400m. was arranged by the water authorities in January.) When the water authorities' facilities are excluded, the fall in syndication activity is much more gradual, as the following figures show:

		Three-month moving average of sterling syndicated credits listed in *Euromoney*, excluding water authorities
1989	Jan	3,638.2
	Feb	3,807.8
	Mar	3,316.3
	Apr	3,776.7
	May	3,286.3
	Jun	4,258.7
	Jul	2,691.7
	Aug	3,200.0
	Sep	2,231.7
	Oct	2,941.0
	Nov	2,852.4
	Dec	2,894.1
1990	Jan	2,034.1
	Feb	1,222.7
	Mar	1,037.3
	Apr	1,236.7
	May	1,285.0

Source: *Euromoney* and Lombard Street Research estimates

It is obvious from these numbers that large companies are planning to borrow much less in the next few quarters than they were during 1988 and 1989. This fits in with the collapse in bid activity, evidence of a more cautious attitude towards large property developments and several pointers to weakness in investment and stockbuilding.

If companies are about to reduce their bank borrowing and mortgage demand is weakening, it is definite that monthly levels of bank and building society lending will be lower in the second half of 1990 than during 1988 and 1989. Broad money growth will also be slower. To repeat what we said in the March *Monthly Economic Review*, "The great 1980s boom in credit growth is over." Here is another element in the case for lower interest rates in late 1990 and early 1991.

More evidence of increasing slack in the labour market

The rise in pay settlements in early 1990 - which contradicted many forecasts that wage growth would decelerate this year - came as a shock to the gilt market. It was undoubtedly one of the main reasons for the slump in gilt prices in the first quarter. The outlook for pay settlements in the next pay round is therefore basic to the future course of the gilt market.

In our March *Quarterly UK Economic Forecast* we took a sanguine view on this question, arguing that - despite the fall in unemployment last year - labour market tightness was already easing and had, in fact, been doing so since late 1988. Our argument was based on survey evidence, notably from the Confederation of British Industry and the Building Employers' Confederation. More recent survey results from both organizations confirms that the trend is in the right direction.

i. CBI survey

We reproduce below figures on the % balance of companies mentioning shortages of skilled labour, in the quarterly CBI survey since October 1988. The figures were given in response to the question "what factors are likely to limit your output over the next four months?". October 1988 saw the highest balance of companies reporting themselves constrained by skilled labour shortages in the recent boom. We also compare the latest cycle with its two predecessors.

% balance of companies reporting output constrained by labour shortages:

		Latest cycle - 18 months from peak %			Two previous cycles - 18 months from peak %			%
Oct	1988	28	Oct	1978	27	Oct	1973	51
Jan	1989	25	Jan	1979	20	Jan	1974	27
Apr		22	Apr		23	Apr		40
Jul		24	Jul		21	Jul		41
Oct		19	Oct		20	Oct		34
Jan	1990	18	Jan	1980	13	Jan	1975	23
Apr		13	Apr		10	Apr		16

Source: CBI *Economic Situation Report*, successive issues

The main point to emerge from the table is that skilled labour shortages have eased as much in the 18 months from the peak of the recent cycle as in the 18 months from the peaks of the two previous cycles. On this basis, the easing of labour market pressures for higher pay has already been substantial and hopes of lower pay settlements in early 1991 are amply justified. (Pay settlements fell in 1976 and 1981.) If correct, this conclusion is very different from that suggested by unemployment data. The unemployment rate fell from 8.0% in Q3 1988 to 5.7% in Q1 1990 and has only just started to rise, whereas it rose from 2.0% in Q3 1973 to 3.1% in Q2 1975 and from 4.7% in Q3 1978 to 4.9% in Q2 1980.

The conclusion must be that the labour market in manufacturing is working better today than in the early and mid-1980s.

ii. Building Employers' Confederation survey

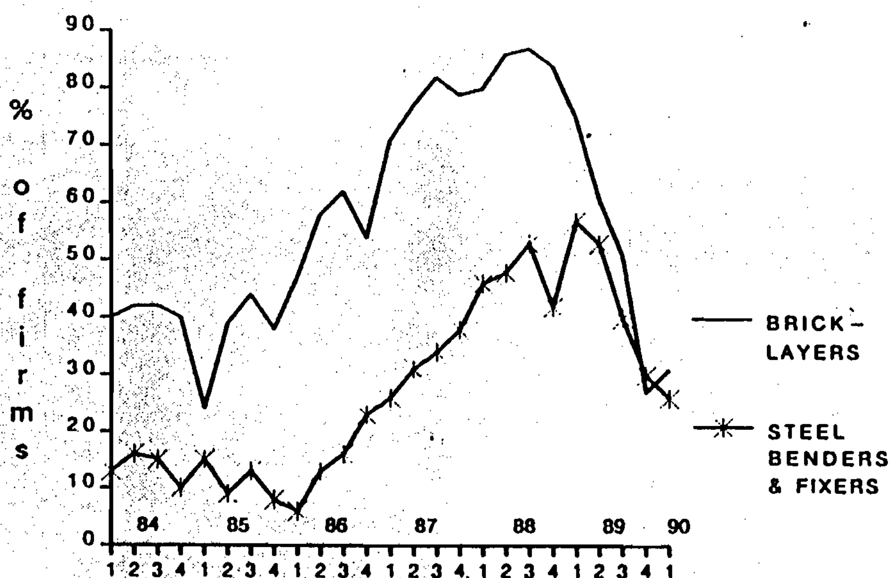
We photocopy the chart in the latest BEC survey, issued last month, on 'Labour availability'. The change from late 1988 is clearly dramatic. Whereas in late 1988 about 90% of building employers were experiencing shortages of bricklayers, the figure now is 31%. Moreover, the fourth quarter of last year was the first since the third quarter of 1986 when more employers expected to cut employment rather than increase it.

The change in the labour market in construction appears to have been even more marked than in manufacturing.

It follows from the survey evidence - in both manufacturing and construction - that settlements ought to be lower in the next pay round than in the current round. If we are right, this ought to be good news for the gilt market, but - with present yield levels - it may already be largely in prices. Certainly gilt yields in the 11 1/2% - 12% area at the long end would make little sense if wage awards were to move up in 1991 from the current 9% - 10% level.

Chart shows % of building employers reporting shortages of bricklayers and steelbenders/fixers.

LABOUR AVAILABILITY



Source: Building Employers' Confederation *State of Trade Enquiry* May 1990