SHIFT OF VIEW

High UK monetary growth starts to cast its shadow over gilts

For most of 1995 Lombard Street Research gave a bullish message on gilts and was positive about the outlook for the UK's short-term interest rates. These conclusions were based on the view that, as the economy was slowing down,

i. late 1995 and early 1996 would see favourable inflation surprises,

ii. contrary to the consensus at the start of the year, some drop in short-term interest rates might be needed by year-end to lift growth towards an above-trend rate.

The analysis has been vindicated by events. Gilt yields at the long end have dropped quite handsomely from 8 1/2% to 8 3/4% at late 1994 to 7 3/4% or less now, giving total returns well into the teens. Even more striking, whereas the short sterling contract in late 1994 pointed to base rates of 9% at end-1995, in fact base rate was 6 1/2%. **But there has been one serious mistake in our work.**

The bullish view on inflation, and so on short rates and gilts, was based on various items of data, but - as always in our work - **broad money growth was crucial.** In late 1994 broad money growth was sluggish and its torpor seemed likely to persist in 1995, mainly because of the continuing financial ordeal of the UK's home-owners. **When broad money growth accelerated in the spring of 1995, our verdict was that it would prove temporary and merely a blip. It is now clear that this verdict was wrong.**

The trend rate of broad money growth - which was consistently under 5% (at an annual rate) between mid-1991 and end-1994 - has increased and is now closer to double digits. The numbers may fluctuate from month to month, but **the central fact - that the trend annual growth rate has accelerated by about 5% - cannot be escaped.** Credit demand appears to be reviving, while banks are eager to expand because of their healthy capital position.

Attached is the first page of our monthly *Portfolio Strategy* publication, which will appear early next week. The market messages appear to be two-fold.

i. Short sterling. Base rates may come down again in the next few weeks, because of the continuing weakness of the economy and falling inflation for the time being. But the worries in late 1996 and 1997 will be rather different, as interest rates may need to be raised to dampen credit and money growth.

ii. Gilts. The bull market in gilts began in the second quarter of 1990, when long yields briefly topped 12%. They declined in the early 1990s and tumbled in 1993 to little more than 6%, but then retraced half the move (in less than six months!) in the bond market collapse of early 1994. But long yields of 9% were as inappropriate as those of 6%, and since mid-1994 there has been another leg of the bull market. **The main message of the latest money numbers is that this further leg of the bull market is over. The inflation news will be good for the time being, but it is too late in the cycle to be chasing gilt yields lower.**

Professor Tim Congdon — 24th January, 1996

Overview on asset allocation

Alarming and unsustainable

High money growth has continued long enough to have important effect on the economy

The last few sets of money supply numbers, and particularly the December numbers, require a significant revision to forecasts of the UK economy. The acceleration in monetary growth which began in early 1995 appears to be well-entrenched. The annualised growth of M4 in the three months to December was 11.8%, virtually the highest in a three-month period since the late 1980s. Meanwhile the twelve-month growth rate keeps on rising and has now reached 10.0%. This is a clear break from the trend in the three- and-a-half years from mind-1991 to end-1994, when M4 growth consistently ran at an annual rate of under 5%. It is no longer possible to claim - as we wrongly did in the summer of last year - that the monetary upturn was a blip. The upturn will certainly prevent the slowdown of mid- and late 1995 becoming a recession in early 1996; it is also likely to act as the principal spur to above-trend growth in late 1996.

The growth of bank credit - as usual, the key driving force behind monetary expansion - is much faster than in the early 1990s. Lending to the private sector by banks and building societies was £6.3b. (seasonally adjusted) in December, despite a special one-off transaction which depressed the lending total (and also M4) by £1.1b. If the £1.1b. is added back, new lending amounted to £15.3b. in the fourth quarter, implying an annualised growth rate in the stock of lending of 9.0%. The Granada/Forte take-over will boost credit growth again in early 1996. Although the growth of mortgage borrowing is still very subdued, banks and their customers have otherwise abandoned the cautious attitude towards incurring new debt which was so marked in the early 1990s.

10% growth of broad money cannot be reconciled indefinitely with inflation under 2 1/2%

Monetary economics has always been an area of controversy. There is undoubtedly scope for debate about current trends in money supply growth. But surely, after the experience of the last 25 years, everyone accepts - or at least ought to accept - that a very well-defined increase in broad money growth will have some effect on economic activity and inflation. In rough terms, broad money growth has stepped up from an annual rate of under 5% during the early 1990s to an annual rate of double digits (or not far off) at present, and there is little evidence that it is about to decelerate again. It is true that in the early and mid 1980s a rather high rate of money growth was absorbed largely in an increased demand to hold money balances, and did not lead to more inflation. But the increased demand to hold the money balances reflected an abrupt move from high inflation and negative real interest rates in the 1970s to lower inflation and very positive real interest rates. No similar change is now in prospect. Despite all the problems of interpretation, 10% growth of M4 cannot be reconciled indefinitely with inflation at 2 1/2% or less.

Professor Tim Congdon

January, 1996