INTERNATIONAL PERSPECTIVES

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Prime Minister. 4

Most interesting — particularly the point marked X on the second page.

November 13, 1986

DRN 28/11

AN OPPORTUNITY IN GILTS

Despite the fact that the British pound sterling has been in a century long slide against the U.S. dollar, there are times when the U.K. bond market looks attractive. In the last few months, several events have occurred, suggesting this is one of those times.

Our last report on the United Kingdom, published on August 15, 1986, concluded that the pound "should remain under considerable pressure, especially against the German mark. ... Considerably higher interest rates in the U.K. would be required to stop the currency's fall." These conclusions were based on the weakness in the U.K. economy, a deterioration in its international competitiveness due to excessive wage gains, and a political climate that argued for a retreat from the policy of keeping sterling overvalued to contain inflation.

All of the risks examined in our report on the U.K.'s economic environment remain in force. Yet, four events have occurred in the last two months that have altered our view concerning the attractiveness of the U.K. bond market:

- U.K. bond yields have risen from the 9.60% level in mid-August to around 11.40% in early November. Short-term rates have increased from 9.75% to 11.19%, as well.

- The German mark/U.K. pound cross exchange rate has moved from a mid-August level of DM/£ 3.08 to the DM/£ 2.80 to 2.95 range, which is much more consistent with British industrial competitiveness.

- German authorities have made clear their interest in Britain joining the European Monetary System's currency arrangement and Mrs. Thatcher has indicated that this is a possibility -- after the elections.

- On the political front, Mrs. Thatcher and the Conservative Party appear to be gaining in the polls, after many months of decline.

As a result of these factors, we now feel that the United Kingdom bond market offers attractive returns relative to its inflation prospects and that the currency is valued competitively in terms of trade. Further, given our view that the German mark may appreciate against the U.S. dollar, even some slippage of sterling against the mark would still provide an atmosphere of currency stability versus the U.S. dollar in which to take advantage of the potential in the bond market.

United Kingdom: A Turnaround Case

Turnaround cases in the currency markets usually involve a situation in which a country's economic policies, especially monetary policy, have been fundamentally altered in order to provide for currency stability or appreciation potential following a period of currency collapse. During the past year the pound has depreciated over 25% against the German mark. The most recent bout of sterling weakness brought this cross rate as low as DM/£2.82. The Bank of England responded to this currency weakness with a significant increase in interest rates. Prior to this tightening of monetary policy, real interest rates in the U.K. had fallen below those in Germany, which contributed to sterling weakness. The recent rate hike, however, has corrected this differential. Currently, U.K. real interest rates are over 7%, as a result of 11.4% bond yields and about 4% inflationary expectations. German real rates, on the other hand, are about 6%, resulting from a combination of 6.4% nominal yields and an outlook for price stability. (In addition, real rates in the U.K. are considerably higher than the 4% to 5% level found in the United States.)

X

The favorable differential relative to Germany has supported the pound versus the mark, such that the DM/£ 2.80 to 2.95 range looks sustainable. With the currency at this level the U.K.'s manufacturing sector is currently more competitive within Europe than at any time in recent years, and the exchange rate is also more in line with its long-term purchasing power parity value.

Chancellor of the Exchequer Nigel Lawson has recently explicity expressed his commitment to preventing further sterling weakness, indicating he would favor even higher interest rates to accomplish this task. But, this may not be necessary. Currently, sterling is in the middle of the likely range of DM/£ 2.80 to 2.95. In the case of general mark strength versus the dollar, sterling could weaken against the mark while still gaining on the dollar.

Further Currency Considerations

As a result of the improved international competitive position of the United Kingdom's industrial sector stemming from sterlings' depreciation, debate over Britain joining the European Monetary System's currency arrangement has intensified. Bundesbank President Poehl traveled to London to discuss the issue with Mrs. Thatcher. She has been an opponent of EMS membership in the past, but now has indicated that membership is a possibility, following the elections.

Even without official sterling participation in the currency arrangement, the German central bank has been intervening directly in the foreign exchange market to support the pound versus the mark. Therefore, some evidence exists suggesting that the Bundesbank and Bank of England may be informally targeting a range for the cross rate. This will aid in reducing the currency risk premium in U.K. interest rates.

Finally, during the last few months the British political situation has changed. The recent gains of the Conservative Party in the electoral polls relative to the Labor Party and the Alliance have significantly improved the likelihood that the current policy stance can be sustained and that the Conservative Party can win reelection.

Further, Mr. Lawson recently proposed a pre-election government spending package which should ease some of the pain of the current tight monetary policy. This last item, though, should be considered a small risk factor, as the markets have reacted negatively to the planned fiscal expansion.

Strategic Implications

The yield pickup of 500 and 400 basis points in the U.K. over the German and U.S. bond markets now provides substantial compensation for the economic, political, and inflationary risks in the gilt market. In addition, the higher real rates in Britain should cause sterling to remain in a relatively narrow trading range against the mark. As the mark gains on the dollar, sterling should appreciate versus the dollar, too. This combination of risk compensation (which was absent three months ago) and the impact of the improved real interest rate differential on the currency outlook has made the gilt market very attractive. In an atmosphere of currency stability and 4% inflation prospects, interest rates could fall 100 basis points over the next three to six months, with a $/£1.40 to 1.50 range for the currency.

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INTERNATIONAL INTEREST AND EXCHANGE RATES

EXCHANGE RATES (A)	U.S. (B)	GERMANY	JAPAN	U.K.
1982	109.80	2.427	249.080	1.751
1983	114.20	2.553	237.510	1.517
1984	122.40	2.846	237.520	1.336
1985	127.10	2.944	238.540	1.296
1985 4TH QTR	117.30	2.584	207.090	1.437
1986 1ST QTR	111.75	2.346	187.880	1.440
1986 2ND QTR	106.80	2.246	170.130	1.509
1986 3RD QTR	102.80	2.085	155.863	1.489
CURRENT (11/13)	102.80	2.020	161.100	1.423
INTEREST RATES (NOVEMBER 13)				
EURO DEPOSIT RATES				
ONE MONTH	5.94	4.56	4.38	10.94
THREE MONTH	5.94	4.69	4.63	11.19
SIX MONTH	5.94	4.69	4.63	11.25
TWELVE MONTH	6.06	4.69	4.63	11.25
GOVERNMENT BOND RATE (C)	7.29	6.40	5.60	11.49

EXCHANGE RATES (A)	AUSTRALIA	CANADA	NETHER-LANDS	ECU
1982	1.017	1.234	2.670	0.968
1983	0.902	1.232	2.854	0.827
1984	0.880	1.295	3.209	0.709
1985	0.701	1.366	3.321	0.888
1985 4TH QTR	0.687	1.379	2.912	0.888
1986 1ST QTR	0.701	1.404	2.649	0.937
1986 2ND QTR	0.713	1.384	2.531	0.978
1986 3RD QTR	0.621	1.386	2.351	1.030
CURRENT (11/13)	0.645	1.383	2.284	1.031
INTEREST RATES (NOVEMBER 13)				
EURO DEPOSIT RATES				
ONE MONTH	16.37	8.25	5.50	7.44
THREE MONTH	16.06	8.38	5.50	7.50
SIX MONTH	15.59	8.50	5.44	7.50
TWELVE MONTH	15.79	8.75	5.44	7.44
GOVERNMENT BOND RATE (C)	13.70	8.95	6.66	8.06

(A) THE AUSTRALIAN DOLLAR, ECU, AND BRITISH POUND STERLING ARE QUOTED AS DOLLARS PER UNIT OF FOREIGN CURRENCY. ALL OTHER CURRENCIES ARE QUOTED AS UNITS OF FOREIGN CURRENCY PER DOLLAR. THE ECU EXHANGE RATE IS AN END OF PERIOD FIGURE. ALL OTHER EXCHANGE RATES ARE PERIOD AVERAGE FIGURES.

(B) MORGAN GUARANTY TRADE WEIGHTED INDEX VERSUS 15 MAJOR CURRENCIES, 1980-82=100.

(C) YIELDS ON GOVERNMENT BONDS ARE FOR MATURITIES OF 8 TO 10 YEARS. THE EUROPEAN CURRENCY UNIT (ECU) BOND YIELD IS FOR A WORLD BANK ISSUE.