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Inflation will kill the gilt rally in the end

The announcement by the monetary authorities in the UK that a policy of quantatitive easing (QE) would be implemented was greeted with euphoria by the gilt market.

By Ian Williams
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The reason the market became so excited was that the method chosen to implement QE would involve the Bank of England buying billions of gilts in the open market to put on its own balance sheet. This expansion of the Bank's balance sheet is the modern day equivalent of printing money and has longer term inflationary implications that are anything but bullish for the longer gilts and longer corporate bonds.

But before everyone gets carried away it is important to understand that while the Bank of England may be a net buyer of gilts, the Government is still a net seller. At the start of the year gilts were heavily sold as the full implications of the Government's truly dreadful fiscal position dawned on the investing public.

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Indeed numbers were being bandied around suggesting gilt issuance in the region of £120bn or more and even the head of the Government's own Debt Management Office (DMO) warned of the possibility of failed gilt auctions in 2009 as the sums required seemed to be unmanageable.

So instead the Government is in effect deliberately under funding its fiscal deficit by printing a significant proportion of the money required. It is having to do this in a convoluted route as the Treasury cannot sell gilts directly to the Bank of England as this is not allowed (for very good reason) under the Maastricht treaty.

The DMO, on behalf of the Treasury, will issue gilts by auction to the investing public and the Bank of England will hold a reverse auction of a different gilt to buy it back from the market. So the Bank of England buying gilts in the open market is a wheeze to get around the Maastricht treaty it is not net buying of gilts by the

Government.

Let's examine the numbers. Say, for example, the fiscal deficit turns out to be £120bn and the Bank of England buys £75bn of gilts, the Government therefore only has to sell £50bn of gilts instead of £120bn.

So will it work and what are the longer term implications? The answer to the first question is that it will almost certainly will work in killing any deflation that exists by confronting it head on with newly manufactured inflation.

Zimbabwe suffers from a collapsing economy but the one thing that Zimbabwe does not suffer is deflation. The only circumstances in which it would fail would be if the Government fell short on the amount of QE required and, judging by the comments from the authorities, this will not happen.

Will it therefore end the recession? This is more problematic but again if they are prepared to print enough money it will eventually turn the economy around. So if it is the answer to all our problems why is this measure so controversial?

The answer is that while it may end deflation and recession there is a cost: there will (not may) be higher inflation down the road. Since Emperor Nero starting clipping coins 2000 years ago, all attempts in history by Governments to print money to pay for their overspending have eventually led to inflation.

Claims by the authorities that they are alive to this threat and will act to drain the newly printed money back out of the system once the economy recovers should be treated with a pinch of salt as the sums involved are simply too big. You could not drain £75bn from the economy without putting it back in recession.

So what should Gilt Investors do? In the gilt fund, The City Financial Strategic Gilt Fund, that I run, I've switched a significant proportion out of conventional Gilts into Index Linked, or inflation-proteted, gilts. I've also avoided ultra long conventional gilts as I expect the yield curve to steepen sharply once the full implications of QE come home to roost. Index Linked Gilts on the other hand could do quite well.

Ian Williams runs the City Financial Strategic Gilt Fund. It has, according to Lipper, ranked Number 1 in the UK since its launch in December 2006.

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