Doomsters do a u-turn on UK gilts

Investors have been piling in to escape the eurozone's plight, writes **Robert Watts**

IT was an incendiary remark, in more ways than one. Bill Gross, managing director of Pimco, the world's largest bond fund manager, declared that UK gilts were sitting on a "bed of nitroglycerine".

Gross's salvo at the start of the year sent a shockwave through the bond market and led to a red face or two in Downing Street. Pimco's European boss is Andrew Balls, whose brother Ed was Gordon Brown's right-hand man when he was at the Treasury.

The statement came in the wake of heated comments from Jim Rogers, the investor and former associate of George Soros. "Sell any sterling you might have — it's finished," Rogers warned.

Gross and Rogers were not alone. After Alistair Darling's final budget on March 24, Monument Securities said gilts were "heading for a downgrade".

Brian Coulton at Fitch, the ratings agency, was also unimpressed with Labour's plan to slash the deficit. "This projected path leaves the public finances vulnerable to shocks," said Coulton, adding that Britain's public debt had risen faster than that of any other AAA-rated country since 2008. "We don't see why the UK thinks it has more time than other countries."

Five months is clearly a long time in bond markets.

"We do not expect the UK to fail in meeting its commitments," Mike Amey, an executive vice-president at Pimco, said last week as the firm upgraded gilts, no longer recommending that they should be avoided. It was a u-turn after weeks in which other investors had been doing the opposite of

chancellor, was able to bask in the glory of this ring of confidence, describing Pimco's new faith as "very good" for Britain's ability to finance the deficit.

The UK bond market has been boosted by problems in the eurozone. As late as April, Gross lumped UK sovereign debt in the same category as Greece's "must avoid" bonds.

Now, Britain is seen as less risky. James Carrick, an economist at Legal & General Investment Management, said the UK was increasingly seen as a safe haven. "There are serious concerns about a European recovery, even whether the euro will survive," Carrick said.

"It seems that many Asian and European investors are moving their money to US treasuries and UK gilts to escape the euro area."

Not all bond analysts are nursing bruised reputations. "Everything we have said would happen has come to pass," said Ian Williams, manager of the City Financial Strategic Gilt fund. Back in March, he quipped that UK gilts were sitting on a "bed of

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They have proved to be one of the top-performing government bonds this year. Yields on the benchmark 10-year notes fell from 4.27% in mid-February to 3.39% by last week. Fitch and Monument are also making more optimistic noises.

Any ratings agency analyst displaying new-found optimism and facing accusations of a u-turn could do worse than quote John Maynard Keynes at the critics. "When the facts change, I change my mind," the economist said. "What do you do, sir?"

The most striking of these changes to the outlook for gilts was the emergency budget on June 22, which has been widely seen as a credible attempt to cut the deficit.

Although the detail of the cuts will not be revealed until the comprehensive spending review in October, the budget was seen as a sign that the new administration would not shrink from drastic surgery on public finances.

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Not all bond analysts are nursing bruised reputations. "Everything we have said would happen has come to pass," said Ian Williams, manager of the City Financial Strategic Gilt fund. Back in March, he quipped that UK gilts were sitting on a "bed of talcum powder" rather than Gross's "bed of nitroglycerine".

Williams said he had never subscribed to the widespread fear in the City during the spring that a hung parliament would lead to paralysis in Westminster and delays in cutting the deficit. "Well before the election all three parties had made it very clear that they would cut the deficit," he said.

He also pointed out that Britain's position outside the eurozone allowed it to print more money — an option that is not available to Portugal, Greece and other ailing European countries.

Williams said he is "fairly relaxed" about gilts. He expects the recent rally will not continue but that yield levels will remain steady in the medium term.

Risks remain, however. "If the Treasury fails to make its cuts, growth turns out to be weaker and inflation remains higher, then the gilts market will be tested," said Marc Ostwald of Monument. "But that is all some time away."

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