UK Interest rate outlook

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In this article we look at why pressure on interest rates is rising, what we expect to happen and what the impact of an earlier forced rise in interest rates might mean for investment markets.

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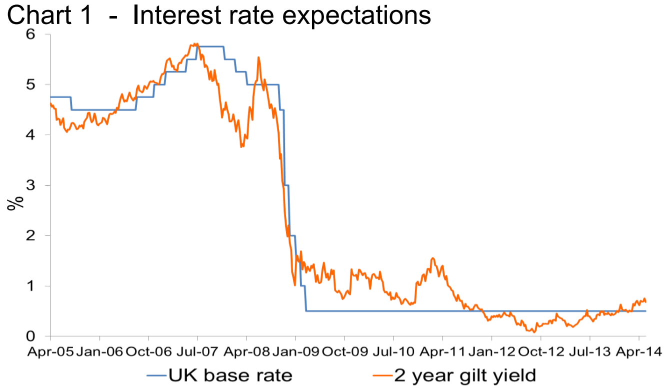
PRIVATE BANKERS SINCE 1672

Recent economic news in the UK has been improving which is leading many to think that interest rates might be raised earlier than expected. However, recent comments from Mark Carney suggest that the Bank of England's (BoE) Monetary Policy Committee is determined to delay raising rates as long as possible.

Chart 1 - Interest rate expectations



Source: Bloomberg, as at 23rd May 2014

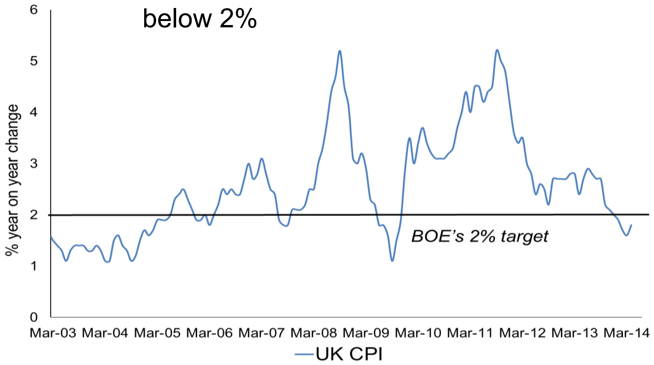
This gives rise to another concern, that interest rate increases will be delayed too long for the good of the overall economy which is showing signs of sustained growth. In this article we look at why pressure on interest rates is rising, what we expect to happen and what the impact of an earlier forced rise in interest rates might mean for investment markets.

Reasons to expect interest rates to rise

The pressure to raise interest rates has been growing as the strength of the UK's economic recovery has been improving. The factors in the economy being debated most often at the moment are the labour and housing markets and inflation.

When Mark Carney took over, from Mervyn King, as Governor of the BoE in July 2013, inflation as measured by the Consumer Price Index (CPI) was above the Government's 2% target.

Chart 2 - Consumer Price Index (CPI), now below 2%



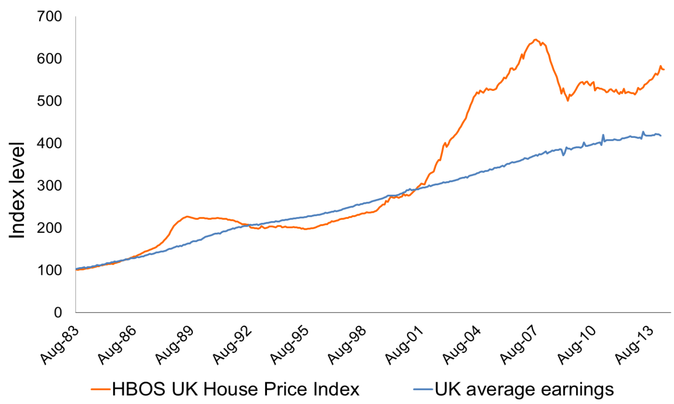
Source: Bloomberg, as at 23rd May 2014

Inflation has been falling steadily (see chart 2) as energy prices have been flat or falling and is now below target, meaning there is little current pressure to raise interest rates as a result of inflationary pressures.

The employment market is showing more conflicting signals, but on the face of it the news has been very good. On the positive side has been the sharp fall in the percentage of the population registered as unemployed. This is now below the important level of 7%, which had been the target set for when the Bank of England would reconsider its policy of very low interest rates. While this is undeniably good news there are caveats that can be highlighted. As unemployment has fallen, there has been a sharp rise in self-employment, part-time workers and 'zero hours' contracts, suggesting some workers may remain under-employed. What little wage pressure there is the Bank of England thinks will be mitigated by increased productivity, indicating that here again it also sees little prospect of rising wages fuelling inflationary expectations.

It is the housing market which is giving the Bank of England its biggest dilemma. It is an important element of the economy both in terms of the construction industry and consumption, as moving house generates consumption and spending.

Chart 3 - House Prices rising faster than average earnings



Source: Bloomberg, as at 23rd May 2014

Additionally, rising prices are important for confidence as homeowners appreciate the warm glow of feeling wealthier. Apparently in London a third of home-owners check the value of their house once a week! There are headlines about feverish activity and record prices in London and the South East drowning out other regions, which again are positive but less overheated. This might be addressed by lenders capping mortgages at four times loan to income ratio as mandated by the Prudential Regulation Authority (PRA). The Bank of England is minded to argue that housing supply in the South East is too low. Indeed, whilst housing starts have recovered somewhat they are from very depressed levels and they remain too low. A fact recently highlighted by Mr Carney, when he pointed out that housing starts, in his native Canada, are at the same level as in the UK despite the population being half the size. This is one sector traditionally very affected by rising interest rates as the cost of funding new developments rises.

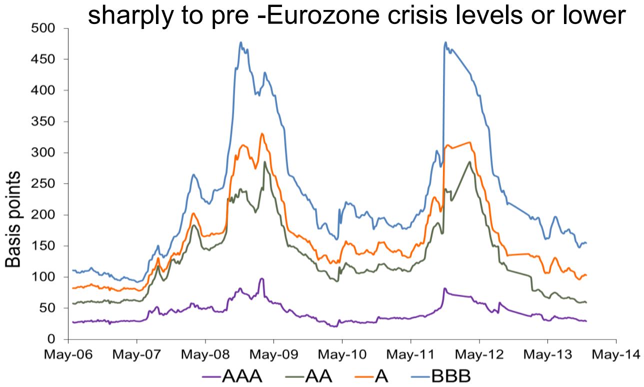
So the dilemma for those making interest rate policy is that they are looking at the market and economy as a whole and want to ensure there is a sustainable recovery. Therefore they are thinking they may need to use more subtle tools to target 'hot' spots rather than hurt the fledgling recovery elsewhere.

Interest rates expected to rise in 2015

In line with everyone else we expect the Bank of England's next move will be to raise interest rates. Where there is more variability is when the first rise will be, and then how far will they go. In this we are not going to be controversial, we believe we are still around 12 months away from the first rise and see no reason not to believe Mark Carney's statements, that they will rise in a steady profile to more normal levels over a lengthy period.

We do believe, however, that the first rise in interest rates needs to be decided on the basis of economic conditions; we have some concern that the first rise may be delayed too long. After a very steep recession Mark Carney is keen to ensure the recovery is sustainable and balanced across the economy and interest rate increases are not applied in a manner that causes material deterioration in sensitive areas of the economy, like housing. Which is why a rise earlier rather than later may be appropriate.

Chart 4 - UK Corporate bond spreads have fallen sharply to pre -Eurozone crisis levels or lower



Source: Bloomberg, as at 23rd May 2014

Expected impact of interest rate rises

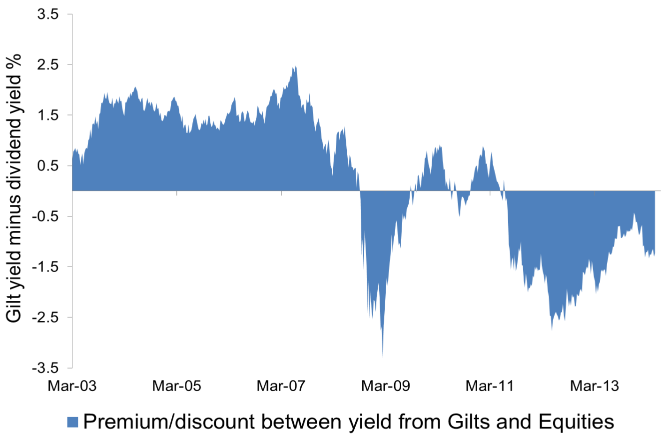
We currently hold an underweight position in government bonds, we expect bond prices to fall and yields to rise over the medium term.

We currently prefer corporate bonds where yields are higher and, despite the yield spread (the difference between corporate and government bond yields, see chart 4) having fallen, remain sufficient to compensate for the still low risk of corporate default.

We are also overweight in equities, particularly overseas but also in the UK. For sterling investors the dividend yield for the equity market is still above that of bonds, where it has been for a little while. This is one indication that equities are still relatively good value despite their strong performance in recent years.

If you take a very long historical view this argument is less compelling as traditionally (before the 1970s) companies compensated investors for the extra risk they took in investing in them by paying high dividends. The difference over the past 10 years is illustrated in Chart 5.

Chart 5 - Equities remain better value than bonds



Source: Bloomberg, as at 23rd May 2014

Any increase in inflation would also add to the attraction of rising dividend income on the back of rising earnings, also helped by high levels of cash on corporate balance sheets.

When are we likely to raise bond weightings?

As a result of our current thinking, we would be unlikely to increase our bond weightings until either government 10 year bond yields reach 3.25% or we feel corporate earnings are faltering. Should we increase government bonds, we expect firstly to reduce our overweight position in corporate bonds before potentially reducing our overweight allocation to equities. As markets are forward looking we will remain flexible and seek to take advantage of opportunities in the markets as we see them.

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Published on 5th June 2014 by C. Hoare & Co., 37 Fleet Street, London, EC4P 4DQ, which is authorised by the Prudential Regulation Authority (PRA) and regulated by the Financial Conduct Authority (FCA) and the PRA with firm reference number 122093.