RESEARCH

PROPONOMICS

FEBRUARY 2018

INTEREST RATES – JOB DONE?

By repricing in anticipation of higher rates, have financial markets now done the job for the Bank of England?

Headlines

Expectations of tighter monetary policy have hit financial markets in February

The era of very low rates is ending, although we doubt there is an urgent need to hike rates

Financial markets have already repriced debt and done part of the job for central banks

Higher rates do not automatically mean higher property yields as the relationship is nuanced

For the financial markets it has been quite a month. Having peaked on the 12th January, the FTSE 100 has dropped 6.7%, with most of that fall occurring in February. Over the same period the All Share index fell by 6.9%, while the 10 year Gilt yield has softened 20 basis points to just over 1.5%. Arguably, for debt the bears have been circling for some time – in early September 2017, the 10 year Gilt was trading below 1.0%.

The cause of the volatility has been interest rates, and the expectation central banks will tighten policy sooner and by more than previously assumed. The concerns originated in the US, but a hawkish statement from the Bank of England has encouraged the view that the same will be true in the UK, and markets are right to expect an increase.

On the rise

For interest rates in major developed economies the only way is up, which is why the softening of the bonds market pre-dates the recent volatility for equities. Where there is more room for debate is how much the Bank of England will raise rates this year. This is particularly the case now Gilts effectively have an additional interest rate hike priced in, on top of the one that we all had previously assumed was coming in 2018. If the market is already passing on higher rates to borrowers, why does the Bank of England need a second rate rise?

Under normal circumstances, the answer to that question would be: if the Bank does not follow through, bond yields will fall again, and so will market interest rates. However, the financial world appears to be moving from debating whether the long bull market for bonds is over to regarding the arrival of a bear debt market as an established fact. There is little doubt the trajectory for rates is upwards, therefore long-term expectations should hold yields up.

Guiding hawkish

Certainly, some economic commentators have suggested that both the Bank of England and the Fed in the US have been playing a game of "guide hawkish, and act dovish", and letting the market do the work of raising the cost of debt. This saves both central banks from falling into the same trap as the ECB, which raised

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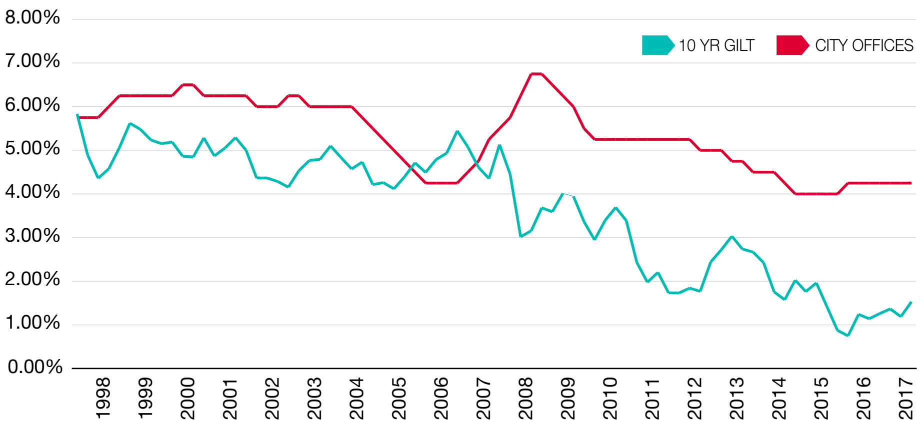
FIGURE 1
City prime office yield vs 10 yr gilt yield



Source: Knight Frank Research / Thomson Reuters interest rates in 2011, convinced the financial crisis had blown over, only to perform a u-turn within months.

Moreover, the Bank of England is in a position to pursue a gradual approach, as the pressures cited to justify raising rates are actually not that severe. Yes, inflation at 3.00% is at the top of the band in which policy tolerates it. However, the consensus forecast is for inflation to fall this year, as the sterling devaluation and the 2017's rally for oil drops out of the figures.

Wages are starting to pick-up, but at least for now pay rises are still well below inflation. Also, the pound has been gradually strengthening for some time now, which will lower the price of imports.

The main reason for raising interest rates is nothing to do with controlling inflation, and all about normalising policy. Were another recession to appear on the horizon, the Bank of England has two interest rate cuts with which to support the economy. It is understandable for policymakers to take the view they would like to lift the rate higher now, during the better times, to accumulate some more cuts to combat any future downturn.

However, there is no urgent hurry for the Bank to be stocking up those future rate cuts. Indeed while the Brexit uncertainty persists, there is reason to be supportive of growth in the near-term. Our forecast assumes a 25 basis point increase, probably in the spring, is a given. However, we remain dovish relative to consensus, and are not yet predicting a second increase in 2018. We take the view the market has already done the job for Threadneedle Street.

Property yields

The upwards drift for Gilt yields has prompted some to ask the question, will property yields follow suit? The reality is that, as figure 1 shows, property yields have a complicated and nuanced relationship with Gilt yields. They can move in opposite directions. It is even possible for property yields in some markets to fall below Gilts, as occurred in 2006-2007; the argument runs that uplifts at rent review can raise the property yield in a positive way over the long-term.

In particular, the idea that higher Gilt yields should be universally bad for property should be viewed with scepticism. Rather than prompting an investor to abandon property entirely, a higher rate environment should push investors towards value add, to get the rental uplift mentioned above. Pursuing this logic, investment should redeploy towards rental growth. We are entering a market that will favour those who pursue asset management.

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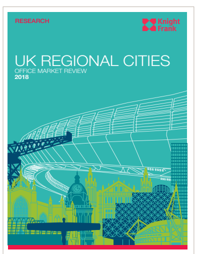

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