RESEARCH

PROPONOMICS

JULY 2018

THE NEXT RATE HIKE – AUGUST OR NOVEMBER?

An August UK base rate increase was looking like a shoo-in until the latest inflation data, but November could now be a possibility

Headlines

A steady rate of inflation has called into question whether rates will rise in August.

We believe that irrespective of August's decision, rates are on a long-term upwards trajectory.

However, the impact of rising rates on property markets is often exaggerated.

The latest inflation data has muddied the waters on the date for the next UK base rate rise. An increase in August had been widely expected, particularly since the latest GDP figures showed a rebound for growth in May. However, subsequent data showed CPI inflation unchanged at 2.4% in June, which is coinciding with marginal real pay growth. This has sparked debate on whether now is the right time to hike interest rates.

That inflation held steady, rather than fell, was largely due to rising energy prices. Inflation excluding volatile items, like food and fuel, fell in June to just 1.9%. The recent decline in the value of the pound could stoke inflation in the short-term, but there is very little evidence of either a build-up of core inflation or a wage-price spiral to justify an immediate rate rise.

September or November?

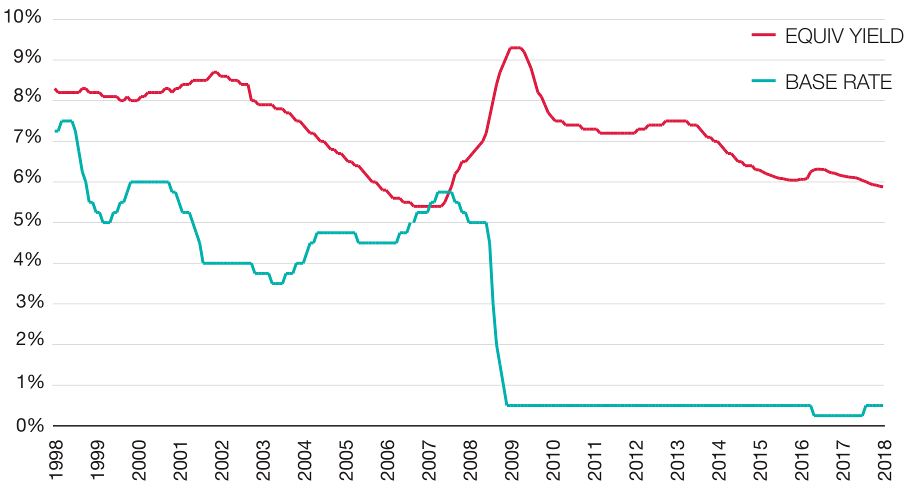
If the Monetary Policy Committee (MPC) does not raise rates in August, the next two meetings are in September then November. However, only the November meeting coincides with the release of the Bank of England's in-house inflation report. The next rate hike could be occurring at a time when inflation is not particularly high by historic standards, and to the backdrop of heightened Brexit uncertainty. Consequently, the MPC might want an inflation report that supports its concerns on the outlook to use to bat away criticism.

Nevertheless, we believe the Bank of England has a general intention to raise rates. Whether it is in August or at a subsequent MPC meeting, a rate rise is coming for good reasons.

The MPC knows that at some point in the future, the economy will hit another downturn. Yet, with rates at 0.5%, the committee would only have two 25 bps cuts available to respond with. This makes it logical to hike rates while the economy is achieving steady growth, to stockpile some future cuts in anticipation of leaner times. Also, there is the risk that firms and consumers become accustomed to very low interest rates, and take on too much debt.

FIGURE 1

UK base rate vs IPD all property yield



Source: IPD / Thomson Reuters

JAMES ROBERTS
Chief Economist

"The recent decline in the value of the pound could stoke inflation in the short-term, but there is very little evidence of either a build-up of core inflation or a wage-price spiral to justify an immediate rate rise.""

Follow James at @KF_JamesRoberts

For the latest news, views and analysis on the world of property, visit Knight Frank's blog www.knightfrank.co.uk/blog

Moreover, a major driver of inflation in recent years has been tumbles in the value of the pound, and both the US Fed and the ECB have indicated they plan to tighten policy in the future. The Bank of England will be conscious of the need to avoid importing inflation by letting the pound fall too low against the dollar and the euro.

Knight Frank's forecast is for one 25 bps base rate increase this year to 0.75%, then two increases of 25 bps each to 1.25% by the end of 2019.

The impact on property

Typically, rate rises are viewed with trepidation in the property world, as borrowing costs will rise. Some heavily leveraged borrowers will be caught out, but not all. These days, most consumers and businesses are sophisticated in their borrowing, and many will have fixed rates or paid debt in anticipation.

However, it is a huge simplification to say that rising interest rates inevitably lead to weaker property markets. The correlation between rates and commercial property yields is low over a twenty-year timescale, and can at times switch from positive to negative. Between July 2003 and July 2007, the Bank of England base rate increased by 225 bps. Yet, for most of this period prime commercial property yields were hardening. This is because so much more than just interest rates shape yield levels.

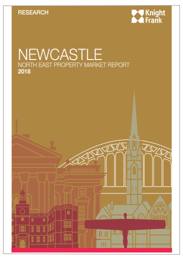
In the US in recent years a rising base rate has largely gone hand-in-hand with continued robust economic growth; and generally, an expanding economy is of far greater importance to supporting a property cycle than interest rates. Economic growth creates more wealth and new jobs. This in turn will result in higher demand for commercial property, across all the major sectors.

In reality, the interest rate rise is a safety valve that curbs excesses, and keeps growth at sustainable levels. If anything, a rate rise is symptomatic of a growing economy.

> "Knight Frank's forecast is for one 25 bps base rate increase this year to 0.75%, then two increases of 25 bps each to 1.25% by the end of 2019."

RECENT MARKET-LEADING RESEARCH PUBLICATIONS

M25 offices Q2 – 2018



Newcastle North East Property Market Report – 2018

Retail Banking Sector Overview

Hong Kong Monthly – July 2018

Knight Frank Research Reports are available at **KnightFrank.com/Research**

COMMERCIAL RESEARCH

James Roberts
Chief Economist
+44 20 7861 1239
james.roberts@knightfrank.com

Newmark Knight Frank