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Interest Rates

The subject of interest rate rises and their timing has become an important issue at the Hanson Asset Management weekly markets meeting. As a result we have set out our views for the three main markets, namely UK, USA and the Euro Zone. Generally, the environment is highly fiscally accommodative with low interest rates and central banks taking measures to increase liquidity. Low interest rates have encouraged people to spend rather than save, to invest in assets that would be revalued as money was devalued, banks to lend and to encourage investment by companies. To an extent this has worked, but the biggest impact has been made by Quantitative Easing (QE) where billions of pounds, dollars and yen have effectively been printed to keep the wheels of commerce oiled and to stop the economy from slipping into a deflationary spiral. The other impact of lower interest rates is to assist in devaluing a currency so that products are cheaper for foreign buyers. This, together with QE which by printing money also devalues it, has helped enormously with the economic recoveries in Britain and America over the last few years, it is too early to conclude on its effect in Japan, while Europe has set out on a different path.

UK

Interest rates in the UK have been at 300 year lows for the past 5 years. Following the Global Financial Crisis it was essential to pump liquidity into markets and one of the levers used was interest rates; the other of course was QE.

The Gilt market has been pricing in an interest rate rise in 2015, following the forward guidance provided by Mark Carney, the Governor of the Bank of England (B of E). However, as the economy continues to recover (GDP is now expected to be 3% in 2014) the construction industry, manufacturing and the services continue to grow, some commentators now believe there is a high chance of interest rates rising before the end of the year. Indeed some analysts have already raised growth rates to 3.1% for GDP and also lowered their forecasts for unemployment. Mr Carney always felt unemployment would have to remain below 7% for rates to rise but with the current rate being 6.8% and labour market slack being used up faster than many expected, there is a view he will have to do something.

The other area of concern is the housing market, which whilst "on fire" in London, has yet to spread convincingly out to the rest of the country. Undoubtedly things are improving but it is not a countrywide bubble. In order to calm things down other methods will be employed rather than just an interest rate rise, which is probably too blunt a tool at this juncture. Already we have seen the loan to values equation being reduced and Lloyds Bank has limited house loans of more than £500,000 to four times a borrower's income. It also looks like the life of a mortgage could be reduced and capped at 30 years.

Another factor to be considered is the outlook for inflation. Whilst there is the concern over a housing bubble it is more likely that the very benign inflationary outlook will keep rates down. The only things that could increase inflation is a leap in wages, an even stronger pick up in GDP growth or if sterling tumbles in value.

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The Bank of England are probably more concerned with deflation than inflation at present and most analysts believe inflation will remain below 2% for the remainder of the year.

We believe that the B of E will hold rates down until business investment is firmly underpinned, productivity improves still further and overseas buyers are propelling our export market. However, post Mr Carney's Mansion House speech he did hint at a possible rise by the end of this year. We still believe the most likely outcome will be for a rate rise in the first quarter of 2015 at the earliest but the cynic in us suggests that before an election (May 2015) a rate rise is a politically dangerous thing to do.

USA

Interest rates in the USA have been stable at 0.25% since December 2008 and the Federal Reserve has injected trillions of dollars into the economy. Commentators believe that interest rates will start to rise after the QE programme has been complemented, which is currently running at $45bn a month by purchases of mortgage backed securities and treasury stock. Economic data in the US has been mixed so far in 2014 with Q1 data hampered by severe storms and subsequent information flattered by a short term boost as a result. The data should normalise over the summer and the US is expected to grow at about 3% this year and next.

Looking more specifically at recent economic data, which continues to drip positive news since the Q1 contraction, the consumer price index in April rose 0.3%, bringing the year on year increase to 2%. US retail sales are increasing (albeit slowly due to weather related causes) and early surveys show that the manufacturing sector is growing above expectations. Indeed, the June publication of the Federal Reserve's Beige book reported

that economic growth increased in all 12 districts. Growth was described as "moderate" or "modest", with employment conditions improving and consumer spending increasing across almost all districts. Interestingly, the report stated that price pressures were "subdued", though other recent data suggests that prices are increasing.

Forward guidance is slightly unclear as the new Federal Reserve Chair, Janet Yellen, has yet to get her feet under the table. She has also surprised some by changing to qualitative measures to asses when to raise rates such as the unemployment rate. This has led some commenters to bring forward rate rises to spring 2015. In light of this, the latest minutes note that exit strategies are being discussed for the first time. The committee was keen to emphasise that this was undertaken as part of prudent planning and does not imply that normalisation would necessarily begin anytime soon. Even so, it is a good indication that we are on the path to tightening and rising interest rates as this is reflective of a sustainable improvement in the economy. Several options were discussed; all centred around short term rates. All this combined makes us think that rates will rise in the USA at the beginning of the first quarter of 2015, with an outside chance of a first small rise in December 2014. We do believe that rises when they do occur will be very gradual.

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Europe

The picture in Europe is completely different from the UK & USA. The ECB has been injecting liquidity by other means including words which started with Mr Draghi's "Whatever it takes" speech in 2012 since when, bond yields in the 'PIG European' countries have fallen considerably. Indeed Spain and Italy have lower government bond yields than the USA and Ireland's are below that of the UK. This programme has enjoyed mixed success while government bond yields have fallen growth has failed to recover and there are fears of deflation. Recently, the ECB has decided it must do more to fight the threat of deflation and promote growth and has cut the deposit rate to -0.10%. This is the first time that a major central bank has introduced negative deposit rates so a hugely significant event. Although financial markets responded as if little has changed, the Euro even strengthened on the day.

In addition, the ECB is working on a plan to buy asset backed securities (ABS's). Generally, the announcement exceeded prior expectations and Mr Draghi stated that additional measures could be announced if necessary. The additional liquidity is positive for equity markets, with European markets rising on the news. In addition, Eurozone (EZ) bond yields, in particular of the peripheral countries, declined.

Looking at the growth picture preliminary GDP data shows an economy that is still weak; in the first quarter of 2014 the region grew at just 0.2%. Country by country the picture was mixed; Germany's expansion was promising at 0.8%, but the Dutch economy disappointed by contracting 1.4%, the Italian economy shrank 0.1% and the French economy stagnated. Flash manufacturing surveys continue to show an expansion but overall this is not enough to settle markets. We are worried that if Europe cannot create more even economic growth, away from just Germany then the significant problems will remain and will reoccur at some point. The market will watch very closely to see if the ECB measures are enough and we would expect that further action will be necessary before growth matches that of the UK & USA, perhaps even some form of QE.

Conclusion

Traditionally a rising interest environment has been bearish for equities, but in this post-recessionary world, it could be that this time, a rising interest rate will be seen as the exact opposite and equities could easily rally. It would, after all, be a statement from the Central Banks that the world is recovering, there is sufficient liquidity in the system, investment is underway, growth is expanding too fast and unemployment is trending downwards in a sustainable fashion. We would not expect interest rates to revert to pre-crisis levels in the UK but stay lower for longer than has historically been the norm, furthermore, the rate of increase will be gradual and limited. The US will revert to their historic 'normal' level and the Euro zone will have very low interest rates for many years to come as growth remains elusive. However, before it happens we feel confident that the possible rise in rates will have been factored in by the Bond Market, where we remain underweight benchmark positions.

This piece represents the personal views of Edward Collins and Jonathan Arthur.

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