It Was Twenty Years Ago Today…

When I hear this phrase, it's usually the formation of Sergeant Pepper's Lonely Hearts Club Band that comes to mind. Last week, however, it was the twentieth anniversary of the Bank of England's effective independence that was being celebrated. The Bank of England cannot exactly be "guaranteed to raise a smile", but for half of those years it seems to have lost the lever that makes interest rates go up, with the last rise being in July 2007, thus keeping the wholesale price of money as cheap as it has been at any time in the Bank's three hundred-and-fifty year history. But that might be about to change.

As recently as early September, the market-derived probability of a base rate rise at November's Monetary Policy Committee meeting was below 20%. That figure is now 83%. Morgan Stanley's "Months to First Rate Hike" indicator signalled thirty months in mid-June. It is now less than three months. Traders have not been this convinced of an imminent increase in the base rate since March 2011, when, of course, they were totally wrong! Then it was the escalation of the Eurozone Crisis that pushed back expectations. It is possible that some new development will intervene this time, but for now the skies ahead are relatively clear.

So why the change in policy direction? One can hardly say that it is in response to a booming domestic economy. Consumption, although rebounding a little over the summer, has been lacklustre; investment is subdued, arguably held back by Brexit uncertainties, although that is impossible to prove; and government spending still tends towards austerity. UK Gross Domestic Product has been notably sluggish relative to other major economies, with the latest revisions pushing annual growth down to 1.5%. The aggregate growth of developed economies is just over 2%, with global growth running over 3%, boosted by emerging economies. Inflation appears to be the problem, at least in the MPC's consideration. The publication of August's Quarterly Inflation Report noted that spare capacity in the economy was being eroded a little faster than expected, and the inference was that weak productivity growth is also acting as a cap on capacity growth. Although headline wage growth also appears to be subdued (+2.1%), the Bank calculates that underlying growth is closer to 3%, with the higher figure being masked by a shift towards lower paying jobs.

There is quite a lot of debate about whether the Bank is over-reacting on the inflation front, and even whether or not it is just a ruse to disguise the real reason for looking to raise rates – the fact that they made a mistake by cutting them after the referendum. Of course, the Bank can claim that cutting rates helped to restore confidence and was responsible for the strong performance of the economy last year, but I am sceptical that that was the case, with Sterling's post-Brexit collapse being the main catalyst.

As for the inflation rate itself, yes, it has been rising recently, again in response to the weaker pound – the rising cost of imported goods, which has taken a while to filter through fully – but also thanks to bouncing commodity prices, which generally bottomed out in the first quarter of 2016. Those effects will start to wash out over the next twelve months (in terms of year-on-year rises, that is – we will be stuck with the higher price levels), suggesting that the annual inflation rate will head lower again. Am I being cynical in suggesting that the Bank knows that, but has cannily worked out that it can take the credit for lower inflation if it raises the base rate at the right time? What better way to justify its independence just as questions are being asked whether or not the government should once again take more control over monetary policy decisions? And while I am in this mode, much has been made of the Bank's good record in keeping inflation contained during its independent life, but one has to observe that goods price inflation has been a rare bird in developed economies since the 1980s, and that we have been living in a disinflationary (sometimes bordering on deflationary) world.

So let us assume that Mr Carney pulls the trigger. Does that spell doom for the economy? In all honesty there are bigger forces at play than a 25 basis point rise that only takes us back to summer 2016 levels. And if the government intends to juice up Help-to-Buy (as floated ahead of the Conservative Party Conference), then the housing market will rumble on, even if momentum has slowed considerably, not least in the London area. Capital Economics, for example, writes that "current strong profitability and a reduced exposure of balance sheets to higher interest rates give us good reason to believe that private non-financial companies should weather a modest increase in interest rates with little difficulty". And a modest increase it will be. Interest rate futures (Short Sterling) suggest the base rate will be around 1% as we enter the next decade.

One key short-term driver of foreign exchange markets is interest rate differentials, and that shift in expected rates has boosted the pound recently. It might well take another such shift to maintain the momentum. Do I actually think the Bank will make the move? Probably, but only because of the risk of losing credibility after having uttered such strong words. I wrote almost four years ago that I would have a cup of coffee the day rates went up, and I am still caffeine free. I am slightly scared of what the effects might be!

Finally, a dobro is a type of guitar. This week, what is the highest mountain in the Southern Hemisphere?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Pearson	6.2%
Taylor Wimpey	5.2%
ITV	5.1%
CRH	4.3%
Berkeley Group Holdings	4.2%
Smiths Group	4.0%
Persimmon	3.9%

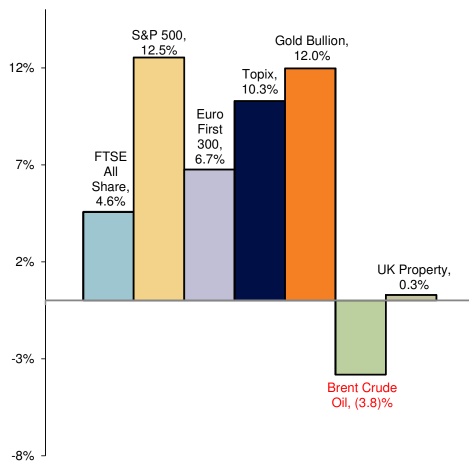
Source: FactSet

FTSE 100 Weekly Losers

Land Securities Group	-5.3%
Mediclinic International	-4.5%
Babcock International Group	-2.6%
BHP Billiton	-2.3%
Fresnillo	-2.2%
National Grid	-2.1%
Johnson Matthey	-2.1%

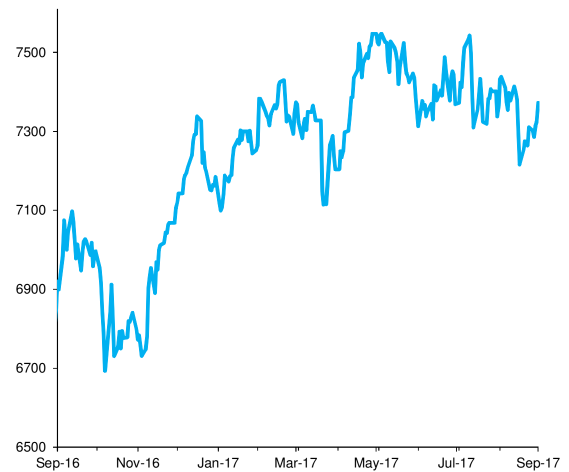
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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