PROPONOMICS

JULY 2017

UK INTEREST RATES

At the Bank of England the debate has begun on when the base rate will rise. We doubt if it will happen this year, but an increase is surely coming.

Headlines

We view a **rate rise this year as unlikely**, as the pound's devaluation will soon drop out the inflation figures

With political uncertainty high, the MPC is likely to remain supportive of growth for now

Yet we believe the **Bank will eventually want to reload the interest rate pistol** in anticipation of future downturns

At present, we believe the **MPC are guiding the market** to allow debtors to prepare in advance

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"The Bank of England is now looking for a period of stability during which it can reload the monetary pistol, to chamber a few extra rate cuts for the future."

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In March 2009, the Bank of England Monetary Policy Committee (MPC) cut the UK base rate to 0.5%, beginning the era of ultra-low interest rates. An end to that era is now drawing closer, raising the questions: when will rates rise, and what will be the impact on property?

Governor Carney's recent statements suggest he would favour a rise if evidence emerges that the increasing strength seen in the global economy is filtering through to the UK, leading to higher wages and demand pull inflation. Were this to happen, a rate rise would be a price worth paying for higher growth.

However, this leads to the reason why we view a rate rise as unlikely this year. The inflation we have seen has been cost push – generated by the fall in the pound's value. Rather than evidence of an inflationary boom, consumer spending has moderated this year compared to last and pay rises have fallen below the rate of inflation.

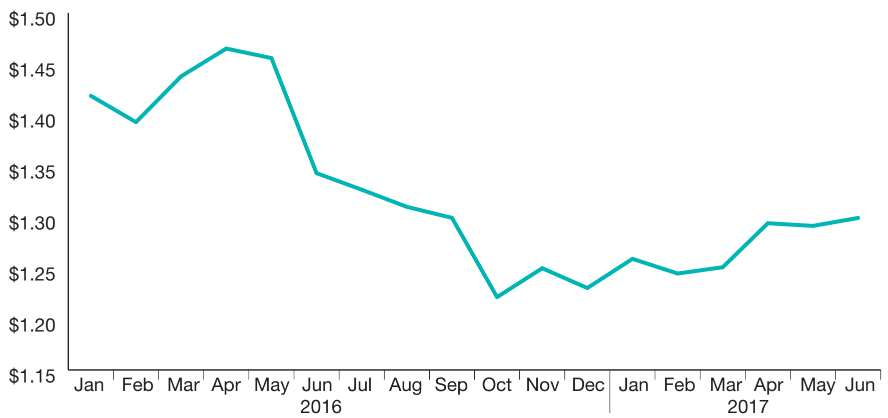
Wait-and-see approach

Prior to the General Election in June, many commentators expected the business sector to pick-up the baton of driving growth from the consumer. However, we believe that the near-term impact of the General Election has been to encourage a 'wait-and-see' approach among businesses towards investment. Arguably the Brexit talks may deter European firms from placing orders with UK suppliers if the contract is set to run over several years.

Consequently, rather than the UK seeing a surge of business activity that prompts a rate rise, it is easier to imagine growth remaining sluggish until there is more clarity on the future trading environment with the EU. Moreover, higher inflation this year has been partly due to the pound's devaluation, which mostly occurred between June and October of 2016 (see graph). That would suggest the sterling effect will drop out the inflation figures over the next few months.

Given there is not a compelling need to raise rates now, we view recent statements from the MPC hinting at an upcoming rise as an attempt to 'guide' the market on a future increase, not a warning of imminent action. By giving plenty of advance notice, the MPC hopes to give consumers and firms time to prepare, via fixing rates or reducing debt.

FIGURE 1
US Dollar to the Pound Exchange Rate



Source: The Bank of England

Re-loading the pistol

However, later on next year we do expect the MPC to raise interest rates, although the reason why is less to do with inflation, and more to do with where we are in the economic cycle. We are now nearly eight years on from the recession of 2008-2009, and inevitably the MPC is thinking of what happens when we reach the next downturn.

At present, were there another recession, the Bank of England has only one interest rate cut left, then it would need to contemplate the murky world of negative rates. So, the Bank of England is looking for a period of stability during which it can reload the monetary pistol, and chamber a few extra rate cuts for the future.

If towards the end of next year the Brexit negotiations are ending with a transitional deal that maintains strong trading ties with the EU, the MPC may view this as an opportune moment to start raising rates. In this scenario, we would expect Q4 2018 to see the UK's first rate rise since July 2007. Our forecast is for periodic increases over the following 24 months to 1.25%. To set this in context, for twenty years prior to July 2007, the lowest the base rate had ever fallen was 3.50%.

The Impact on Property

For property, a rate rise is often viewed as a bad thing, and is associated with the end of the cycle. However, the upcoming period of monetary tightening will be unlike any we have seen before. Higher rates will be a reflection of the fact that the economy no longer needs the crutches of exceptionally low rates. Moreover, by historic standards the level of rates we are forecasting are very low – many readers of this note probably remember double digit interest rates. Debt has also played less of a role in this commercial property market cycle compared to previous cycles.

Recent statements by ministers suggest the government is now leaning towards a business-friendly Brexit, with a transition deal to prevent any cliff edges for firms. For the property market, we believe that the boost for the economy of a pro-business Brexit – probably unlocking fresh investment and new export orders – should more than compensate for any increase in the base rate. Indeed anticipation of an increase in the value of sterling after the announcement of a soft Brexit deal could draw overseas money into the UK property market over the next twelve months.

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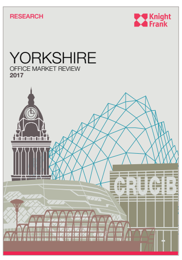

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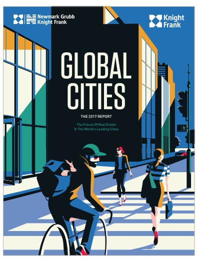

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