INVESTMENT THEMES 2020

Canaccord Genuity Wealth Management

Will UK interest rates ever go up?

Understanding the path of interest rates is an important exercise when managing multi-asset portfolios, and the interest rate level is the most important input when valuing an asset and its respective future cash flows. If there is reason to believe the interest rate will change, we can reassess the relative value of the individual assets we are investing in.

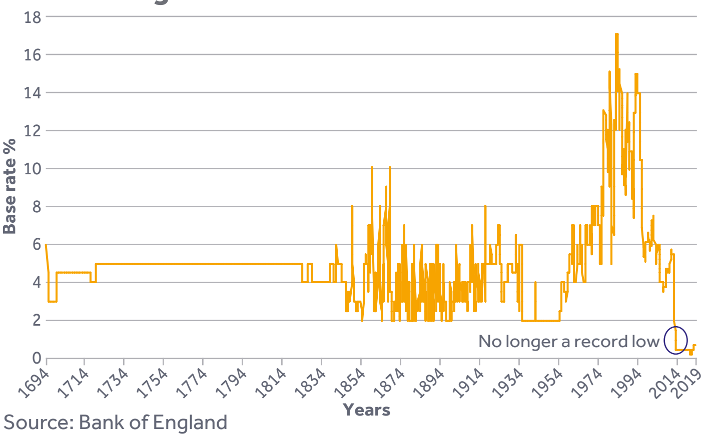
Whilst we don't manage our discretionary portfolios through political forecasting (but see our article here for more details about the importance of politics to investments), it is critical to focus on both the short- and long-term drivers of interest rates in an economy.

Interest rates in the UK, as well as globally, have been at extreme lows in the post financial crisis era. In this article we aim to identify what has driven this, and what the consequences have been, before assessing whether this long-term interest rate trough will force change in the shorter-term interest rate environment. We also try to answer the question "Will interest rates in the UK ever go up?"

Background

The date 5 March 2009 was a seminal moment for the Bank of England, the world's second oldest central bank, when it cut UK interest rates to a historical low of 0.5%. Since the Bank was founded in 1694, interest rates had never been this low, over a period that included two world wars and the Napoleonic War.

Bank of England base rate 1694-2017



Source: Bank of England

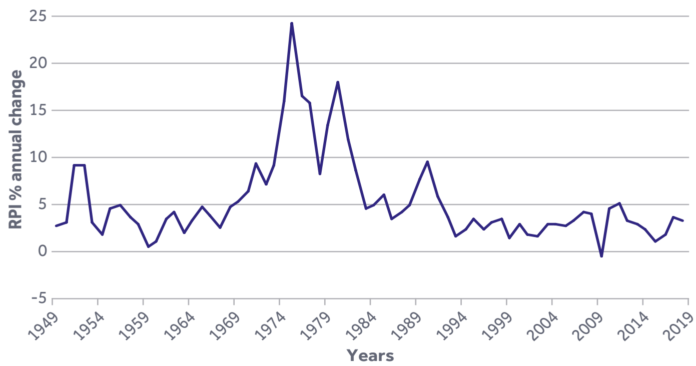
This interest rate, known as the Bank of England base rate, fell to 0.25% after the EU referendum and has since risen to 0.75%. When interest rates are bouncing just above the zero line, it is fair to say the return on cash in your bank account is negligible. This has been a clear and intentional move from central banks, to force savers to spend money and keep the wheels of the global economy suitably oiled.

Yet, a decade later, one might have expected rates at the bank to have moved a little higher. After all, we can't constantly keep spending – it is simply unsustainable, surely? To gain some insight into this question we need to look back at the last 40 years of interest rate policies (aka monetary policy) in the UK.

A natural evolution for interest rates

If March 2009 was seminal, then October 1980 was the line in the sand that signalled the end of economic decline in 1970s Britain. The oil price spike of 1973 and higher wages driven by powerful unions meant inflation in the UK peaked at a high of 25% in 1975. By October 1980, interest rates had risen to 17% to combat the wild inflation and have been on a downward trajectory ever since.

UK inflation since 1949



Source: Office for National Statistics

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While we still live in a world of volatile commodity prices, technological advances in the extraction of raw materials have created a price ceiling. In the 1980s, Margaret Thatcher and the Conservative government also put a ceiling on the power of the unionised workforce, in effect limiting how far wage increases could rise. While those two factors on their own were important for suppressing inflation and therefore interest rates, the last four decades have also seen a distinct change in the demographics of more developed countries.

Blame it on the boomers

The twin forces of the retiring baby-boomer generation coupled with declining fertility rates have changed the shape of the working population. Those approaching retirement typically need a pension to replace their income in old age and the most common way to generate income for a pension is through purchasing a blend of government and corporate bonds (often referred to as an annuity). Bonds are used because they pay a fixed level of interest per annum, and this forms the building blocks of a portfolio that delivers a set target income.

As more of the working population retires, so the demand for bonds increases. Higher demand leads to higher prices for bonds (bond yields have an inverse relationship, so higher prices mean lower yields and vice-versa) which has contributed to this low yield/low interest rate environment.

Technology – the transparent truth

The extraordinary advances in technology over the past 25 years (see more on technology here) have completely changed the way we do business, and this has also helped to reduce inflation, which in turn has kept interest rates down.

Because we now do so much shopping around online, and can compare prices in a few seconds, the price we pay for goods and services has become far more transparent, and this has driven prices lower over time. Lower prices lead to lower inflation. In economic times of old, academic textbooks would tell us that lower prices reflect lower demand and a weakening economy. Today – aided by the power of technology – we can have lower prices, robust demand and a strengthening economy.

The turbo-charged period of ultra-low rates has created negative side effects

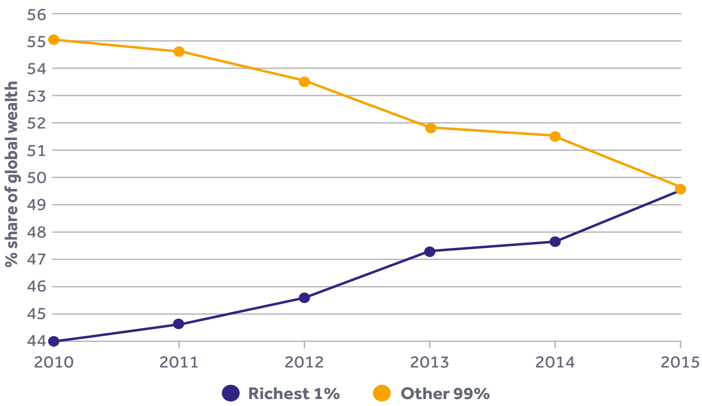
Interest rate policy over the 30 years prior to the financial crisis clearly reflected structural changes in the economy: as inflation fell, interest rates fell in sync. Yet monetary policy in the 10 years since the financial crisis has been more aggressive, with interest rate cuts being greater than the fall in inflation.

Clearly, the global economy faced a once-in-a-generation financial crisis at the end of the last decade and arguments around the efficacy of central bank decisions taken back then are beyond the scope of this article. Suffice to say, those 10 years of ultra-low interest rates have been to the detriment of UK savers, and the negative side-effects have spread far and wide. Indeed, we can attribute some of today's polarised political outcomes to this era of so-called 'emergency' policy making.

As we now know, the changing of the political guard has been driven by a myriad of events. However, one very clear cause has been the level of wealth creation for asset owners and wealth destruction for asset renters. Interest rates at rock-bottom levels were meant to force investors away from cash and bonds and into riskier asset classes, namely property and equities, where investment was desperately needed at the depth of the crisis. This huge uplift in both property and equity prices has benefited homeowners and investors, while those at the other end of the financial spectrum have struggled along in this post-crisis world.

Global economic growth has been strong over the past decade and central bank policy makers cannot be faulted for their efforts here, but growth has been unequal and the dispersion of wealth has widened.

Share of global wealth 2010-2015



Source: Oxfam

The political landscape has changed

Monetary policy is the only tool available to central banks as they attempt to guide the course of their respective economies. This means they control interest rates in order to encourage saving (through higher rates/'tighter' monetary policy) or spending (through lower rates/'looser' monetary policy).

Governments, on the other hand, can also use fiscal policy, which allows them to deploy spending and taxation policies to guide their electorate through the economic cycle. When economic growth is weak, governments can spend more to fill the gap left by consumers. In the good times, governments can tax more to replenish the spending deficit incurred while growth was weak.

Brexit and Trump are two recent examples of the new political landscape that may plausibly change the course of monetary and fiscal policy for the next generation. The shift towards populist politics will force governments to think harder about policy-making. The concept of 'trickle-down economics' posits the view that the wealthiest in society spend the most and contribute the most by way of taxes – i.e. so long as their wealth increases this should trickle down to the poorer members of society.

Ben Bernanke, former Chair of the Federal Reserve, famously pushed this argument forward when the US central bank launched quantitative easing (QE) in the aftermath of the financial crisis. Perhaps, coincidentally, he has pulled back from this view in recent years – as the evidence suggests that this trickling down effect has not, in fact, occurred.

This has led to a growth in popularity of more left-leaning political leaders, represented by Jeremy Corbyn in the UK and Elizabeth Warren in the US – widely tipped to be the Democrat nomination ahead of the US presidential election in 2020. Both individuals want to reverse growing levels of income inequality and, in order to do that, will need to move away from loose monetary policy and towards more egalitarian fiscal policy (i.e. taxing the rich, spending on the poor).

Herein lies the crux of the issue. Should politics become further fragmented in the next year, it's highly possible we could see more socialist policies take shape. The most significant consequences of more socialist policy-making could be the elimination of subsidies to asset owners (through low interest rates) and an attempt to redistribute towards the financially disadvantaged and disenfranchised (through more fiscal stimulus).

Another material shift in the political sands of 2020 could finally trigger a rise in UK interest rates.

Fiscal stimulus vs monetary policy toolbox

Understanding the path of interest rates is key to managing multi-asset investment portfolios

The structural drivers of low inflation remain in place. The labour market gets ever more flexible, with remote working, zero-hours contracts, the gig economy – all examples of change that limit wages from spiralling too high. Furthermore, the push for greener forms of energy that minimise the impact on climate change will reduce our reliance on fossil fuels and limit oil prices from spiking materially higher in times of supply constraints. Longer term, lower inflation will combat the need for excessively high interest rates.

The structural drivers in play in the global economy suggest that low interest rates are likely to be here for some time, all other things being equal. However, in today's polarised political environment, nothing can be assumed equal and this may provide the catalyst for higher interest rates in the short term.

The election of Jeremy Corbyn and/or Elizabeth Warren could force markets to rethink the current modus operandi. Raising an excessive amount of government debt to inject a large dose of fiscal stimulus into their respective economies may play well to the electorate but could raise concerns over their ability to repay the debt. This can cause international capital to flow out of a country, triggering higher interest rates as central banks entice investors to keep their money onshore. Whilst this scenario is unlikely today, the shifting sands of politics force us to stay alert.

This is crucial for risk management across all discretionary portfolios here at Canaccord Genuity Wealth Management. As the economic cycle gets longer and investor uncertainty rises, asset prices inherently become more volatile; this is a common behavioural bias in financial markets.

We believe the most important way to manage volatility in your portfolio is through a comprehensive understanding of the direction of travel for interest rates.

Contact a personal Wealth Adviser today

If you would like to know more about how we allow for the potential effects of changing interest rates when investing, please contact a Canaccord Wealth Adviser today on **+44 20 7523 4500** or **here.**

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Jordan is head of the Managed Portfolio and Passive Services. He also sits on the firm's Portfolio Construction Committee and Fixed Interest Committee. He specialises in managing investment portfolios for intermediaries, trusts, charities and pension funds with a particular focus on multi-asset portfolios. Jordan is a Chartered Financial Analyst and previously worked at Mercer where he managed corporate pension funds.

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