



# Is the Bank of England on the Cusp of Tightening Policy?

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*"Lower interest rates are usually considered good for stocks because they lower the cost of borrowing and make bonds a less attractive alternative investment"* Alex Berenson

What were you doing on the 5 July 2007? I cannot remember either, but the history books tell us that this was the last date when the Bank of England raised interest rates (by a quarter of a percentage to 5.75%). Since this point, interest rates have only fallen, including the most recent August 2016 decrease to the current rate of just 0.25%.

But is this about to change? Traditionally, independent Central Banks with relatively narrow inflation control mandates, like the Bank of England, typically raise interest rates when the level of price increases threatens to pierce their target inflation level. For the Bank of England this moment was, a number of months ago, influenced by the impact on imported prices, like energy, by the sharp fall of the Pound in the second half of last year.

Given the uncertainties around Brexit and recent economic growth data, which has been typically weaker than other developed market peers, this has caused a conundrum for the Bank of England. Reflecting this, the Bank's own Monetary Policy Committee (MPC) observed a few weeks ago, after a meeting which concluded that interest rates should be currently held, that:

*"The MPC's remit specifies that, in such exceptional circumstances, the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably to the target and the support that monetary policy provides to jobs and activity."*

'Exceptional circumstances' covers a variety of sins but maybe something has changed in the water at Threadneedle Street because Mark Carney, the Governor of the Bank of England, in an even more recent national radio interview said that 'we can see that in the coming months if the economy continues on this track it may be appropriate to raise interest rates'.

Well that is a surprise - and certainly induced an immediate response from both the bond markets as well as mortgage lenders. So what is

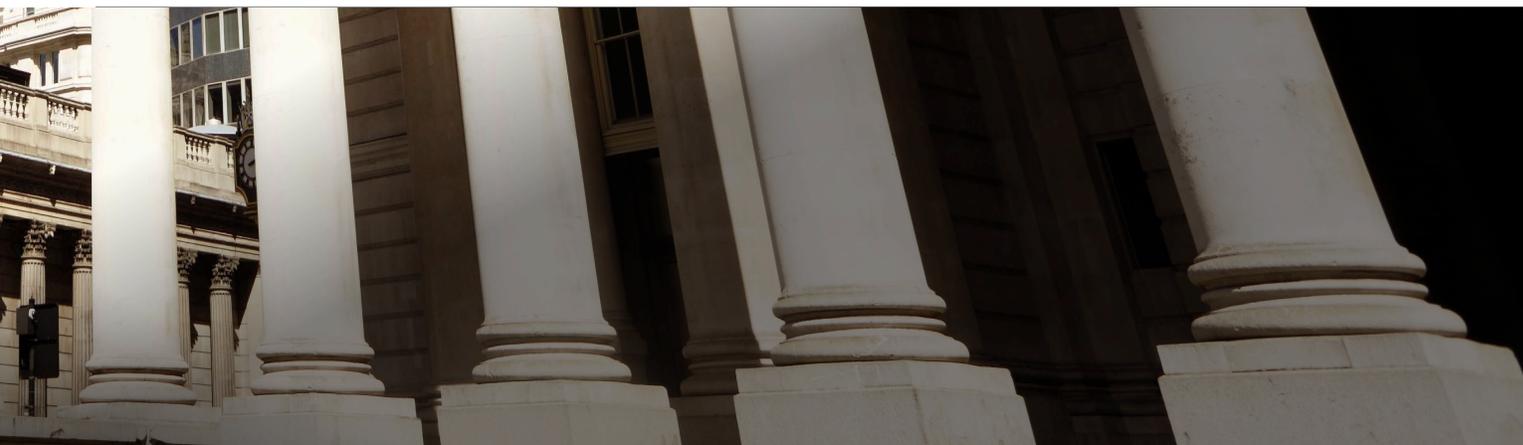
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the reality and can we expect, for the first time in over a decade, an increase in interest rates?

The economic case for an interest rate increase is currently not wholly proven. Brexit negotiations are an uncertainty and the average consumer remains under pressure with limited wage increases and high personal debts. However, monetary policy remains exceptionally loose with a negligible 0.25% base interest rate, the Pound on a trade weighted basis near multi-decade lows and a quantitative easing stimulus programme, which was further augmented at the time of the last interest rate reduction in August 2016 when the big fear was an imminent shift of the UK economy into recession.

In short, a very mild tightening of policy - maybe reversing some of the extraordinary additional stimuli measures implemented fourteen months ago - is quite plausible and would reflect an acknowledgement that, whilst the backdrop is still uncertain on an absolute basis, relatively speaking there is slightly more clarity. However, the bigger insight is that anyone expecting a return to the interest rate or broader monetary policy norms of the generation before the global financial crisis a decade ago is going to be incorrect.

The Bank of England is not the only central bank coming to these conclusions. The Federal Reserve in the United States was the first



Date UK interest rates changed	Base rate level
4 August 2016	0.25%
5 March 2009	0.50%
5 February 2009	1%
8 January 2009	1.50%
4 December 2008	2%
6 November 2008	3%
8 October 2008	4.50%
10 April 2008	5%
7 February 2008	5.25%
6 December 2007	5.50%
5 July 2007	5.75%
10 May 2007	5.50%

Source: Bank of England

major western central bank to slash interest rates and introduce a quantitative easing stimulus programme in the aftermath of the events in 2007 and 2008. As is often the case with economic policy, the 'first in, first out' rule is very apparent. Famously, the Federal Reserve raised interest rates after seven years of pause in December 2015, and since then there has been a further three small tweaks up. Perhaps more insightfully is that the pause on the creation of new central bank stimulus pre-dated any of these interest rate movements and occurred in October 2014 (and actual balance sheet size reduction is only starting this month).

The essential conclusion from all of this is that the speed of policy tightening is, by historical standards, desperately slow reflecting the ongoing challenges for most global economies. This broad profile is highly likely to be replicated by the Bank of England: potentially a minor tweak up in interest rates and a progressive end to new expansion of the quantitative easing balance sheet. If the Bank of England does decide to move in upcoming months, the magnitude of the shift will be extremely minor: there are too many fears out there to do anything else.

And this is why knowing what you are investing in and why is absolutely critical for the next few years, whether you are a bond or equity investor. ■

#### KEY TAKEAWAYS:

- The Bank of England last raised interest rates in 2007 but rumours are swirling of an imminent increase
- Current policy is extremely loose and fears from this year that the UK will enter a recession have abated
- The Federal Reserve indicate that any policy tightening is extremely slow and will focus first on reversing the new stimulus added after the Brexit vote

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