Market Bulletin

3 November 2017

The Bank of England increases rates

In brief

- The first rate rise in a decade was widely expected by markets. Mark Carney's suggestion that even in a relatively optimistic scenario for the economy, only two more rate rises would probably be required over the next three years, led to a fall in the pound and in Gilt yields. The lower pound supported the FTSE 100 given its high foreign revenue exposure.
- We feel the outlook for the UK economy may be less positive than the Bank of England is assuming and therefore think being overweight companies that get most of their revenues from within the UK is a potential risk.
- The immediate impact on the UK economy of the increase in interest rates should be manageable but there are already signs of weakness in the housing market, consumer confidence and retail sales, and higher interest rates will act as a small additional drag on the economy.

What was announced?

- The Bank of England's Monetary Policy Committee voted 7-2 to increase interest rates by a quarter of a percentage point, the first rate rise since 2007.
- Governor Mark Carney suggested that two more rate rises would be required over the next three years in order to return inflation to target.
- The central bank expects GDP to grow by 1.6% in 2018 and by 1.7% in both 2019 and 2020.
- Inflation is expected to fall to 2.4% in 2018, 2.2% in 2019 and 2.1% in 2020.

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Why did rates rise?

Bank of England (BoE) Governor Mark Carney said that the economy was operating with limited spare capacity and that low unemployment was expected to start to translate into higher wage growth. Wage growth has so far failed to accelerate meaningfully but it was noted that job vacancies are at elevated levels and surveys suggest wage growth will start to accelerate. In addition, Carney pointed to the fact that the "churn rate" has picked up, with more employees quitting their jobs for new jobs. He also observed that wage growth has risen for new recruits. The inflation report notes that the BOE estimate that recent growth in employment has been disproportionately in occupations typically associated with lower wages, pushing down on measures of average wage growth.

Whether wages will actually start to pick up as the BoE forecasts remains to be seen but deputy governor Ben Broadbent said that the BoE still believes that low unemployment should put upward pressure on wages.

In addition, continued low productivity growth is estimated to mean that the economy has limited potential to grow without generating inflationary pressures as demand bumps up against diminishing spare capacity.

What will the impact be on the economy?

Carney said that households are well positioned to withstand a rate rise. The average outstanding mortgage is about £125,000 and the BOE estimates that this rate rise would lead to an increase of around £15 a month on that average mortgage, if fully passed through. About one fifth of those who have a mortgage have never experienced a rise in interest rates since they took on a mortgage. The inflation report also notes that only about one third of households have mortgages and less than 1.5% of households spend more than 40% of their pre-tax income on their mortgage.

Another important factor to note is that 60% of outstanding mortgages are now on fixed rates, which is up from only about 30% in 2012. Just under half of those fixed rate mortgages are fixed for more than two years. This means that there will be some delay in the pass through of higher borrowing costs.

Companies are currently enjoying near record low debt servicing costs and this rate rise will still leave them very low by historical standards. So, while this increase in interest rates will be a drag on the economy its impact should be relatively small and manageable.

Where next for interest rates?

Carney noted that the BoE would remain flexible in adjusting to economic developments and in particular to the outcome of the ongoing Brexit negotiations. He noted that based on the BoE's current assumptions for the economy, maintaining interest rates at their current level would not be sufficient to bring inflation back close enough to target within an already extended time horizon of the next three years. However, he said that only two more rate rises over the next three years would probably be enough to bring inflation back to target, in line with their guidance that any future rate rises would be at a "gradual pace and to a limited extent."

The BoE is keen to signal that rates are unlikely to rise very quickly at all. However, the Monetary Policy Committee (MPC) has an almost impossible task trying to set monetary policy without knowing whether or not the UK will get a transitional Brexit deal or what the final outcome of trade negotiations with the European Union (EU) will be. The MPC is essentially being forced to drive blindfolded given the political clouds that are obscuring the medium term economic outlook.

Investment implications

The market reaction has been a fall in the pound and in Gilt yields. As investors have become accustomed to, the fall in the pound drove the FTSE 100 higher. The market had already priced in this rate rise before the meeting and has now moved to price in a lower probability that rates will rise more than once more next year. Carney said that even in a somewhat optimistic scenario where wage growth accelerates, GDP picks up slightly and there is an assumption of a "smooth adjustment" to the UK's new trading relationship with the EU, only two rate rises would be required over the next three years.

Prior to the September meeting, expectations were for rates to rise to 0.75% by the end of 2020. September's meeting's guidance was that rates would actually need to rise by "a somewhat greater extent" than the 0.75% expectation. By now specifying that only two more rate rises will probably be required by the end of 2020, the BOE has set a slightly more dovish tone by reducing the probability of rates rising above 1%.

Concerns that the outlook for the UK economy may be less positive than the BOE's assumption would now justify an expectation of less than two rate rises in the next three years. We see potential downside risks to the economy and to the outcome of the Brexit negotiations. As such, we think being overweight stocks that get most of their revenues from within the UK, such as many mid and small cap stocks, is a potential risk.

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