THE RATES WAIT

JUNE 2018

SENIOR ASSET ALLOCATION MANAGER ANDREW COLQUHOUN TAKES A LOOK AT PROSPECTS FOR UK AND GLOBAL INTEREST RATES

For most of 2017, strong, synchronised economic growth coupled with negligible inflation kept interest rates low and turbo-charged investors' appetite for "risk assets" like equities and credit. But to date, 2018 has seen the growth/inflation mix turn slightly worse as growth has turned patchier, particularly in Europe, while inflationary pressure has finally started to emerge. The consensus among market observers seems to be that interest rates are still going up, but with increasing divergence across regions. As we approach the mid-year point, the strongest view seems to be that the US Federal Reserve (Fed) will raise rates furthest and fastest among major central banks. This has been buoying the dollar's rise since April, which in turn has taken a hit on emerging markets with US-dollar-denominated debt. Meanwhile in Europe, investors have pushed back expectations for an increase from the European Central Bank (ECB) until 2020 on data that suggests that Europe's economic growth has lost some steam in recent months.

IN BRITAIN, BREXIT AND MIXED ECONOMIC DATA FORCE A WAITING GAME

The UK appears to be halfway between EU and US, in terms of growth, inflation and the prospects of higher interest rates. The Bank of England (BoE) held rates steady at 0.5% as of 10 May. BoE Governor Mark Carney has been quoted as saying the central bank's base case is that there eventually will be an agreement on a deal for the UK to leave the EU, clearing the way for higher rates, but on the other hand, a "disorderly Brexit" could force a cut. Crucially, inflation – which had hovered around 3.0% from September 2017 – fell to 2.5% in March and 2.4% in April, lower than expected, while GDP growth slowed to 0.1% for the first quarter of 2018. The ramifications from Brexit will continue to be a swing factor, but their effects remain ambiguous; employment data, particularly wage growth, will be in sharp focus as the BoE determines its rates path.

IN THE US, SLOW AND STEADY FOR NOW

The Fed has increased its overnight lending rate six times since 2015, with the consensus estimate calling for at least two more hikes this year. Most recently, at its May meeting, the Federal Open Market Committee (FOMC) voted to leave its overnight lending rates unchanged at 1.5% – 1.75%, citing an inflation rate that was moving closer to its 2% target while hinting it would be prepared to see inflation run a little above target for a while after a prolonged undershoot, which took some of the steam out of market expectations for increases. But a stronger-than-expected jobs report in early June saw the market return to expecting at least two and possibly three more increases in 2018. The Fed seems to think the "neutral" interest rate is around 2.8%, which should be reached some time in 2019 if the market consensus is right. The question now for investors is whether the Fed stops about there or whether significant further increases are necessary to rein in inflation. Sharply higher rates than the market is currently expecting would undermine risky-asset valuations.

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