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## End of an Era

Published on: 10 November, 2017 | Author: Investment Team

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Last week Mark Carney, Governor of the Bank of England, brought the curtain down on the decade long policy of ultra-easy interest rate policy. The 0.25% increase in UK base rate was the first increase since the Global Financial crisis sent interest rates to historic lows across the developed world and introduced the public to the notion of the “zero lower bound” and “liquidity trap” economics.

The market interpretation was not the one expected by the Governor. The pound fell and the yield curve inverted. An inverted yield curve is typically associated with an economic slowdown. There is little doubt now that the market is discounting a negative domestic impact from the Brexit negotiations. As the clock ticks down to March 2019, one gets the sense that in the business world the fog is beginning to lift and real business decisions in respect of investment, employment and location are beginning to be taken.

In our view the interest rate increase, despite some hard words from Mr Carney, is unlikely to presage the beginning of a significant tightening cycle. Wage growth is too weak, business uncertainty too high and inflation is likely to subside as base effects drop out of the annual calculation.

However, as we have noted before, the global economy is accelerating: interestingly the commodity complex, energy and materials has been strengthening recently, supporting the idea that global growth is both robust and that some of the capex excesses of the last boom have been dealt with. Ten years after the crisis over capacity is being worked off.

Central banks typically embark on a tightening cycle at the end of extended periods of strong growth when the supply side of the economy, as indicated by rising prices and wages, is unable to meet the demands placed on it. Such “overheating” triggers interest rates higher, a shift in relative asset prices and occasionally a recession. Indeed, Paul Volcker at the Federal Reserve, famously engineered a recession in the early 1980s to bring such a wage / price spiral to an end.

In the UK we remain a long way from such a position. Nevertheless, central bankers are clearly uncomfortable with life at the “zero bound.” Unconventional policy is unpredictable and of its nature an “emergency measure.”

It seems more realistic that far from initiating a series of rate hikes, the Governor simply wants to begin the move away from the unconventional and to have some policy ammunition in the tank, so to speak, to deal with future shocks to the system.

In this respect there was a clear hope that the move would be regarded by markets as the beginning of return to normal. Indeed, when interest rates do start to tighten significantly it will be a welcome sign that normal service is about to resume.

Sadly, the market reaction tells us that in the UK, times remain far from normal.

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