Heartwood
Investment Management

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Investment Insight

Weekly Insight

UK Rate Cut - The Giant Awakes

After seven years of slumber, the Bank of England sprang into action yesterday, with Governor Carney unveiling three big changes to monetary policy in order to assist the UK economy's adjustment to life post-Brexit:

1. The Bank base rate was cut from 0.50% to 0.25%.
2. A four year 'Term Funding Scheme' was launched to provide commercial lenders with cheap financing with the intention of filtering the base rate cut through to consumers.
3. The Asset Purchase Programme ('Quantitative Easing') was expanded by £70bn (including £10bn of high grade, sterling corporate credit).

This amounts to a meaningful loosening of monetary policy and the initial reaction of the markets recognised this; equities were buoyed, sterling slumped and bond yields collapsed, again.

Next stop, negative?

Increasingly, central banker words are as important as their decisions, and yesterday investors received clear guidance on several outstanding questions:

Will the UK policy rate go negative?
Whilst a majority in the Monetary Policy Committee signalled their intent to push for a 0% base rate by the end of the year, when quizzed on the possibility of negative interest rates in the UK, Governor Carney could not have been more emphatic in his response - 'No'. However, with 'doves' such as chief economist Andy Haldane on the committee, and a potential new Governor in 2018, this question is likely to re-emerge down the road.

What's most important?
The bank of England has a dual mandate; 1) stable inflation and 2) support for economic growth and employment. Post-Brexit, the Bank now forecasts inflation rising above target (due to more costly imports) and the growth rate falling meaningfully (although the core scenario sees the UK narrowly avoiding a recession). Yesterday's actions prove that it is the latter that is driving policy, and likely will continue to do so over the medium term. Under the Bank's central forecast, unemployment will increase by 250,000 in spite of looser monetary policy.

Is that it then?
Despite Carney's best efforts to reassure the market that all of the above policies can be expanded and extended, and that other monetary tools are still available, investors will be very wary of the recent experiences of Japan and Europe. Over the last two years both have embarked on unprecedented money-printing programmes with limited success. Eurozone growth remains tepid at 1.6% year-on-year and Japan at just 0.1% year-on-year. In his communication it was evident that Governor Carney believes that monetary policy alone cannot solve the UK's structural issues.

Over to you, Hammond

The UK Chancellor publicly welcomed the Bank's action yesterday (as we would expect, having authorised the expansion of quantitative easing). He has also been vocal in his willingness to soften George Osborne's austerity goals and 'reset' UK economic policy. Now the question is how far will he be willing or able to loosen

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the purse strings? And will it be enough to make a difference? And a point to consider, is it the right thing to do with a national debt of 91% of Gross Domestic Product? Philip Hammond will no doubt have been keeping a watchful eye on the Japanese markets this week, as Prime Minister Abe announced a new $45bn fiscal stimulus package to boost welfare and infrastructure. Since the announcement on Tuesday the market has been underwhelmed, with the Nikkei 225 index falling over 2%.

The Portfolio Manager view

Whilst the Bank of England filled the headlines yesterday with meaningful consequences for individuals (helping those on tracker mortgages or hurting savers), the policy changes were perhaps less significant for global macro-economic investors. Incredibly loose monetary policy has become a little looser, extremely low bond yields have fallen further and historically cheap sterling now looks even cheaper. With this broader context in mind, we continue with our prudent approach, holding short-medium dated UK government bonds and foreign currency denominated assets for diversification benefit whilst seeking out areas of value to drive portfolio returns.

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