

# Thesis Reaction

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## The UK Interest Rates Outlook

**There is considerable interest in the current outlook for UK interest rates. Following the latest Inflation report we thought this was a useful time to give a brief synopsis of how the Thesis Fixed Interest committee views the position.**

As everyone knows the Consumer Price Index (CPI) rose to 4% in January whilst the Retail Price Index (RPI) now stands at 5.1%; these figures are obviously well above the Bank of England's target rate which stands at 2% for the CPI index. This does mean that Bank of England Governor Mervyn King is suffering from writer's cramp as he regularly has to write to the Chancellor explaining this overshoot.

The inflation report was subtly changed in the January report where inflation was expected to overshoot its target in two years time if interest rates remain at 2%, whilst in the previous report in November it was expected to undershoot its target by a fair margin. Although the overshoot is marginal this must increase the chance of an interest rate rise and it has been noticeable that the number of commentators expecting a rise has increased in recent weeks. It should also be remembered that Mervyn King is amongst the dovish element on the Monetary Policy Committee (MPC) and therefore whilst his views get the greatest level of publicity the latest decision on rates was 'finely balanced' and so his fellow members might be becoming more likely to take action. This has been recently confirmed by the news that three members of the committee have voted for a rise - two for 0.25% and one for 0.5%.

However, in the face of an inflation rate that has overshoot its target for many months now there has to be pressing reasons not to have already acted, I think we can take it as a given that the MPC would be more comfortable with rates in their more normal range and it is therefore their concerns on the fragility of the recovery, bolstered by the weakness of the UK housing market and a high unemployment rate that have kept a record low level of interest rates for 24 months now.

If the strength of the recovery seen at the early stages of 2010 had been maintained then rates might already have risen, but there are fears of weakness in an economic rebound that

is different to other periods of emergence from recession due to the weakness of the banks. This lack of lending by banks was confirmed by the fall in GDP in the fourth quarter figures, initially quoted at a 0.5% decline subsequently increased to 0.6%.

Our view has been that the need to reduce borrowing, primarily government but also personal, would have to hit consumer spending upon which traditionally so much of our economic growth depends. The direct cut in government and local council payroll, the imposition of VAT at 20%, the rise in the price of oil/petrol (especially relevant currently) and the effect of pay freezes or wage increases below the inflation rate will all cut disposable incomes and so act as a rein on inflation pressures. It is these factors which have caused the MPC to sit on their hands so far, and it is these factors that despite the increasing calls for rate rises, which many expect by April/May that we think still make this a finely balanced call. Even if rates are increased we would expect base rates to go no higher than 1% - 1.25% by the end of 2011 with the distinct possibility of the MPC then having to cut rates back towards the current level.

Our expectation is for a rebound in GDP for the first quarter of 2011, helped by a bounce back from the snow affected conditions in December but that growth will remain slow and low remaining in the 1% - 2% range in both 2011 and 2012. Under those conditions we still see merit in holding fixed interest stocks and after the pullback in Gilt prices over the past two months there could be a useful rebound later in the year. In broad terms our Fixed Interest weighting is split between a two-thirds allocation to Corporate Bonds and a one-third Government Security weighting. During the pullback in Gilt prices this positioning has helped our performance and if this weakness were to continue we could even envisage increasing the Treasury weighting.

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