Investment Bulletin

SAUNDERSON HOUSE

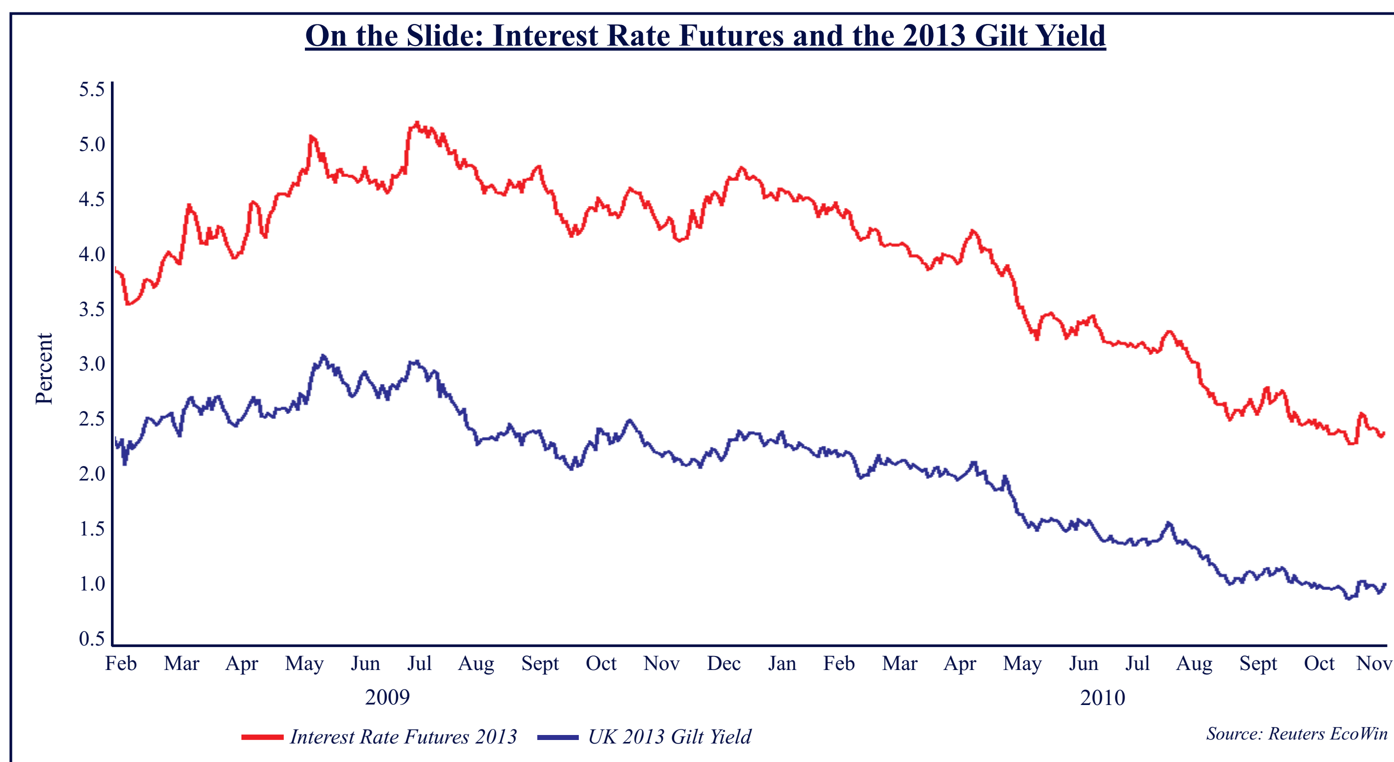
16 NOVEMBER 2010

CONFLICT-FREE FINANCIAL ADVICE

UK INTEREST RATES: LOWER FOR LONGER

Earlier this month, the Bank of England's Monetary Policy Committee (MPC) concluded that, at present, there was no need to extend the UK's programme of quantitative easing. At the same meeting, the MPC also agreed to leave the Bank Rate at 0.5%. This was the twentieth successive 'no change' meeting since rates were cut to this level in March 2009. As 2010 has progressed, it has become increasingly clear to us that UK interest rates will remain lower for longer. In this note, we discuss the reasons why, and recommend that clients make further reductions in their 'cash buffers' where appropriate.

The chart below illustrates the downward path of expectations for short-term UK interest rates since the final reduction in the Bank Rate in early 2009. The blue line shows the gross redemption yield on a UK government bond with c2 years to redemption. This has declined from c2.3% at the start of the year to less than 1% now. The red line shows the 2013 interest rate futures contract. This is a simple, exchange traded, instrument that allows investors to hedge or speculate on the level of interest rates in 2013. It is somewhat higher than the gilt yield as the interest rate underlying the futures contract is an interbank rate, rather than a 'risk free' government rate. Nevertheless, it has followed a similar downward path to the 2013 gilt, as the view that interest rates are not set to increase for some considerable time has become more widespread.



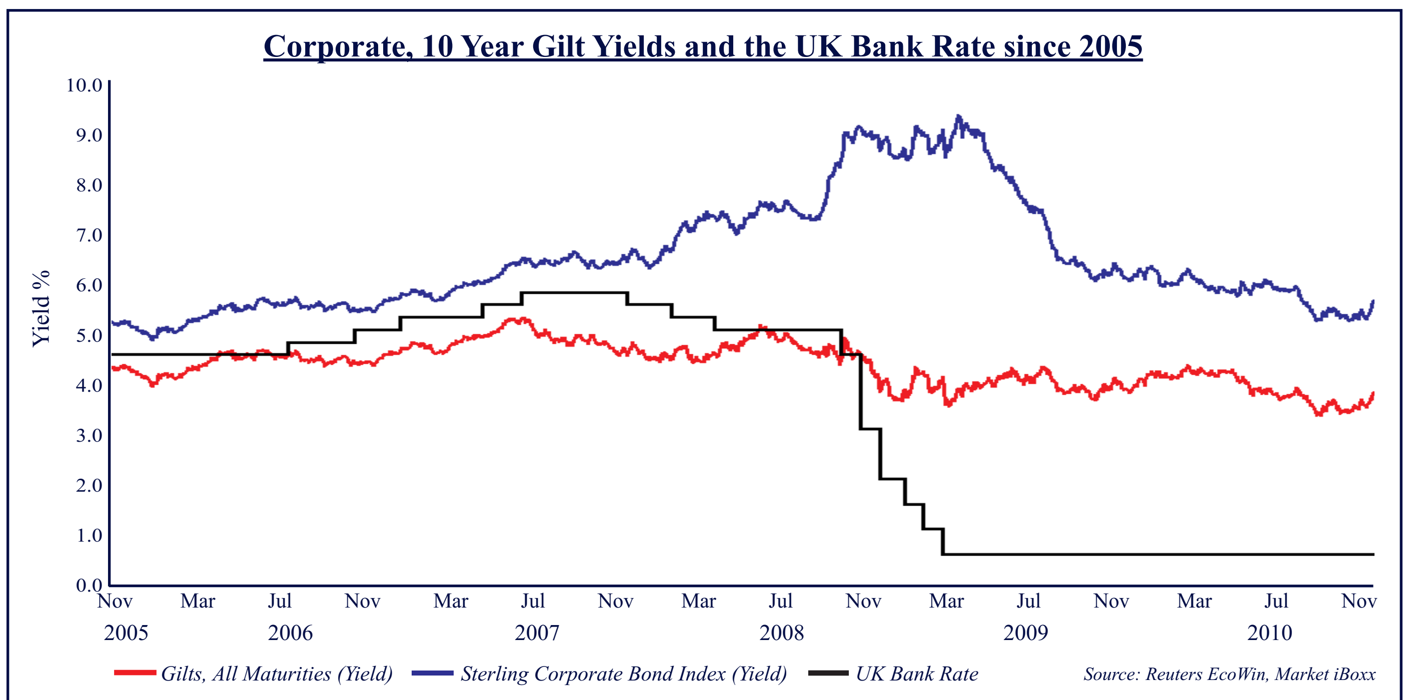
Saunderson House Ltd, Independent Financial Advisers, 1 Long Lane, London EC1A 9HF
tel: 020 7315 6500 - fax: 020 7315 6550 - web: www.saunderson-house.co.uk

Three developments explain the decline in interest rates expectations:

- the pace of economic recovery, thus far, has been slower than expected;
- the magnitude of the public sector cuts, introduced by the coalition government, are likely to bear down on future economic activity necessitating greater monetary support for the economy;
- inflation, while currently above the Bank of England's target, is expected to fall in the coming months. If bond investors were concerned about rising inflation undermining real returns, bond prices would be falling, putting upward pressure on interest rates.

The above analysis suggests that UK policymakers are in a 'straightjacket'. The fiscal tightening is necessary to maintain the confidence of investors who are funding the UK's fiscal deficit, but policymakers must simultaneously give the economy as much support as they can to avoid a slide back into recession. Thus, short-term interest rates must stay low to bolster growth and ease the impact of spending cuts and tax increases. Should the economy show further pronounced weakness, a second programme of quantitative easing (QE) is likely to be introduced. Alternatively, if we see upgrades to growth expectations, QE may begin to be withdrawn.

With interest rates looking set to remain lower for longer, we see little advantage in holding heavy allocations to cash within portfolios. We are recommending, therefore, where appropriate, reducing cash holdings in favour of corporate bond funds. As the chart below shows, investment grade corporate bonds still offer an attractive yield relative to both gilts and cash deposits. We will be analysing individual portfolios and will write with any specific recommendations, as appropriate.



This note is for general guidance only and represents our current understanding of law and HM Revenue and Customs practice as at 16 November 2010. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor. Saunderson House Limited is authorised and regulated by the Financial Services Authority.

Saunderson House Ltd, Independent Financial Advisers, 1 Long Lane, London EC1A 9HF
tel: 020 7315 6500 - fax: 020 7315 6550 - web: www.saunderson-house.co.uk