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UK RATES – TAKING THE FIRST BABY STEPS

With UK GDP growing at 'potential' and about to be revised higher in September, inflation probably troughing and the MPC mindful of bubbling house prices, Hermes Group Chief Economist Neil Williams believes the first 25bp rate hike could come as early as November.

Real house prices have long been one of the best indicators of UK GDP growth. Previous Bank Governor King believed this was coincident, not causal, with little effect on wealth. While this may be true in the long run, it's encouraging that the MPC now warn of the destabilising effect that house-price gyrations can have – especially after five years of negative real rates and housing subsidies (FLS, Help-to-Buy).

National house prices, running at a real 9% increase yoy, may in time be calmed by macro-prudential measures, but this is "*no substitute for monetary policy*" (Governor Carney, Mansion House speech).

Planting the flag early for Carney to cap the peak rate at 3%

For markets, UK monetary policy starts to tighten as soon as a visible split emerges within the nine-member MPC. Monthly votes during Carney's one-year tenure so far have been unanimous. But given the change in 'mood-music' now being signalled by some, a minority vote for hiking looks imminent.

Based on recent remarks, early advocates of a hike could be Weale, McCafferty and, as gate-keeper to the Bank's quarterly inflation forecast, Haldane, although they may wait for the next forecast round in August to justify it.

Such a vote might spark the more dovish Carney to use the November forecast round to 'plant the flag' with the first 25bp hike, to 0.75%. Logistically, this then gives the MPC the chance to 'sit on hands' through the election, before picking up the baton again in the second half of 2015.

This would roughly preserve the BoE's 2% yoy medium-term CPI inflation target, and allow the BoE to move in lockstep with the US Fed, which in turn might take some of the strength out of the pound.

Planting the flag early should help Carney make sure the peak rate, when it comes, is "*materially*" lower than its 5% historic average. Yet despite the earlier start and the need to 'travel further' (given no G10 economy has loosened its policy mix as much as the UK), a combination of factors means that the MPC is likely to take only the smallest 'baby steps' to normalisation.

First, the UK may have reclaimed its pre-crisis GDP level, but it remains towards the back of the G10 pack. The UK compares unfavourably with a 'dollar bloc' that has more than made up its lost ground. The UK is also still constrained by its main trading partner, the eurozone.

Second, growth will not be surrendered for as long as 'demand' (core) inflation remains low. The key to change here will be wage growth, which, according to our Phillips Curve analysis, needs faster unemployment cuts before picking up. Carney has rightly dropped his formal linkage of rate tightening to a predefined unemployment rate, and aggressive rate rises make little sense while real wages are deflating

The third reason for a slow journey is the need to telegraph the changes carefully, given how complex monetary policy has become. While the MPC look at a range of capacity indicators, they have most difficulty explaining the 'output gap'. Expectation of the gap closing also implies rate tightening in 2015.

Then there's the possible policy 'curveball' of Scotland's independence vote. If delivered, the threat of the UK 'losing' around 8% of its GDP (*circa* £129bn), Scotland's top-heavy bank-assets-to-GDP ratio, the risk of capital flight, and uncertainty about gilts payments could all cause a significant jolt to the pound.

But perhaps more critically for the Bank (and US Fed), it has too much 'skin in the game' to want to take markets off guard. This is by virtue of its £375bn of gilts bought under QE. If it does, their balance sheet gets hurt.

However by turning this position to its advantage, the Bank has a second lever to pull to take money out of the system. With QE untried before 2009, the difference this time is the Bank can raise rates in tandem with reductions in its gilts stock via 'QT' (quantitative tightening). We estimate that:

- the MPC would need to take rates to 4% to normalise policy fully: *i.e.* to move to its 'neutral' or 'Goldilocks' rate. This gets close to threatening Carney's mantra of falling short of the 5% historic average;

- a meaty £107bn erosion of QE (to £268bn) would thus be needed to fill the gap – *i.e.* normalise policy at a lower, peak rate of 3%. But, given the redemptions profile, this would take until March 2018;

- in which case, the *quid pro quo* for keeping rates down is the Bank will after 2015 have to sell a significant portion (up to a third) of its gilts.

So, investors should brace for higher UK policy rates. Yet if we're right about lower peak rates and gilts sales, this should offer some support to equities and other growth assets, relative to conventional bonds.

In the meantime, BoE policy is about to get more interesting.

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Notes to Editors:

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