Walking to stand still

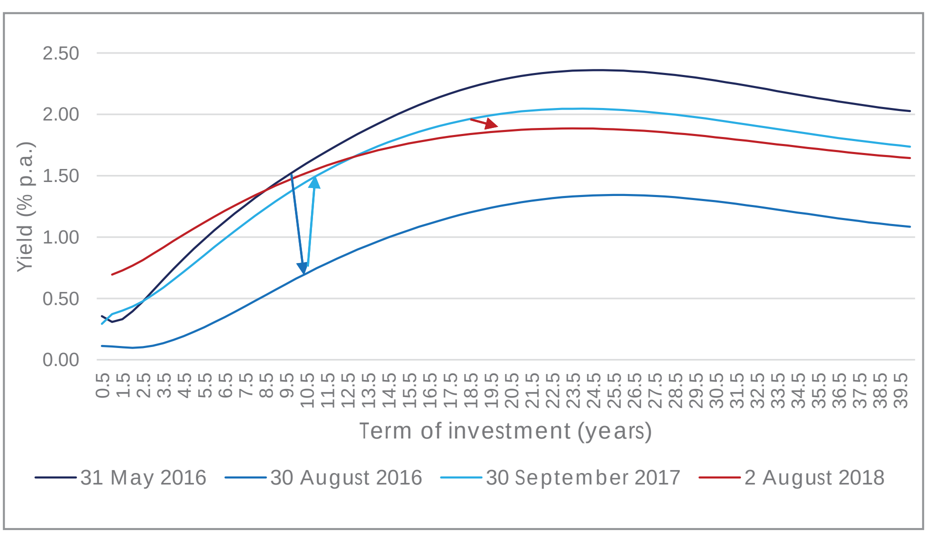
On 2 August the Bank of England raised bank base rates to 0.75% pa, the highest rate since 5 March 2009. To put this in perspective, from the end of 1694 to the end of 2008 base rates (or the equivalent) had never been below 2.0% pa

The level of interest rates

Interest rates are on the way up. Great news for defined benefit schemes! A little investigation reveals that the market had largely priced in this rise. The impact of the announcement on the day was the smallest of falls in prospective returns on shorter-term government bonds (a fall in yields of .01% p.a.), as the Governor suggested that UK policy needed to "walk, not run, to stand still".

But the market must have still priced in a rise? The chart below shows the Bank of England's plot of yields on government bonds held for different terms, with the arrows highlighting the change over four dates:

- 31 May 2016 – shortly before the EU Referendum vote, then down to
- 30 August 2016 – a little after the Bank lowered rates to 0.25% pa, up to
- 30 September 2017 – when the market participants believed on average that interest rates were on the up, and then to
- 2 August 2018.



Looking at the chart shows longer-term rates are still below those of a year ago, even after the announcement.

Implications for schemes

Long-term interest rates remain stubbornly below those that prevailed before the EU referendum vote. Within two months of the vote, longer-term rates reached an all-time low (see 30 August 2016 in the chart), with the bank reducing base rates to 0.25% pa on 4 August 2016. Long-term rates then recovered in 2017 as the economy picked up, but have since fallen, with any 'Brexit' deal remaining to be settled and GDP growth remaining well below trend.

We are starting to see a flattening of the yield curve, as investors see disruption to economic growth, the latest of which is the escalation of trade confrontations with the US. The bank's "limited and gradual" approach to lifting rates means diminishing prospects for meaningful future rises. Might rates never recover to the historic norms seen since the 17th century? As Carney said, never is a very long time, but the poor outlook continues to weigh on pension scheme liabilities. Events could mean rates being cut suddenly (there is now a precedent) and schemes should plan to appropriately mitigate this risk.

There are also opportunities. Those pension schemes investing in gilts, to bank equity gains, in 2017 and early 2018 when gilt yields were higher, will have found the value of these gilts since increase due to a fall in yields. Furthermore, on the very same day that base rates rose, some investors with liability-driven investment funds, i.e. funds focused on matching movements in their liabilities, received announcements that they are to receive a cash distribution (due to a 'rebalancing' of these geared investments) to invest.

The world is travelling new roads, but a proper plan opens up the opportunities. Look ahead, and stay on top of your plan to make the most of the increasing uncertainty, even if we are now walking not running.

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