Comment w/c 12th February

Interest Rates, Stockmarkets & Productivity

So the oracle - that is, the Bank of England - has spoken, confirming what Capital Economics forecast two weeks ago: that interest rates are likely to rise sooner and further than hitherto expected. But by that time the stockmarket had already reacted to the prospect of higher rates, first in the United States and then across the world, including London.

Why do share prices fall when interest rate rises are pencilled in? Simply, in order to raise the yield which can be expected on an investment. A falling stockmarket does not in itself indicate an economy in danger. Calculating yield is simple: income is divided by price. Unless income - that is, dividends on shares – rises, the only way to increase yield is to reduce prices. That's what the stockmarkets are up to.

Of course if those interest rate rises are punitive it can put a brake on the economy, thereby raising questions over future business performance – the ability to maintain dividends - but we are not in that place at present.

Interest rates have been so low for so long that people have almost forgotten what 'normal interest rates' feel like. For the past two decades we've lived in a new experience of hugely scalable supply as a result of the technological revolution, including its incredibly empowering impact on what were previously called third world countries. Wages in developed countries have been suppressed as their economies have been flooded with cheap imports from overseas, and as so much of the early digital economy has been de-monetised.

But a plateau has been reached now, as workers start to test labour markets for higher wages, and the tech giants start to flex their pricing models. As a result, inflation can no longer be assumed to just 'settle back down again', and interest rates have to nudge upwards to take excess heat out of the business cycle.

In the United Kingdom, we predict that as interest rates rise there will also be a seemingly miraculous rise in productivity:

A couple of weeks ago we drew attention to Capital Economics' analysis, showing that the financial services sector has been responsible for more than half of the fall back in productivity following the 2008 crash. Our commentary then drew attention to the way financial services have been challenged over the past 30 years by the introduction of dual capacity, and the ensuing regulatory overload and margin compression that has resulted from irreconcilable conflicts of interest in these businesses. But we should also be aware that much of the value added in the sector, particularly in banking, insurance and investment firms, arises directly from earning interest on substantial cash deposits.

When interest rates are at normal levels – say, 3% or more - this income remains relatively constant as rates rise and fall. But when rates drop markedly lower, as they have done over the past ten years, a mighty hole appears in their revenues and bottom lines. So, without any reference to "employees in the United Kingdom having to work an extra day each week to produce what their counterpart in Germany does in a day less", a hole appears in the productivity figures. As interest rates recover to normality, that cause of falling productivity will be removed: so expect an improvement!

Where's the bad news now?

Gavin Oldham

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