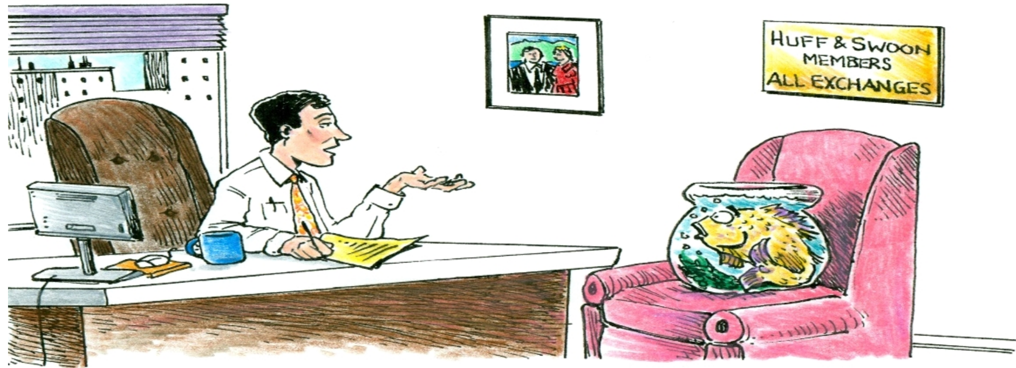
Monthly Newsletter

'Why Interest Rates Don't Go Up' July 2019



And why is liquidity so important to you?

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With the US economy growing for the longest period in history, unemployment at historic lows and inflation nudging slightly higher, it prompts a second take when reading that the Federal Reserve, the US's central bank, is expected to cut interest rates this summer.

Normally when unemployment is low, interest rates rise to put a lid on wage inflation. Wage inflation tends to be the key driver of overall inflation. So why are interest rates going down, not up?

The answer might lie in the restructuring of the financial system following the 2008-9 financial crisis. The response to the collapse of the banking system was to force the banking sector to reduce their borrowing levels and to attribute different costs to different types of lending. Put simply, a loan to a householder for a mortgage is cheap for a bank to do, however a bank borrowing to buy shares is expensive for a bank to do. No surprises then that the banks have withdrawn from buying shares and we've seen increased competition in the mortgage market.

But as with most regulatory changes they have unexpected consequences. Banks that buy shares as part of their business are generally called investment banks. With reduced borrowing encouraged and the higher costs imposed there has been a largescale withdrawal from investment banking. This has reduced the lifeblood of the financial markets - liquidity. Liquidity refers to the speed with which an asset (a share for example) can be bought or sold in the market without affecting its price - the ease of converting it into cash.

The recent disintegration of Woodford Investments and the big job losses in Deutsche Bank's equities division are renewed signs that the blood pumping around the financial system is once again getting clogged. The response is the "surprising" interest rate cuts on the horizon. Because of the new regulation interest rate cuts are now pretty much the only way to provide liquidity to the financial markets. Effectively, regulation has meant the central banks have had to substitute themselves for investment banks.

The end game? Well it is two-fold. Firstly there will be, and already is a stampede towards owning only the largest, most liquid companies. These are the only shares big investment managers can sell out of quickly. The value of what they are buying is now just a secondary concern. The second is that central banks will end up buying shares in the stock market, having consigned investment banking to the regulatory sinbin. Farfetched? Well the Bank of Japan is one of the largest shareholders in Japan for this very reason.

All this doesn't spell disaster for shares but it does mean we should get used to the sharp up and down moves we have seen lately. It would be nice to think the authorities would have the foresight in seeing the current problem and provide liquidity to markets in a more sustainable way than using the blunt weapon of interest rates. The history of finance suggests otherwise….

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