A RIDDLE WRAPPED UP IN AN ENIGMA

THE DYNAMICS OF THE RELATIONSHIP BETWEEN INTEREST RATES AND INFLATION IS COMPLEX, SAYS WILL HAISER

In the relatively short history of sophisticated financial markets, there has generally been a backdrop of monetary policy to suppress inflation. As a result, short-term interest rates have been higher than headline inflation to dampen buoyant growth fuelled by overextended asset prices.

Now the world has changed with a pivotal readjustment of fundamentals. In key developed economies, headline inflation has been allowed to drift close to, or above, base rates to encourage an increase in economic output in the face of an economic downturn not seen since the Great Depression of the 1930s.

The new dynamics of how the relationship between interest rates and inflation reverts back (or not) is complex. The different scenarios of possible reversion to previous patterns both in timing and scale is already being played out in the capital markets as forward guidance from central banks battles with future expectations to determine market pricing. As these future levels impact both rate and currency valuations, there are significant consequences for corporates that will affect their funding and investment decisions, which, in turn, can also influence international capital flows.

Even the recent decision of the US Federal Reserve to continue its quantitative easing (QE) programme is a timely reminder of the complex interdependency of global economic policy.

We have used the UK as a case study below because it has a long-established culture of inflation linking and the Bank of England has a comprehensive database from which to robustly illustrate developing patterns.

UK interest rates and inflation background pre-crisis

Historically, the main access to sterling inflation products was via government indexed-linked bonds. With further technological advances facilitating the growth of derivatives and monetary policy effectively targeting inflation, a stable correlation between interest rates and (declining) inflation was created.

This correlation encouraged the use of shorter-term proxy hedges by market participants, and the consequences of better liquidity incentivised their use further. In reality, this was inconsistent with the potential mismatch risk between fixed-rate exposure and indexation for longer-term horizons. So, as the derivative markets grew, they became the de facto pricing benchmark. Increased liquidity across the term structure allowed for mathematically constructed forwards to be implied from these fixed-rate market levels.

UK post-crisis – responding to the lessons learned

But the financial markets have been warned about factoring in an imminent rise in interest rates in the UK. "If the financial markets are pricing in a sharp rise because they think in the past, every time the economy's growing quickly the bank's raised interest rates, I think they should think again... Our forward guidance says clearly that's not the case," said Bank of England chief economist Spencer Dale in October.

The implementation of QE has created a double-edged sword for those managing the mismatch between fixed rates and inflation indexation:

(i) The first, less obvious, effect is via a powerful indexation effect incorporating above-target inflation to boost both present and future revenue flows (an index incorporates the past); and

(ii) The second, in the guise of low interest rates, is to assist short-term funding.

It has been generally assumed that implied interest rate forwards are an unbiased snapshot view of the future path of rates and can become indistinguishable from expectations. The question therefore for those managing the mismatch between fixed rates and inflation indexation is: are these derivative markets still offering a balanced entry point that gives an equitable outcome for all? If the answer is 'no', then there may be unintended direct and secondary effects.

Onwards and upwards: how to tackle the future

Can the divergent opinion between the Bank of England's forward guidance issued in August 2013 and interest rate forwards derived from interest rate derivatives be rationally explained? Should we still seek the sanctuary and certainty of fixed rates? Should we be relying on history to explain how we will emerge from this crisis when we possess no historical precedent to guide us?

Our follow-up article suggests a decision-making framework to provide potential answers to these crucial questions. It can be viewed at www.treasurers.org/thetreasurer

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To read the follow-up article by Will Haiser on a decision-making framework to help treasurers weigh up their interest rate options, see www.treasurers.org/thetreasurer