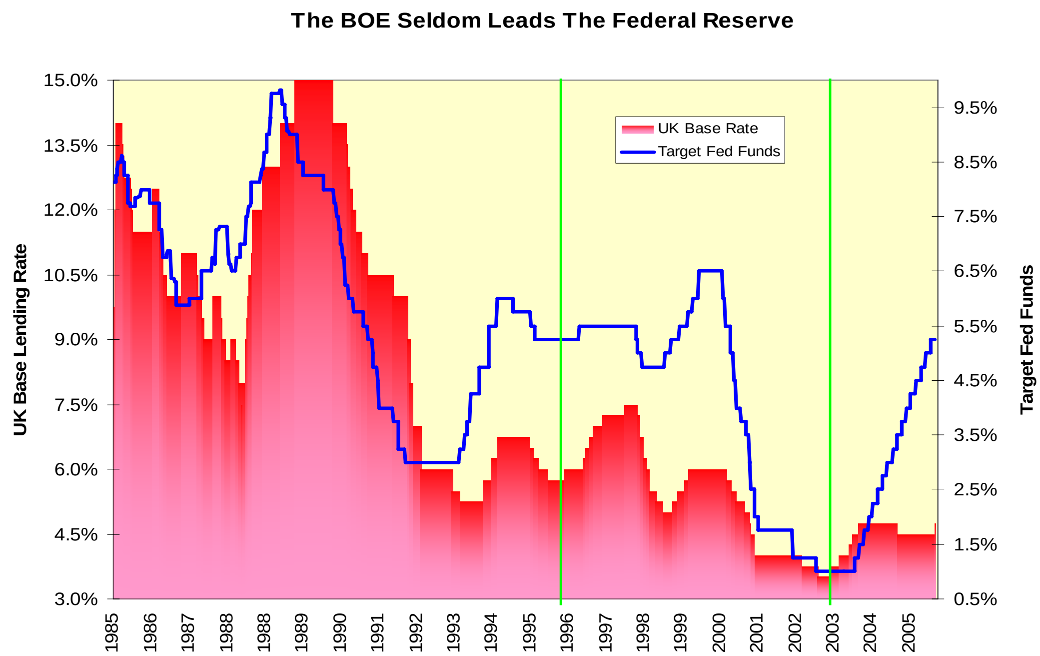
European Rates; No Worries, Mates

The decisions by the European Central Bank and the Bank of England to raise their respective interest rates last Thursday were greeted with concern by the usual folks who greet things with concern, the Union of Concerned Scientists not included.

The thinking, if that is not granting too much credit, was these rate increases not only were part of a pattern of global credit tightening – we know all about our Federal Reserve's 17 consecutive rate hikes and the Bank of Japan's historic withdrawal of liquidity, discussed here last month – but the European actions were going to embolden the Federal Reserve to pause in its prospective pause before having yet paused even once. Yes, this is a scary world, my friends.

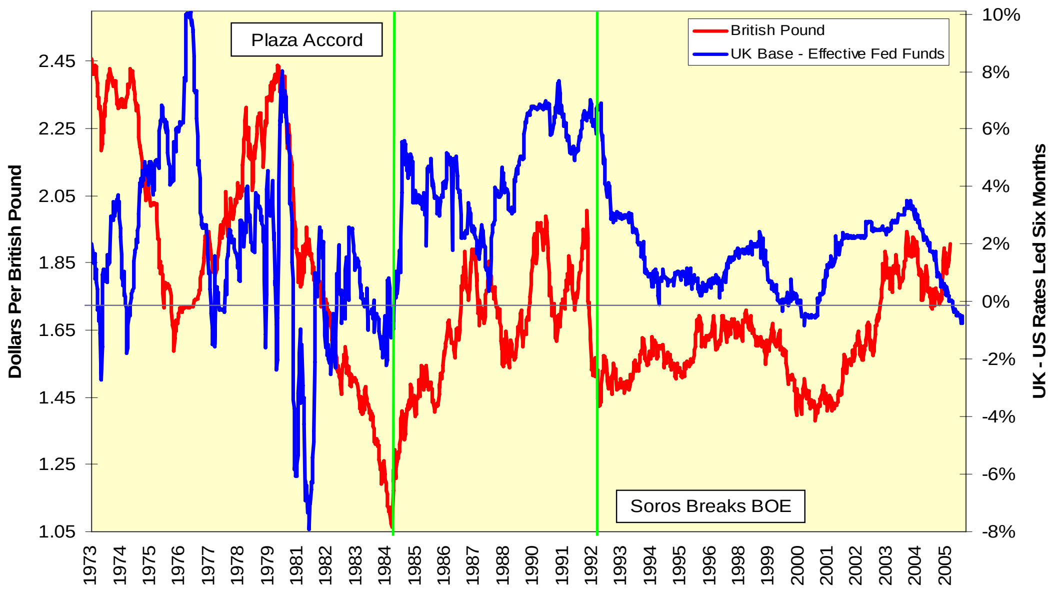
We Ignore Them

History suggests something very different. As the ECB is the veritable newbie in the world of central banking, having come into existence only in June 1998, and is the only central bank representing a consortium of nations – sort of like having all the downsides of polygamy without any of the benefits – we cannot produce a long comparative history of its actions next to those of the Federal Reserve. We do, however, have a long history for the Bank of England. Only twice since the modern era of central bank coordination arrived in the mid-1980s has a BOE rate hike preceded one by the Federal Reserve, once in June 1996 and once in February 2004.



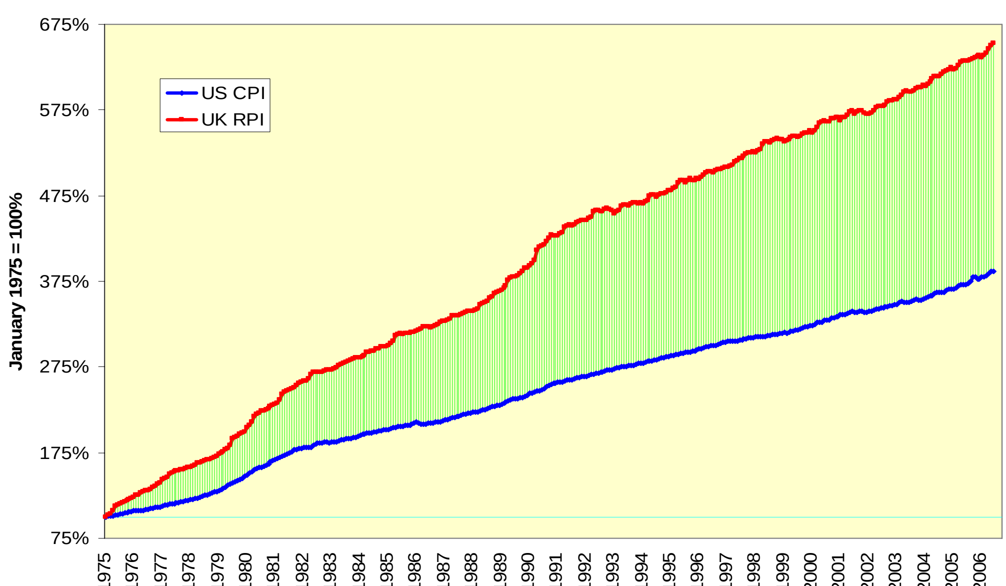
Once central banks began their modern era of coordination – contrast the relative behavior of the federal funds rate and the British base lending rate during the pre-Plaza Accord era of floating exchange rates to what has followed since – we would be hard-pressed to link the course of the British pound to the rate gap between the U.S. and the U.K. For virtually the entire time since 1985, the U.K. base lending rate was greater than the effective federal funds rate, including the period in September 1992 when the pound collapsed under the weight of speculative attacks. The present period is one of the few when the effective federal funds rate exceeds its British counterpart. If this starts to reverse, we should expect to see the British pound firm against the dollar; the average lead time for this relationship has been six months.

Interest Rate Differentials Had Favored Dollar



Has the history of high British base lending rates led to positive macroeconomic or market outcomes for the U.K.? If higher short-term interest rates are so effective at combating inflation, the main justification given by interest rate hawks for continued rate hikes, then how do we explain three decades of faster growth in the British retail price index than in the American consumer price index? The relationship has been one of consistent failure for the BOE; it is hard to see a period in which British inflation did not exceed its American counterpart.

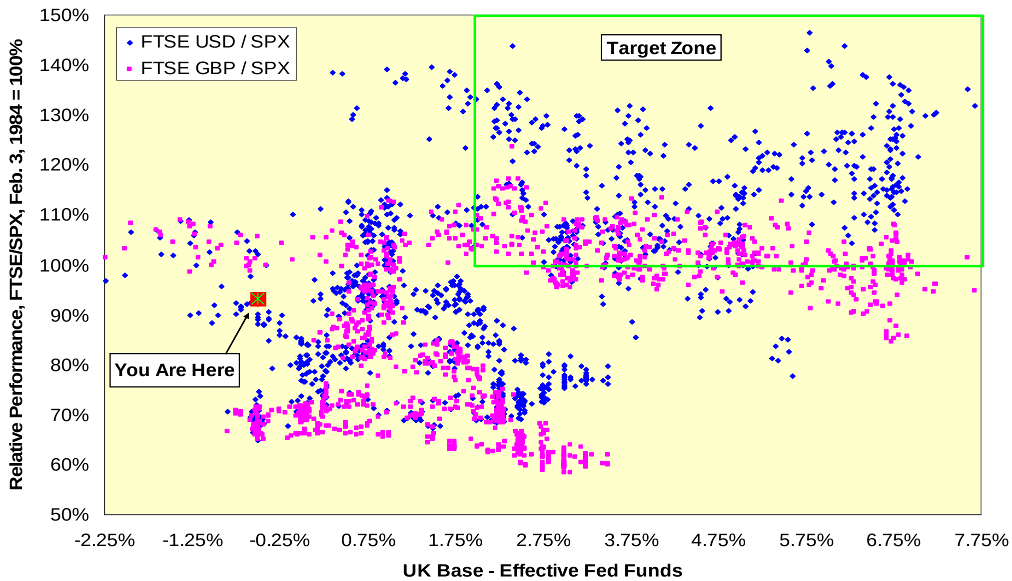
A Tale Of Two CPI's



How To Invest

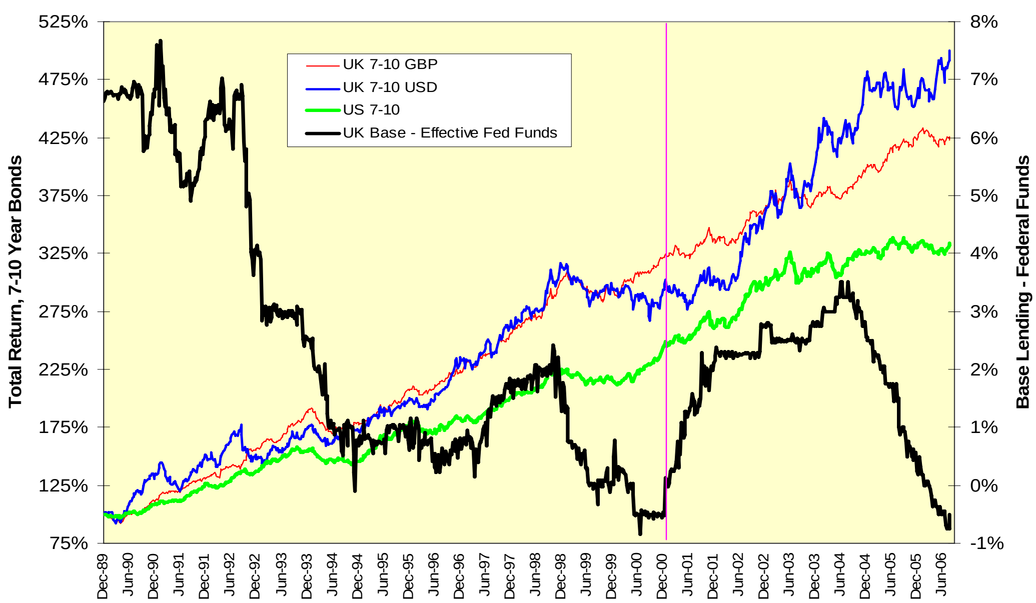
Now let's turn to relative stock market performance as a function of monetary policies. Regardless of whether we measure the performance of the FTSE in dollar or pound terms, those periods such as today when the base lending rate is low relative to the federal funds rate are times of underperformance by the British stock market. Perhaps the British impulse is similar to ours, that low interest rates are nothing but good news for stocks, but this would be unfortunate. Low interest rates more often than not are the handmaiden of a weak economy and hence of weak profit growth. The consistent zone of outperformance by the FTSE exists only when the base lending rate is 200 basis points higher than the federal funds rate. Given that, buying British stocks today may prove to be an effective value play if U.K. interest rates continue their move higher.

Monetary Policies' Effects On Equities



A similar conclusion is reached by looking at comparative bond returns. If we compare the total returns for 7-10 year Treasuries and Gilts since December 1989, we see how the U.K. bonds in dollar terms have led the performance race. Their total return since that time has been 325%, as opposed to 224% for Treasuries. Moreover, the last time the base lending rate increased relative to the federal funds rate, in early 2001, U.S. bonds outperformed briefly before the British bonds left them in the dust.

Monetary Policy And Relative Bond Returns



The end result of the BOE's rate hike action might be nothing less than creating an opportunity for U.S. investors in both British stocks and bonds. The less-complete data set prevents us from drawing a similar conclusion for euro-denominated stocks and bonds. But the whole affair emphasizes, as if further emphasis were necessary, how the proper response to a policy change is searching for the next trade, not running expressing panic or even concern.