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BREWIN DOLPHIN

Stimulating times

There has been much excitement recently about the possibility of a cut in interest rates in the US, and its potential to provide stimulus for the US economy. However, investors need to bear in mind that monetary policy operates with what Milton Friedman called "long and variable lags"[1].

This rather dry and uninspiring phrase has become a mantra for economists but is often forgotten by the investment community. What it means is that it can take up to two years before the majority of the impact of a change in interest rates is felt within the economy.

So, although stock markets often react to the mere hint of a change in interest rates – futures rose as the chairman of the Federal Reserve hinted at rate cuts later in 2019 – these tend to be short-lived. They represent noise, rather than the message the market needs to be looking out for.

Lower yields

That said, there are encouraging signs elsewhere as we believe that US monetary policy is already offering a meaningful stimulus to the economy. This comes in the form of lower bond yields.

Bond yields are the interest rates which governments and companies have to pay to borrow from investors. In the US, mortgage lending is funded by issuing bonds. When bond yields rise mortgage rates go up and vice versa.

Higher mortgage rates reduce the demand for houses, which in turn reduces the incentive to build or develop property. This is important because housebuilding is one of the most economically impactful forms of work.

Each house is a big outlay relying upon lots of materials which are generally sourced locally (because they are often bulky). Housebuilding is very manual, unlike lots of jobs which are increasingly automated. Houses need to be furnished, decorated and moved into.

Pent up demand

So far in 2019 the pace of housebuilding has declined for the first time since 2010, stalling at a rate of around 1.2m new homes per year. Not coincidentally, in November 2018 interest rates on a US 30-year mortgage were at 5.2%, the highest rate since 2009.

However, today, just over six months later, that rate has fallen to 4.1%, making the prospect of buying a house distinctly more attractive. And there is a lot of demand sitting on the side lines.

Despite eight previous years of expansion, the rate of US housebuilding growth has been slow since 2008, despite the population continuing to rise. Between 1960 and 2008 the US consistently averaged a new house each year for every 170 people in the population. Today, a new home is being built for every 360 people. This implies an entire decade of under-building of homes and considerable pent-up demand.

Energy boost

The recent fall in energy prices is also potentially stimulative. For most of the past three years oil prices have been rising relatively consistently, peaking at $86 in October last year. Now they are back in the mid $60s.

[1] Milton Friedman: The Lag in Effect of Monetary Policy, October 1961.

Almost all businesses, governments and households suffer the cost of high oil prices and so when prices fall they constitute a windfall for the vast majority. Declining oil prices are like the stimulus central banks can only dream of in terms of their effectiveness.

Taken together, we believe that falling oil prices and lower bond yields will support US growth in the second half of this year. They will help stave off recession a while longer in this remarkably long period of economic growth.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team, providing recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. He is a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.