

# Staying ahead of the (money market) curve

February 2011

**U**K interest rates are currently being discussed more than at any time in the past two years. Everyone knows that the next move in UK interest rates will be up. Market and media debate centres on when the first increase will be made, and how far rates will rise. For money markets, however, history shows that when the market decides a rate rise is imminent, money market curves often move a long way very quickly. We believe that money market investors should therefore be cautiously positioned at present, but ready to take a more aggressive stance once the market has moved.

The UK economy is at a crossroads. The credit crunch acted as the catalyst for a sharp recession. The impact on the financial sector was particularly severe, and this led to unprecedented policy responses. Interest rates were slashed to the lowest levels since the Bank of England was formed in 1694, and when this was not seen as sufficient to stabilise the financial sector and the broader economy, £200 billion was spent as part of a quantitative easing programme.

These actions are credited with avoiding a severe slump. Yet growth has not yet fully rebounded. After recording positive figures for Q2 and Q3 2010, the Q4 figure was negative. This was impacted by the poor weather conditions seen in December, but even allowing for this, growth was worse than expected, and forecasts have been scaled down accordingly.

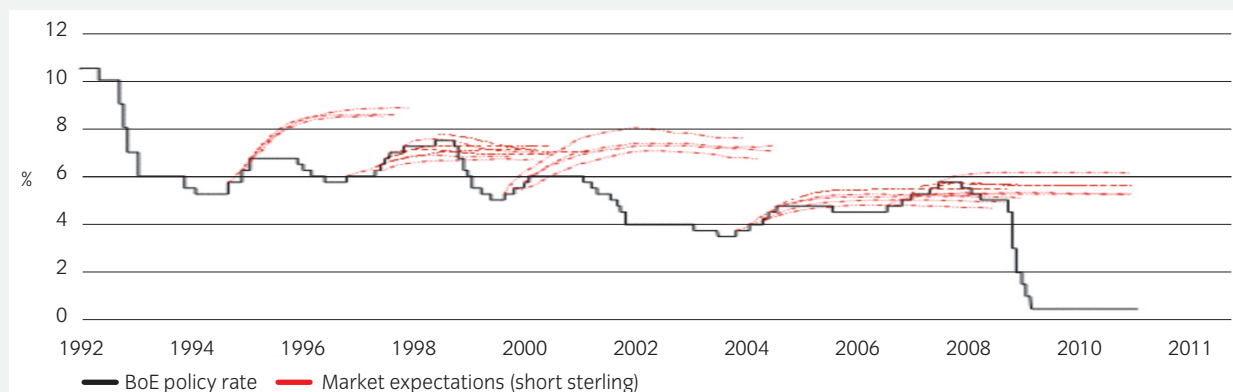
Ordinarily, this would mean that interest rates were likely to be held at low levels. But CPI has been above the 2% target for over a year and inflation is a growing consideration for the Bank of England. Eventually inflation will outweigh growth as a concern (whether from the former or latter increasing) and rates will increase. Hence speculation has been focused on when the first hike will be made, and at what level rates will eventually peak.

## The historical perspective

While many investors may think that money markets will adjust gradually to interest rate changes, the reality is quite different. In particular, money markets tend to shift dramatically at turning points in interest rate cycles, and tend to overshoot at the same time.

An excellent example of the overshooting tendency can be seen in the US in 1994. The Federal Reserve was moving into a tightening mode after rates had been held at 3% for nearly 18 months. US treasury 5-year yields rose by 150bp in just two months, while futures moved to price in a rate peak of 8½%. That rate cycle would actually peak at just 6%. A similar reaction was seen in the short sterling market (as shown in chart 1). This market effect was not limited to 1994 – the tightening cycles in 2000, 2004 and 2007 all saw the market taking too hawkish a view. This meant that even in mid 2008, 12-month LIBOR was printing at nearly 6.5% – even after the MPC made the first cut en route to 0.5% base rates.

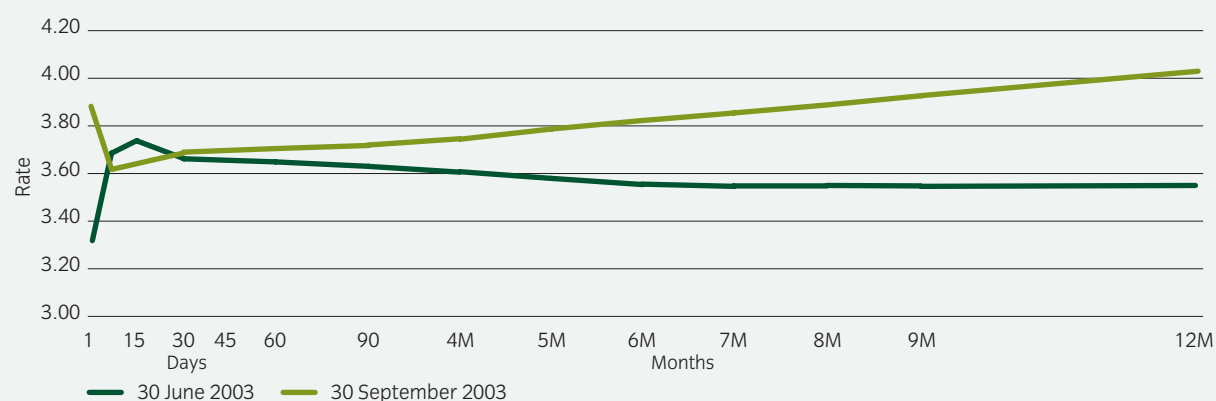
Chart 1: Market over-reaction



Source: Nomura Rates Strategy

A recent example shows how the money markets move to price in a lot of changes, often before a single rate move, can be seen in the most recent UK rate hike cycle from Q4 2003. Chart 2 shows that the sterling LIBOR curve moved dramatically over the course of Q3 2003 – i.e. before any actual change in UK base rates.

Chart 2: LIBOR curve comparison: end of Q2 and Q3 2003



Source: Bloomberg.

## Catalysts for change

The two lessons we take from historical performance are that the curve will move from ‘all is well’ to ‘rates are going a long way’ in a very short space of time, and that it will probably overshoot in its expectations. As a fund manager, we believe that this means that there is a difficult period to negotiate, but that this period will also present opportunities.

A cautious approach means that rather than fixating on when rates go up, the key consideration is when we believe markets will move to price in rate hikes. Exactly what would act as a catalyst for such a move is not predictable – we would look to quarterly inflation reports as perhaps the most likely, but more hawkish speeches by MPC members, stronger-than-expected economic data or a combination of all these factors could all push the market past a tipping point.

## The Insight approach

The market had been expecting a first hike in the autumn, but by the end of January was pricing this in for the summer. Short rates have therefore remained relatively unchanged, while those beyond three months moved higher. Our own worst-case scenario modelling suggests that the long-end of the curve does not offer compelling value at present, as the market appears to have ruled out any spring rate rise. While we are not predicting such a rise, it cannot be ruled out.

We believe that adding duration in the current environment is therefore a poor idea. While the additional yield available further along the curve may seem attractive, security and liquidity must receive equal attention. At present, the market is simply not rewarding buyers for the risk that rates rise early or fast – when history suggests that this is entirely possible.

Our expectation that the market will then overshoot means that adding longer-dated paper now would not only be a poor risk / reward trade, but also decrease available liquidity, thus making it harder to take advantage of market inefficiencies when these emerge. For example, we see little point in buying one-year paper at a yield of 1% when we believe that similar paper may soon be yielding double that.

While we wait for this over-enthusiastic curve shift, we retain a defensive bias in our Sterling Liquidity Fund. Exposure to high quality bank floating rate notes has been increased, while our holdings in certificates of deposits or other fixed interest paper are focused at shorter maturities. We believe that it is not only still possible to outperform the benchmark with this cautious approach, but that this will leave us better positioned for when the market moves.

Past performance is not a guide to future performance. Unless otherwise attributed the views and opinions expressed are those of the fund manager at the time of publication and are subject to change. The value of investments and any income from them will fluctuate (this may partly be due to exchange rate changes) and investors may not get back the amount invested.

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