

21st May 2007, No. 266

**“Guaranteed to Break the Ice at Parties”**

by Stewart Cowley

**Newton Global Fixed Income Strategy**

Underweight UK duration

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All that I have really learned in my fund management career is that an Englishman’s brain is almost exclusively preoccupied with;

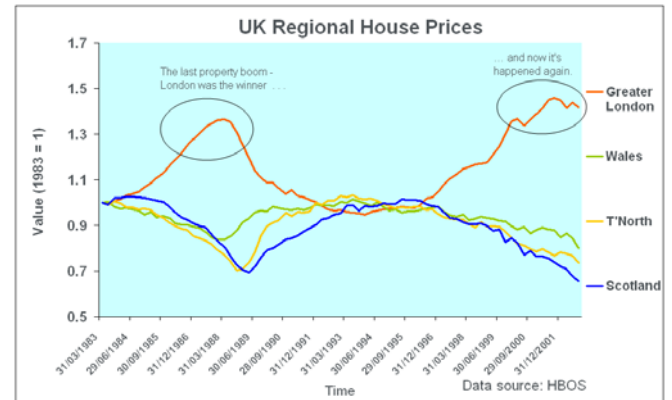
1. The value of their house
2. How much holiday money they will have this year

So if you really want to break the ice at parties and get everybody’s attention then the mere mention that you might have some information on either (or preferably both) of these subjects will have a small crowd milling around you in no time. It’s the only perk of being a global bond manager.

These preoccupations seem to have risen dramatically over the past couple of years and what was a swaggering delight in the value of one’s home has suddenly become a concern. Things look a little stretched to say the least. In fact, things are so bad that Prime Minister-elect Gordon Brown has pledged to build five new towns to ease the UK housing supply/demand imbalance whilst the Bank of England (BOE) is meekly protruding from behind his coat tails trying to suggest to the electorate that “Maybe they should stop borrowing” by inching interest rates up 0.25% at a time.

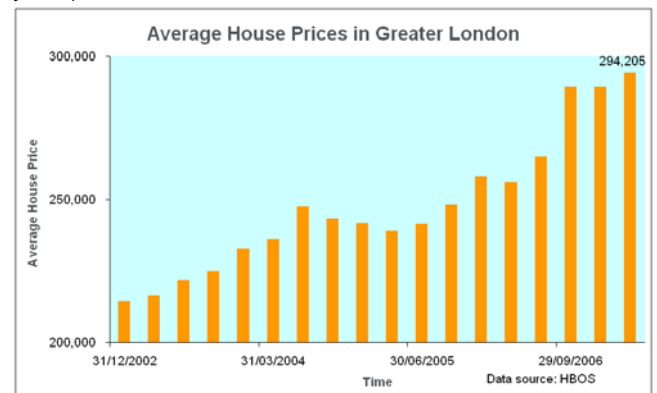
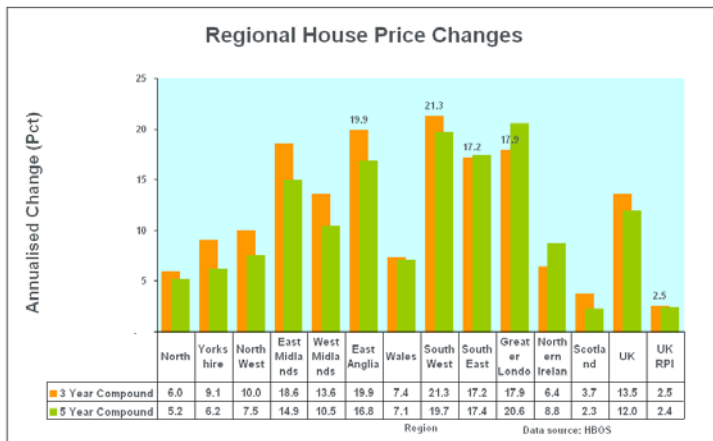
The problem is made worse by the fact that changes in house prices are so unevenly spread throughout the country. To be sure, every region has benefitted from the generalised property boom (see first illustration). Annualized changes over three and five years are well into double digits for most regions of the UK whilst headline inflation has been around 2.5% per annum. But clearly some people have been luckier than others; in particular the winners have been Greater London and the South whilst the North and Scotland have been relative losers.

You can see this if we look at a time series of the relative movements of the regions compared to how the national home values as a whole are moving (see second illustration).



By far the biggest winner has been Greater London and the relative losers have been Wales, the North and Scotland. Interestingly this is the same pattern as the last property boom that ended so dramatically in the late 1980’s. Again, London led the way. After a long period of reshuffling valuations came back to more equal levels for a few years in the mid-1990’s until the whole cycle was reignited again post-1996. Believers in mean reversion would be justified in starting to worry at this point.

This poses some problems for the BOE and Gordon Brown (politically). First of all, the BOE is trying to control the excesses of a relatively small group of people by applying an interest rate policy that everybody in the country is subject to. The chances of causing regional recessions is therefore high as a “one size fits all” interest rate is passed through the system. The fact that the BOE *have to do something* about house prices is undeniable; our current account and budget deficits can’t be allowed to continue to grow as they are without the pound taking the strain for loose monetary and fiscal policies (much like the U.S. dollar has done over the years).



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As the BOE has found out in the past, this is a very difficult trick to pull off without getting to the point of over-kill. But, so far, the message just doesn't seem to have gotten through to the target audience (see third illustration). The average value of a home in Greater London is now well over £200,000 and rising with no sign of let up. In that case, don't be surprised if the BOE

pushes interest rates up to 6% or above in 2007 which, in the near-term, will be seen as a good thing for the pound but will, eventually, come home to bite sterling .

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