

Henderson's Pattullo comments on the MPC interest rate cut

John Pattullo sees good value in the investment grade corporate bond sector

The Bank of England Monetary Policy Committee (MPC) yesterday applied a hatchet to interest rates, announcing a cut of 1.5%. This takes the base rate to 3.0%, its lowest level since the 1950s. The announcement was more aggressive than the market was expecting, however their reasoning behind the decision is understandable. There is an important signalling aspect to monetary policy which dictates that in times of financial market distress, more is better. Markets have so far taken the news of the cut in their stride, with little movement in Sterling which is comforting given the wild volatility that has greeted most economic announcements of late.

A rate cut was inevitable; the question was simply how far the MPC was prepared to go. Pressure has been mounting after a sharp decline in construction, manufacturing and services sector data suggested that the economy is heading into a contraction at least as deep as that experienced in the early 1990s.

Inflation is no longer the driver of monetary policy in the UK, and the US, instead, plunging commodity prices mean that deflation is now a growing concern. Deflation would mean a long, slow economic retrenchment where consumers and businesses lack spending power, sending prices for goods and services plummeting and causing widespread unemployment.

Back in 2002, the US Federal Reserve published a paper entitled *Preventing Deflation: Lessons from Japan's Experience in the 1990s*. The paper concluded that "...with the benefit of hindsight, perhaps the most important concern raised by Japanese policy during this period was not that policymakers did not predict the oncoming deflationary slump... but that they did not take out sufficient insurance against downside risks through a precautionary further loosening of monetary policy." Perhaps with this in mind, the MPC has acted swiftly to avoid a similar fate by taking out some further insurance of their own.

Where does this leave us? The announcement is of course very positive for bond investors, much less so for cash investors, where reduced interest rates will be looking increasingly unattractive. Fixed income is now firmly the place to be.

The investment grade corporate bond sector in particular now looks to be particularly good value. Using our cash we are currently adding investment grade bonds that are offering yields between 9 – 12%, while the sector as a whole is discounting default rates at levels which are commensurate with the Great Depression rather than a severe recession. This represents an excellent buying opportunity.

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7 November 2008