

## INTEREST RATES FORECASTS

The Council has appointed Link Group as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1st November 2012.

The latest forecast on 4th February is compared below to the last forecast (20th December) in the previous quarter. A comparison of these forecasts shows that PWLB rates have increased generally and show a speed up in the rate of increase in Bank Rate as inflation is now posing a greater risk. The increase in PWLB rates reflects a broad sell-off in sovereign bonds internationally as inflation concerns abound. To that end, the MPC has tightened short-term interest rates with a view to trying to slow the economy sufficiently to keep the secondary effects of inflation – as measured by wage rises – under control, but without pushing the economy into recession. A difficult juggling act at the best of times, and now against a backdrop of the Russian invasion of Ukraine.

Link Group Interest Rate View		7.2.22											
	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3 month av. earnings	0.80	1.00	1.00	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
6 month av. earnings	1.00	1.10	1.20	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
12 month av. earnings	1.40	1.50	1.60	1.70	1.70	1.60	1.60	1.50	1.40	1.40	1.40	1.40	1.40
5 yr PWLB	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
10 yr PWLB	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
25 yr PWLB	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
50 yr PWLB	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40

Link Group Interest Rate View		20.12.21												
	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3 month ave earnings	0.20	0.30	0.50	0.50	0.60	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00
6 month ave earnings	0.40	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.00	1.10	1.10	1.10	1.10	1.10
12 month ave earnings	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.10	1.10	1.20	1.20	1.20	1.20	1.20
5 yr PWLB	1.40	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.80	1.90	1.90	1.90	2.00	2.00
10 yr PWLB	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10	2.20	2.30
25 yr PWLB	1.80	1.90	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.50	2.50
50 yr PWLB	1.50	1.70	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.20	2.20	2.30	2.30

*Additional notes by Link on this forecast table: -*

- *LIBOR and LIBID rates ceased from the end of 2021. We have replaced LIBOR with rates based on SONIA (Sterling Overnight Index Average). In the meantime, our forecasts are based on expected average earnings by local authorities for 3 to 12 months.*
- *Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.*

## A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- The threat from Omicron was a wild card causing huge national concern at the time of December's MPC meeting; now despite record numbers of infection, the relatively low number of hospitalisations suggests there will be no further lockdowns (at least over spring and summer).
- The MPC has now set out upon a monetary policy tightening spree. In March it voted 8-1 for rates to increase to 0.75%.
- Our forecast now expects the MPC to deliver another 0.25% increase in May to 1%; their position appears to be to go for sharp increases to get the job done and dusted but the cost-of-living squeeze will provide a headwind to tightening too far and too quickly, so for now we only have a further 0.25% increase in place for H2 2022.
- If, however, the MPC is becomes more heavily focused on combating inflation than on protecting economic growth, we will revise our forecast up further.
- However, 54% energy cap cost increases from April, together with 1.25% extra employee national insurance, food inflation around 5% and council tax likely to rise in the region of 5% too - these increases are going to hit lower income families hard despite some limited assistance from the Chancellor to postpone the full impact of rising energy costs.
- Consumers are estimated to be sitting on over £160bn of excess savings left over from the pandemic so that will cushion some of the impact of the above increases. But most of those holdings are held by more affluent people whereas poorer people already spend nearly all their income before these increases hit and have few financial reserves.
- The BIG ISSUE – will the current spike in inflation lead to a second-round effect in terms of labour demanding higher wages, (and/or lots of people getting higher wages by changing job)?
- If the labour market remains very tight during 2022, then wage inflation poses a greater threat to overall inflation being higher for longer, and the MPC may then feel it needs to take more action.

## PWLB RATES

- The yield curve has flattened out considerably.
- We view the markets as having built in, already, nearly all the effects on gilt yields of the likely increases in Bank Rate.
- It is difficult to say currently what effect the Bank of England starting to sell gilts will have on gilt yields once Bank Rate rises to 1%: it is likely to act cautiously as it has already started on not refinancing maturing debt. A passive process of not refinancing maturing debt began in March when the 4% 2022 gilt matured; the Bank owns £25bn of this issuance. A pure roll-off of the £875bn gilt portfolio by not refinancing bonds as they mature, would see the holdings fall to about £415bn by 2031, which would be about equal to the Bank's pre-pandemic holding. Last August, the Bank said it would not actively sell gilts until the "Bank Rate had risen to at least 1%" and, "depending on economic circumstances at the time."
- It is possible, but unlikely, that Bank Rate will not rise above 1% as the MPC could shift to relying on quantitative tightening (QT) to do the further work of taking steam out of the economy and reducing inflationary pressures.
- Increases in US treasury yields over the next few years could add upside pressure on gilt yields though, more recently, gilts have been more correlated to movements in bund yields than treasury yields.

## Forecasts for PWLB rates and gilt and treasury yields

The current PWLB rates are set as margins over gilt yields as follows: -.

- PWLB Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB Certainty Rate is gilt plus 80 basis points (G+80bps)
- PWLB HRA Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB HRA Certainty Rate is gilt plus 80bps (G+80bps)
- Local Infrastructure Rate is gilt plus 60bps (G+60bps)

**Gilt yields.** Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. Our current forecasts reflect much of the recent increases seen in global bond market yields generally since the turn of the year (2022).

**Upside risk to gilt yield forecasts.** While monetary policy in the UK will have a major impact on gilt yields, there is also a need to consider the potential impact that rising treasury yields in America could have on UK gilt yields. As an average since 2011, there has been a 75% correlation between movements in US 10-year treasury yields and UK 10-year gilt yields. This is a significant upward risk exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.

**US treasury yields.** US President Biden and the Democratic party have pushed through a huge programme of fiscal stimulus over the past couple of years, whilst the following factors were also in play:

1. A fast vaccination programme had enabled a rapid opening up of the economy during 2021.
2. The economy has been growing swiftly over the second half of 2021/22, whilst unemployment has continued to fall/spare capacity in the labour market has tightened.

It was not much of a surprise that a combination of these factors would eventually cause an excess of demand in the economy which generated strong inflationary pressures. This has eventually been recognised by the Fed and an aggressive response to damp inflation down during 2022 and 2023 is expected.

The flurry of comments from Fed officials following the mid-March meeting – including from Chair Jerome Powell himself – hammering home the hawkish message from the mid-March meeting makes it difficult to see how the Fed will not tighten aggressively through 2022 as a minimum with markets expecting the Fed Funds Rate to hit close to 2% by year end.

In addition, the Fed will soon announce an increasing series of caps on the value of assets they allow to run off the balance sheet each month. That announcement could come as soon as May.

**Downside risk to gilt yield forecasts.** There are also possible downside risks from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England not reinvesting maturing gilts and then later selling gilts, will be interesting to monitor.

## Significant risks to the forecasts

- COVID vaccines do not work to combat new mutations and/or new vaccines take longer than anticipated to be developed for successful implementation.
- The Government implements fiscal policies that suppresses GDP growth.

- The MPC tightens monetary policy too quickly – by raising Bank Rate or unwinding QE.
- The MPC tightens monetary policy too late to ward off building inflationary pressures.
- Geo-political risks - on-going global power influence struggles between Russia/China/US/Iran and the Russian invasion of Ukraine.

**The balance of risks to the UK economy: -**

- The overall balance of risks to economic growth in the UK is now to the downside unless excess savings are deployed by consumers to maintain their spending despite the cost-of-living squeeze.

**The balance of risks to medium to long term PWLB rates: -**

- There is a balance of upside risks to forecasts for medium to long term PWLB rates because of the lengthy increase in inflation (>6% for the remainder of 2022 and only reducing slowly through 2023).