LINK Group

Updated Interest Rate Forecast

11th May 2021

LINK GROUP UPDATED INTEREST RATE FORECAST

Updating of our forecasts 10th May 2021

Comparison of forecasts for Bank Rate today v. previous forecast

	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
10.5.21	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.25
9.3.21	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
change	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.15	0.15	0.15

- We have put in one increase in Bank Rate from 0.10% to 0.25% in Q3 2023.
- There are 10bps increases in some of our PWLB rate forecasts due to the stronger and quicker UK economic recovery.
- LIBOR and LIBID rates will cease from the end of 2021. In the February edition of CityWatch, we outlined how these rates are expected to be replaced. 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.

Our current and previous 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.

Link Group Interest Rate View 10.5.21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.25
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.30	0.30	0.30
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.20	0.30	0.40	0.40	0.40
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.30	0.30	0.40	0.50	0.50	0.50
5 yr PWLB	1.20	1.20	1.30	1.30	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50
10 yr PWLB	1.70	1.70	1.70	1.80	1.80	1.90	1.90	1.90	2.00	2.00	2.00	2.00
25 yr PWLB	2.20	2.20	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.50	2.60
50 yr PWLB	2.00	2.00	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.30	2.40

Link Group Interest Rate 8.3.21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	1.20	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.40	1.40	1.40	1.40
10 yr PWLB	1.60	1.60	1.60	1.70	1.70	1.70	1.80	1.80	1.90	1.90	1.90	1.90
25 yr PWLB	2.10	2.10	2.20	2.30	2.30	2.30	2.40	2.40	2.50	2.50	2.50	2.50
50 yr PWLB	1.90	1.90	2.00	2.10	2.10	2.10	2.20	2.20	2.30	2.30	2.30	2.30

MPC meeting 6.5.21

- Bank Rate was left unchanged at 0.10% and the stock of QE at £895bn, although the pace of QE purchases was slowed, as the MPC had previously implied, so as to last until the end of the year. The MPC's words were distinctly more hawkish in five ways: -

    1. The MPC's **annual GDP growth forecast** for 2021 was revised up from 5.0% in February to 7.25% - the fastest pace of growth since the 1940s. Growth was revised down in 2022 by a slightly smaller amount (7.25% to 5.75%). The Bank now expects GDP to return to its pre-crisis peak in Q4 2021 rather than in Q1 2022. This feeds through into the unemployment rate peaking at 5.4% in Q3 2021, rather than 7.8% in Q3 2021 previously. It also raised the **inflation forecast** in the near term, but lowered it further out so that it is around 2% from the second half of 2022 and for all of 2023. That is a bit earlier than before. Consumers were now expected to be confident enough to spend 10% of their excess savings rather than the 5% it had assumed in February. The MPC expects there to be less excess supply in 2021 and for there to be more excess demand in 2023, suggesting that the MPC has revised up demand by more than supply.
    2. The new economic forecasts imply that the date at which the conditions **for tighter monetary policy** might be in place, e.g. a 4.5% unemployment rate and 2.0% inflation rate, has come forward by at least a year, from the end of 2023 to the end of 2022. The Bank's forecast for CPI inflation stays above 2.0% for the next two years. That suggests at least one rate hike will be needed to keep inflation at the 2.0% target.
    3. The MPC tweaked its **forward guidance** by removing the phrase "if the outlook for inflation weakened" as the risks were now more balanced than being on the downside; this presumably means that the MPC is now ready to tighten policy as well as loosen it.
    4. The MPC decided to slow the pace of its **asset purchases** from about £4.4bn a week currently so that it could stay on track to hit its target for QE by the end of the year.
    5. Andy Haldane, the most hawkish member of the MPC, but also soon to leave the MPC, voted to **reduce the QE target** by £50bn.

- The MPC is likely to want to be sure that **inflation** is going to stay around 2.0% and that the unemployment rate is continuing to decline before it decides to start tightening policy. This suggests that, even on the Bank's forecasts, a series of rate hikes is unlikely until 2023 at the earliest. However, by then, the initial surge in inflation in 2021 and 2022 due to a combination of base effects, energy price increases and a release of pent-up demand hitting supply constraints, will have subsided. It will, therefore, turn into a question of when the elimination of spare capacity in the economy takes over as being the main driver to push inflation upwards; this could then mean that the MPC will not start tightening policy until 2023 or even later.
- As **Bank Rate** at 0.10% was an emergency response to a dire situation, we have put in one increase to 0.25% in Q3 2023 to reflect a likely desire by the MPC to recover a little flexibility in being able to use Bank Rate cuts as a monetary policy tool in the future. The timing for such a move is highly unpredictable, as is whether there could be more than one such hike.
- The **financial markets** are predicting that Bank Rate starts rising in 2022 but this appears to be premature.

Gilt and treasury yields

Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. What has most unsettled financial markets has been US President Biden's, and the Democratic party's, determination to push through a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic. However, this is in addition to the $900bn support package passed in December. This was then followed by two further packages – a $2trn infrastructure plan in April spread over 8 years and a $1.8trn American families plan in May spread over the next decade, but paid for by increases in taxes. The last two will have only a minor impact on growth and inflation as their impact is spread over the next decade, assuming they get passed by both Houses. But financial markets have been alarmed that all this stimulus is happening at a time when: -

1. A fast vaccination programme is enabling a rapid opening up of the economy.
2. The economy is already recovering strongly.
3. It is starting from a position of little spare capacity due to less severe lockdown measures than in many other countries.
4. And the Fed is still providing stimulus through monthly QE purchases.

This could cause an excess of demand in the economy which could unleash inflationary pressures. This could then force the Fed to take much earlier action to start increasing the Fed rate from near zero, despite their stated policy being to target average inflation and saying that increases were unlikely in the next few years as the impending surge in inflation was only “transitory”.

A further concern in financial markets is when will the Fed end QE purchases of treasuries and how they will gradually wind it down. These purchases are currently acting as downward pressure on treasury yields. Nonetheless, during the last week of February and the first week of March, yields rose sharply. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards there will invariably impact and influence financial markets in other countries. It is noticeable that gilt yields moved higher through February and that international factors have been combining with domestic factors to this effect.

Increases in Bank Rate

While our forecast in the above table shows only one increase from 0.10% to 0.25% in the next three years, we have had a considerable internal discussion as to how the MPC might approach doing the first increases. The current rate of 0.10% was an emergency rate introduced at the height of the financial markets sell-off in March 2020. However, as the global economy recovers from the worst of the pandemic:-

- Would the MPC still feel it is appropriate to keep Bank Rate down at such a low level until inflationary pressures are entrenched?
- Would it feel that the first increases in Bank Rate should be in the form of, perhaps, 10 bps movements, to better signal to the markets their intent for the rest of the economic recovery?
- OR would it do a first increase back to 0.25% to get a foothold back on the ladder of 0.25% increases thereafter?

Interesting questions, but we do not have the answers! We are just pointing out that there should be caution in assuming that Bank Rate will definitively stay at exactly 0.10% for the next three years. What the MPC will NOT want to do, however, is to delay any Bank Rate increase to the extent that investors in gilts lose confidence in the Bank’s inflation fighting credentials or to allow inflation expectations of consumers to build up to unacceptable levels which then feeds through into putting upward pressure on pay inflation.

There are two views in respect of Bank Rate beyond our three-year time horizon: -

a. The MPC will be keen to do a series of increases in Bank Rate as soon as possible in order for it to become a usable tool when the next economic downturn comes along. This is in line with thinking on Bank Rate over the last 20 years.

b. Conversely, that we need to adjust to the new post-pandemic era that we are now in. In this new era, the shift to a <u>sustainable level</u> of 2% inflation targeting has set a high bar for raising Bank Rate i.e., only when inflation is demonstrably and sustainably above 2%, (which means it will be backward looking at factual evidence). In addition, many governments around the world have been saddled with high levels of debt. When central bank rates are low, and below the average GDP growth rate, the debt to GDP ratio will gradually fall each year without having to use fiscal tools such as raising taxes or austerity programmes, (which would depress economic growth and recovery). This could, therefore, result in governments revising the setting of mandates to their national central

banks to allow a higher rate of inflation linked to other economic targets. This is the Capital Economics view – that Bank Rate is unlikely to rise for the next five years and will probably then struggle to get to 1% within 10 years.

Globally, our views on economies are as follows: -

- **EU.** The economy was recovering well towards the end of Q2 after a sharp drop in GDP. However, a second wave of the virus caused a renewed fall back in growth during Q4 and in Q1 this year. The slow role out of vaccines will delay economic recovery but the vaccination rate has picked up sharply in Q2. Prospects for Q2 have improved as 70% of the adult population will have been vaccinated by July. That should embolden governments to begin to lift restrictions in the coming weeks and this in turn should bring forward some of the pick-up in economic activity to around 1%. There is little sign that underlying inflationary pressure is building.

- **China.** After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of the year; this has enabled China to recover all the initial contraction. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. At the same time, China's economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies. However, the pace of economic growth will fall back after this initial surge of recovery from the pandemic.

- **Japan.** After declaring a second state of emergency on 7th January, which depressed growth in Q1 2021, the economy should make a strong recovery to pre-pandemic GDP levels in the rest of the year as the slow role out of vaccines eventually gathers momentum.

- **World growth.** World growth has been in recession in 2020 but should recover during 2021. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

The balance of risks to the UK: -

- The overall balance of risks to economic growth in the UK is now to the upside though there are still residual risks from variants - both domestically and their potential effects worldwide.

- There is relatively little domestic risk of a series of increases in Bank Rate in the next three years and, therefore, in shorter-term PWLB rates. Gilt yields and PWLB rates are, nonetheless, expected to be subject to on-going volatility.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include: -

- **Mutations** of the virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed, resulting in further national lockdowns or severe regional restrictions.

- **UK / EU trade arrangements** – if there was a major impact on trade flows and financial services due to complications with customs paperwork or lack of co-operation in sorting out significant remaining issues.

- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In

addition, the EU agreed a €750bn fiscal support package which has still to be disbursed. These actions will help shield weaker economic regions in the near-term. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.

- Weak capitalisation of some **European banks**, which could be undermined further depending on the extent of credit losses resulting from the pandemic.

- **German minority government & general election in September 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, because of the rise in popularity of the anti-immigration AfD party. Subsequently, the CDU has done badly in state elections, but the SPD has done even worse. Angela Merkel has stepped down from being the CDU party leader but remains as Chancellor until the general election in 2021. This then leaves a major question mark over who the major guiding hand and driver of EU unity will be when she steps down.

- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile and, therein, impact market confidence/economic prospects and lead to increasing safe-haven flows.

- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe-haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates: -

- Stronger than currently expected recovery in UK and/or other major developed economies.

- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

LINK GROUP FORECASTS

We do not think that the MPC will embark on a series of increases in Bank Rate during the current and next two financial years as we do not expect inflation to return to being sustainably above 2% during this period.

With unpredictable virus factors now being part of the forecasting environment, there is a risk that forecasts could be subject to significant revision during the next three years.

Gilt yields and PWLB rates

The general situation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e., equities, or the safe haven of government bonds. The overall longer-run trend is for gilt yields and PWLB rates to rise.

There is likely to be exceptional volatility and unpredictability in respect of gilt yields and PWLB rates due to the following factors: -

- How strongly will changes in gilt yields be correlated to changes in US treasury yields?
- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?

- Would the MPC take action to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the "taper tantrums" in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

Our forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within our forecasting time period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

Our target borrowing rates and the current PWLB (certainty) borrowing rates are set out below.

PWLB debt	Current borrowing rate as at 10.5.21 p.m.	Target borrowing rate now (end of Q2 2021)	Target borrowing rate previous (end of Q2 2021)
5 year	1.14%	1.20%	1.20%
10 year	1.68%	1.70%	1.60%
25 year	2.16%	2.20%	2.10%
50 year	1.95%	2.00%	1.90%

Borrowing advice: Our long-term forecast for Bank Rate is 2.00%. As some PWLB certainty rates are currently near or below 2.00%, there remains value in considering long-term borrowing from the PWLB where appropriate. Temporary borrowing rates are likely, however, to remain near Bank Rate and may also prove attractive as part of a balanced debt portfolio. In addition, there are also some cheap alternative sources of long-term borrowing if a client is seeking to avoid a "cost of carry" but also wishes to mitigate future re-financing risk. Please speak to your CRM to discuss options.

Our suggested budgeted investment earnings rates for investments up to about three months' duration in each financial year for the next six years are as follows: -

Average earnings in each year	Now	Previously
2020/21	0.10%	0.10%
2021/22	0.10%	0.10%
2022/23	0.10%	0.10%
2023/24	0.25%	0.10%
2024/25	0.50%	0.25%
2025/26	1.00%	1.00%
Long term later years	2.00%	2.00%

The long-term later years forecast in the table above is an indicator for 10 years+.

As there are so many variables at this time, caution must be exercised in respect of all interest rate forecasts. The general expectation for a trend of gently rising gilt yields is unchanged. Negative, (or positive) developments could significantly impact safe haven flows of investor money into UK, US and German bonds and produce shorter-term movements away from our central forecasts.

Our interest rate forecast for Bank Rate is in steps of 25 bps, (apart from the current rate of 10 bps), whereas PWLB forecasts have been rounded to the nearest 10 bps and are central forecasts within bands of + / - 25 bps.

Naturally, we continue to monitor events and will update our forecasts as and when appropriate.

Interest Rate Strategy Group

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