Updated Interest Rate Forecast

10th November 2020

LINK GROUP UPDATED INTEREST RATE FORECAST

Updating of our forecasts 9th November 2020

- We have extended our forecasts by one year to now include 2023/24.
- There are no changes to our Bank Rate forecasts. Bank Rate is forecast to stay at 0.10% during this forecast period.
- There are minor decreases in some of our PWLB rate forecasts in line with our lower for longer view.
- LIBOR and LIBID rates will cease from the end of 2021. We will be continuing to look at market developments in this area and will monitor these with a view to communicating with you when agreement is reached on how to replace LIBOR. In the meantime, our forecasts are based on expected earnings by local authorities for 3 to 12 months.
- Traditionally, we have provided 3m LIBID forecasts with the rate calculated using market convention of 1/8th (0.125%) taken off the LIBOR figure. Given that 3m LIBOR is currently running below 10bps, that would give a figure of around 0% to somewhere modestly into negative territory. However, the liquidity premium that is still in evidence at the short end of the curve means that 3m rates actually being achieved by investors is still modestly in positive territory. While there are differences between counterparty offer rates, our analysis would suggest that an average rate of around 10bps should be achievable.

Our PWLB rate forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012. The table below is for PWLB Certainty Rates for non-HRA borrowing (currently gilts plus 180 basis points). The Treasury consultation on reviewing PWLB margins and lending ended on 31 July. We expect that the Non-HRA Certainty Rate will be subject to revision downwards post the PWLB Consultation Paper conclusion but we don't know the precise timing of that i.e. we would expect it to be somewhen before the end of March next year.

Link Group Interest Rate View	9.11.20													
	Dec-20	Mar-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	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	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	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	0.20	0.20
5 yr PWLB	1.80	1.80	1.80	1.80	1.80	1.90	1.90	1.90	1.90	1.90	2.00	2.00	2.00	2.00
10 yr PWLB	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30
25 yr PWLB	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70	2.70	2.70	2.80	2.80	2.80	2.80
50 yr PWLB	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.60

In addition, the following rates also apply:

- **PWLB Standard Rate** is gilts plus 200 basis points (G+200bps)
- **PWLB HRA Standard Rate** is gilts plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilts plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

- The Bank of England's Monetary Policy Committee kept **Bank Rate** unchanged on 5th November. However, it revised its economic forecasts to take account of a second national lockdown from 5th November to 2nd December which is obviously going to put back economic recovery and do further damage to the economy. It therefore decided to do a further tranche of **quantitative easing (QE) of £150bn**, to start in January when the current programme of £300bn of QE announced in March to June, runs out. It did this so that "announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target".
- Its forecasts appear to be rather optimistic in terms of three areas:
    - The economy would recover to reach its pre-pandemic level in Q1 2022
    - The Bank also expects there to be excess demand in the economy by Q4 2022.
    - CPI inflation is therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- However, the minutes did contain several references to **downside risks**. The MPC reiterated that the "recovery would take time, and the risks around the GDP projection were judged to be skewed to the downside". It also said "the risk of a more persistent period of elevated unemployment remained material". Downside risks could well include severe restrictions remaining in place in some form during the rest of December and most of January too. That could involve some or all of the lockdown being extended beyond 2nd December, a temporary relaxation of restrictions over Christmas, a resumption of the lockdown in January and lots of regions being subject to Tier 3 restrictions when the lockdown ends. Hopefully, restrictions should progressively ease during the spring. It is only to be expected that some businesses that have barely survived the first lockdown, will fail to survive the second lockdown, especially those businesses that depend on a surge of business in the run up to Christmas each year. This will mean that there will be some level of further permanent loss of economic activity, although the extension of the furlough scheme to the end of 31st March will limit the degree of damage done.
- As for **upside risks**, we are waiting expectantly for news to confirm that various vaccines have been cleared as being safe and effective for administering to the general public and there is always some possibility that the trade negotiations with the EU could turn out better than expected.
- Significantly, there was no mention of **negative interest rates** in the minutes or Monetary Policy Report, suggesting that the MPC still remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it "stands ready to adjust monetary policy", the MPC this time said that it will take "whatever additional action was necessary to achieve its remit". The latter seems stronger and wider and may indicate the Bank's willingness to embrace new tools.
- Public borrowing is now likely to increase by about £30bn to around £420bn (21.7% of GDP) as a result of the new lockdown. In normal times, such an increase in gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels, (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country in the world. Overall, this means that the total interest bill paid by the Government is manageable. It is also quite possible that the Bank of England will do more QE in 2021 to support the economy, although negative interest rates could also be a usable tool in the tool box later on in 2021.
- While our Bank Rate forecast contains no increase up to March 2024, it is quite possible that Bank Rate may not increase for some time further out than then as it is going to take a considerable time for the economy to recover lost capacity and momentum. We do not think that inflation will pose a threat requiring increases in Bank Rate as there is likely to be spare capacity in the economy for a considerable time.

- **EU.** The economy was recovering well towards the end of Q2 after a sharp drop in GDP. However, a second wave of the virus has caused a renewed fall back in growth during Q4.

- **US.** The result of the November elections means that while the Democrats have gained the presidency and a majority in the House of Representatives, it looks as if the Republicans will still have a majority on the Senate. This means that the Democrats will not be able to do the large fiscal stimulus they had been hoping to do after the elections. This would have resulted in another surge of debt issuance and would have put upward pressure on debt yields – which could have also put upward pressure on gilt yields. On the other hand, financial markets have leapt today (9th November) on the first news of a successful vaccine - so that could cause a big shift in investor sentiment i.e. a swing to sell out of government debt into equities and so cause debt prices to fall and yields to rise. It is too early yet to say how enduring this shift in market expectations will be or whether the Fed would feel it necessary to take action to suppress this jump up in debt yields. However, the next two years, and possibly four years in the US, could be a political stalemate where neither party can do anything radical.

- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and into Q3; this has enabled China to recover all of the contraction in Q1. 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.

- **Japan.** Japan's success in containing the virus without imposing draconian restrictions on activity should enable a faster return to pre-virus levels of output than in many major economies. While the second wave of the virus has been abating, the economy has been continuing to recover at a reasonable pace from its earlier contraction of 8.5% in GDP. However, there now appears to be the early stages of the start of a third wave. It has also been struggling to get out of a deflation trap for many years and to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The change of Prime Minister is not expected to result in any significant change in economic policy.

- **World growth.** While Latin America and India have, until recently, been hotspots for virus infections, infection rates have begun to stabilise. World growth will be in recession this year. 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 probably relatively even, but is subject to major uncertainty due to the virus. It may also be affected by what, if any, deal the UK agrees as part of Brexit.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

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

- **UK** – further national lockdowns or severe regional restrictions in major conurbations during 2021.

- **UK / EU trade negotiations** – if it were to cause significant economic disruption and downturn in the rate of growth.
- **UK - 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. These actions will help shield weaker economic regions for the next year or so. 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 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, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity 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.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been a rise in anti-immigration sentiment in Germany and France.
- **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

- **UK -** stronger than currently expected recovery in UK economy.
- **Post-Brexit** – if an agreement was reached that removed the majority of threats of economic disruption between the EU and the UK.
- 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.

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We do not think that the MPC will increase Bank Rate during the current and next two financial years as we expect the economy to take a prolonged period to recover momentum after the Covid crisis.

Forecasts for average investment earnings beyond the three year time horizon will be heavily dependent on economic and political developments.

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, albeit gently, although there are likely to also be periods of sharp volatility from time to time.

Our forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), 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 9.11.20 p.m.	Target borrowing rate now (end of Q4 2020)	Target borrowing rate previous (end of Q4 2020)
5 year	1.82%	1.80%	1.90%
10 year	2.15%	2.10%	2.10%
25 year	2.74%	2.50%	2.50%
50 year	2.58%	2.30%	2.30%

Borrowing advice: since November 2018, PWLB rates have fallen significantly up until 100 bps were added to all PWLB rates in October 2019. As our long-term forecast for Bank Rate is 2.00%, and PWLB certainty rates are close to or above 2.00%, there is little near-term value in borrowing from the PWLB at present, particularly until it is clear what the new non-HRA borrowing rate will look like after HM Treasury concludes its review of the PWLB Consultation Paper responses. Accordingly, clients will need to reassess their risk appetite in terms of either seeking cheaper alternative sources of long-term borrowing or switching to short term borrowing in the money markets until such time as the Government might possibly reconsider the margins charged over gilt yields. Please speak to your CRM to discuss alternative borrowing sources available.

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	0.10%	0.25%
2024/25	0.25%	0.75%
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 an eventual 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 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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