Updated Interest Rate Forecast

9th March 2021

LINK GROUP UPDATED INTEREST RATE FORECAST

Updating of our forecasts 9th March 2021

- There are no changes to our forecasts for Bank Rate or investment earning rates. Bank Rate is forecast to stay at 0.10% during this forecast period.

- There are, however, increases in our PWLB rate forecasts of around 20-30 bps to take account of recent movements in financial markets and the Budget.

- 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	8.3.21												
	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
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
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
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
5 yr PWLB	1.20	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	1.60	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	2.10	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	1.90	2.00	2.10	2.10	2.10	2.20	2.20	2.30	2.30	2.30	2.30

Link Group Interest Rate View	8.2.21												
	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
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
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
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
5 yr PWLB	0.90	0.90	0.90	0.90	1.00	1.00	1.10	1.10	1.10	1.20	1.20	1.20	1.20
10 yr PWLB	1.30	1.30	1.30	1.30	1.40	1.40	1.50	1.50	1.50	1.60	1.60	1.60	1.60
25 yr PWLB	1.90	1.90	1.90	1.90	2.00	2.00	2.10	2.10	2.10	2.20	2.20	2.20	2.20
50 yr PWLB	1.70	1.70	1.70	1.70	1.80	1.80	1.90	1.90	1.90	2.00	2.00	2.00	2.00

The Budget

- The Budget provides more near-term support to the economy, but it also uses higher taxes from 2023/24 to reverse support quicker. The latter means the public deficit declines almost back to pre-pandemic levels by 2025/26. The implication is that taxes may not need to rise much further than currently scheduled. If recovery is stronger than in the forecast, taxes may not need to be raised as much.
- The long list of extended support schemes (including the furlough scheme, and hospitality VAT cut) adds up to a loosening in fiscal policy relative to previous plans of about £54bn (2.6% of GDP) in 2021/22. So, although public sector net borrowing (PSNB) in 2020/21 was revised down from £394bn (19.0% of GDP) to £355bn (17%), in 2021/22 it was revised up from £164bn (7.4%) to £234bn (10.3%).
- Thereafter, the increase in taxes (e.g., main corporation tax rate up from 19% to 25% from 2023/24, freezing of income tax and other tax thresholds from 2021/22 etc.) and some cuts to current day-to-day spending will have a downward influence on PSNB.
- In 2025/26, PSNB was revised down from £102bn (3.9%) to £74bn (2.8%). Only a small part of that decline was due to the upward revisions to the OBR's GDP forecasts, mainly as the OBR stuck to its assumption that real GDP in 2026 will be 3% lower than it would have been without the pandemic. Instead, it is the future tax hikes that do most of the work.
- The underlying debt to GDP ratio is projected to rise from 100.2% in 2020/21 to 109.7% in 2023/24 before falling to 103.8% by 2025/26.
- The total level of debt is now twice as sensitive to any rises in interest rates than before the crisis due to Bank of England purchases of gilts meaning that long term debt via gilts has effectively been replaced by short-term borrowing by the Bank from financial institutions, the cost of which will rise as Bank Rate rises.
- The median debt maturity for the Bank of England has, therefore, reduced to only 4 years; maintaining market confidence in fiscal policy and medium to long-term control over inflation is, therefore, very important for dampening any natural elevation in gilt yields as the economy recovers.
- The amount of fiscal stimulus put into 2021/22 and 2022/23 has heightened concerns around how quickly the output gap in the economy caused by the pandemic, could be used up, and so increase inflationary pressures at a time when base effects from a year ago e.g., cuts in the cost of petrol, VAT cut for the hospitality sector etc, fall out of the calculation of the rate of inflation and send it towards, and probably over, 2%. Financial markets are on edge at the new Bank of England policy of targeting average inflation over a period i.e., it will allow inflation to go above its 2% target for periods to balance out periods below 2%, and probably will remain so until the Bank of England and MPC can show a proven successful track record in this area. The rise in gilt yields in February also reflects a financial market view that the prospect for a negative Bank Rate has now been firmly killed off and been replaced by a focus on when Bank Rate will need to start to go up. However, examination of a graph of the 10 year gilt yield shows that the yield rose very sharply, and by far more than the rise in treasury yields, after the outcome of the MPC meeting of 4th February.

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. Financial markets have been alarmed that the two packages could cause an excess of demand in the economy which could unleash inflationary pressures and force the FOMC 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.

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 have 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 no increases in the next three years, we did have 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 assuming that Bank Rate will definitively stay at exactly 0.10% for the next three years may turn out to have been a brave assumption. 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.

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

a. The MPC will be keen to raise Bank Rate as soon as possible in order for it to be 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 average inflation targeting has set a high bar for raising Bank Rate i.e., only when inflation is demonstrably and sustainably above 2%. 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 will not 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 has caused a renewed fall back in growth during Q4 and in Q1 this year. The slow role out of vaccines will delay economic recovery.

- **US.** The US economy should recover strongly in 2021 due to two stimulus packages and a fast roll out of vaccines which should lead to an end of restrictions.

- **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.

- **Japan.** After declaring a second state of emergency on 7th January, which will cause the economy to contract during Q1 2021, the economy should make a strong recovery to pre-pandemic GDP levels in the rest of the year as the role out of vaccines 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 but is subject to uncertainty due to the virus - both domestically and its potential effects worldwide.

- There is relatively little domestic risk of increases in Bank Rate in the near-term and therefore in shorter-term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates anytime soon but increases in Bank Rate are likely to be some years away given the underlying economic expectations. 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 due to complications with customs paperwork or lack of co-operation in sorting out significant 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. 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 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 increase 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 treasuryyields?
- 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 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 8.3.21 p.m.	Target borrowing rate now (end of Q1 2021)	Target borrowing rate previous (end of Q1 2021)
5 year	1.16%	1.20%	0.90%
10 year	1.63%	1.60%	1.30%
25 year	2.11%	2.10%	1.90%
50 year	1.93%	1.90%	1.70%

Borrowing advice: Our long-term forecast for Bank Rate is 2.00%. As all 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	0.10%	0.10%
2024/25	0.25%	0.25%
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