Updated Interest Rate Forecast 10th May 2022

Part of **Link Group**

LINK GROUP UPDATED INTEREST RATE FORECAST

Updating of our forecasts 10th May 2022

Bank Rate	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25
10.5.22	1.25	1.50	1.75	2.00	2.00	2.00	2.00	2.00	1.75	1.75	1.75	1.75	1.75
7.2.22	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
change	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.50

- We have forecast that the MPC will reluctantly increase Bank Rate at a much faster pace through 2022 to try and keep inflation in check, with further rises of 0.25% in June, and then in each of the three subsequent quarters to peak at 2% by the close of the calendar year. However, those increases in Bank Rate are likely to add to the considerable headwinds impacting the UK economy and, therefore, tentatively we have priced in a small reduction in Bank Rate in 2024. As 2022 proceeds we will be in a better position to judge the overall strength of those economic headwinds and will revise our forecast as appropriate.

- Gilt yields and, therefore, PWLB rates, have been highly volatile since the start of Q4 2021 and that trend has continued throughout the first four months of 2022; indeed, they have risen sharply as concerns focusing on inflation and the secondary round effects, as measured by wage inflation, have taken centre stage.

- At the MPC's 5th May meeting, the 6-3 vote in favour of a 0.25% Bank Rate increase to 1% was followed by a press conference in which it became clear that the nine members of the Committee had varying concerns and voted accordingly. Some emphasised the slowing economy; others the degree to which inflation could rapidly become uncontrollable unless monetary policy was tightened very promptly; and others saw labour shortages as having to be dampened to prevent spiralling wage demands.

- The fact that the economy is forecast to flatline in Q2 and Q3 2022 is an added complication for policy makers, and the forecast -0.9% contraction in the economy in Q4 2022 followed by a further -0.2% contraction in Q2 2023 only adds to the growing possibility that the UK economy may fall into recession at some point during the next year.

- International factors cannot be ignored. The war in Ukraine has added to already present inflationary pressures, as economies bounced back from the effects of Covid-induced lockdowns. Pricing pressure pertaining to oil, gas, electricity, wheat and fertilisers are only some of the better-known aspects.

- Moreover, reductions in the number of people actively seeking employment have also put upward pressure on wages and those costs are likely to be passed on to consumers. Regarding the UK, Brexit factors will also have had a negative impact on the number of workers with appropriate skill-sets available to fill the current record 1.3m job vacancies.

- PWLB rates have risen sharply since the turn of the year, in line with similar movements in bond markets in developed economies.

- Financial markets are currently pricing in increases to Bank Rate to c2.5% by April 2023. So, although we have increased our Bank Rate forecast significantly, we are still positioned some 50bps lower than market expectations. However, from a PWLB perspective, we believe that the market has already priced in most of the increases that pertain to the high inflation outlook (peaking at 10.2% on the CPI measure in Q4 2022 according to the Bank).

- LIBOR and LIBID rates ceased at the end of 2021. In a continuation of our previous forecasts, our money market yield 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	10.5.22												
	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25
BANK RATE	1.25	1.50	1.75	2.00	2.00	2.00	2.00	2.00	1.75	1.75	1.75	1.75	1.75
3 month ave earnings	1.20	1.50	1.70	2.00	2.00	2.00	2.00	2.00	1.70	1.70	1.70	1.70	1.70
6 month ave earnings	1.60	1.90	2.10	2.20	2.20	2.20	2.20	2.10	2.00	1.90	1.90	1.90	1.90
12 month ave earnings	2.00	2.20	2.30	2.40	2.40	2.30	2.30	2.20	2.20	2.10	2.10	2.10	2.10
5 yr PWLB	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.60	2.50	2.50	2.50	2.50	2.50
10 yr PWLB	2.80	2.80	2.90	2.90	2.90	2.90	2.90	2.90	2.80	2.80	2.80	2.80	2.80
25 yr PWLB	3.00	3.10	3.10	3.20	3.20	3.20	3.10	3.10	3.00	3.00	3.00	3.00	3.00
50 yr PWLB	2.70	2.80	2.80	2.90	2.90	2.90	2.80	2.80	2.70	2.70	2.70	2.70	2.70

Link Group Interest Rate View	7.2.22											
	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	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 ave earnings	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 ave earnings	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 ave earnings	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	2.30	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	2.40	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	2.50	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	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- Our central forecast for interest rates was previously updated on 7th February and reflected a view that the MPC will be keen to further demonstrate its anti-inflation credentials by delivering 0.25% increases in Bank Rate in March and May, both of which were implemented. Now we expect further 0.25% increases in June, August, November and February, with the latter three decisions coinciding with updated Bank of England Quarterly Monetary Policy reports.
- The CPI measure of inflation is now forecast to rise to above 10% in Q4 2022 and the MPC will be keen to stifle the prospect of average earnings data (5.4% y/y currently including bonuses) providing further upside risk to inflationary factors that are primarily being driven by supply-side shortages. Conversely, the Bank indicated at its 5th May meeting that markets may have over-estimated how far monetary policy will need to be tightened, as the May Quarterly Monetary Policy report indicated that inflation would be considerably below the 2% target by Q1 2025 if rates were tightened to 2.5%.
- Now that Bank Rate has reached 1%, the MPC has indicated (no earlier than August) that it will also consider the extent to which it implements Quantitative Tightening (QT), primarily the selling of its gilt holdings, although they are likely to take any such decision cautiously as they are already not refinancing maturing debt.
- Notwithstanding the MPC's clear desire to increase Bank Rate throughout the first half of 2022, negative real earnings, a 54% hike in the Ofgem energy price cap from April, at the same time as employees (and employers) incurred a 1.25% Health & Social Care Levy, growing commodity and food inflation plus council tax rises - all these factors will hit households' finances hard. However, lower income families will be hit disproportionately hard despite some limited assistance from the Chancellor to postpone the full impact of rising energy costs.
- Given the above outlook, it poses a question as to whether the MPC may shift into protecting economic growth if it flatlines in Q2 and Q3 2022, let alone contracts by -0.9% in Q4. Accordingly, we remain tentative about whether the MPC will increase Bank Rate as far as the market is currently pricing in (2.5% in April 2023).
- In the past months, our forecasts will be guided not only by economic data releases and clarifications from the MPC over its monetary policies, but the on-going conflict between Russia and Ukraine, including the manner in which the West and NATO respond through sanctions and/or military intervention.
- Currently, oil, gas, wheat and other mainstream commodities have risen significantly in price and central banks will have to balance whether they prioritise economic growth or try to counter supply-side shock induced inflation.
- On the positive side, 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. However, most of those are held by more affluent people whereas lower income families already spend nearly all their income before these increases hit and have few financial reserves.

PWLB RATES

- The yield curve has flattened out considerably and PWLB 5 to 50 years Certainty Rates are, generally, in the range of 2.3% to 3%.
- We view the markets as having built in, already, nearly all the effects on gilt yields of the likely increases in Bank Rate and the poor inflation outlook.
- It is difficult to say currently what effect the Bank of England starting to sell gilts will have on gilt yields now that Bank Rate has hit 1%. Nothing will be decided before August, however, but the Bank is likely to act cautiously as it has already started on not refinancing maturing debt. A pure roll-off of the peak £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.
- Increases in US treasury yields over the next few months could add further upside pressure on gilt yields.

The balance of risks to the UK economy: -

- The overall balance of risks to economic growth in the UK is now to the downside.

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

- **Mutations** of the Covid virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed or unable to be administered fast enough to stop the NHS being overwhelmed.

- **Labour and supply shortages** prove more enduring and disruptive and depress economic activity (accepting that in the near-term this is also an upside risk to inflation and, thus, rising gilt yields).

- **Bank of England** acts 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.

- **The Government** acts too quickly to increase taxes and/or cut expenditure to balance the national budget.

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

- **Geopolitical risks,** for example in Ukraine/Russia, Iran, China, North Korea and Middle Eastern countries, which could lead to increasing safe-haven flows.

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

- 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.

- Longer term US treasury yields continue to rise strongly and pull gilt yields up higher than forecast.

LINK GROUP FORECASTS

We now expect the MPC to swiftly increase Bank Rate during 2022 to combat the sharp increase in inflationary pressures. We do not think that the MPC will embark on a series of increases in Bank Rate that would take it to more than 2.00%.

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 moderately at most, given the extent to which market expectations are already priced in.

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

PWLB debt	Current borrowing rate as at 10.5.22 a.m.	Target borrowing rate now (end of Q2 2022)	Target borrowing rate previous (end of Q2 2022)
5 year	2.39%	2.50%	2.30%
10 year	2.74%	2.80%	2.40%
25 year	3.00%	3.00%	2.50%
50 year	2.72%	2.70%	2.30%

Borrowing advice: Our long-term (beyond 10 years) forecast for Bank Rate is 2.00%. As nearly all PWLB certainty rates are now above this level, borrowing strategies will need to be reviewed in that context, especially as the maturity curve has flattened out considerably. Better value can be obtained at the shorter end of the curve. 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 earnings rates for investments up to about three months' duration in each financial year are as follows: -

Average earnings in each year	Now	Previously
2022/23	1.60%	1.00%
2023/24	2.00%	1.25%
2024/25	1.70%	1.25%
2025/26	1.70%	1.25%
Years 6 to 10	2.00%	1.50%
Years 10+	2.00%	2.00%

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 moderately rising gilt yields is unchanged.

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