

A low-angle, upward-looking photograph of several modern skyscrapers with glass facades. The buildings are set against a clear blue sky with some light clouds. The perspective creates a sense of height and architectural scale. A large, semi-transparent blue rectangle is overlaid on the left side of the image, containing the title text.

# Updated Interest Rate Forecast 19 December 2022

# LINK GROUP UPDATED INTEREST RATE FORECAST

## Updating of our forecasts 19 December 2022

Comparison of forecasts for Bank Rate today v. previous forecast													
Bank Rate	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
19.12.22	3.50	4.25	4.50	4.50	4.50	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
08.11.22	3.50	4.25	4.50	4.50	4.50	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
Change	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

- Since our last update on 8 November, the Bank of England's Monetary Policy Committee (MPC) has increased Bank Rate to 3.50% from 3%. The increase was made last Thursday and was in line with our expectations. However, there was a range of views within the Committee, with six members voting for a 50 basis points increase, one for 75 basis points and two for no increase at all.
- Over recent weeks, relative calm has returned to the gilt markets and the £ has now risen from a historic low of \$1.03 to \$1.22, and the cumulative movement in gilt yields over the course of 2022 remains broadly in line with that seen in the Euro-zone bond markets but somewhat higher than the US (40bps).
- Market expectations remain for Bank Rate to peak at between 4.5% and 4.75% by mid-2023, and it has been announced today that the Chancellor's Budget will take place on 15 March, accompanied by analysis from the Office for Budget Responsibility, and followed on 23 March by the planned MPC meeting.
- Market views remain similar to those of Link Group's Interest Rate Strategy Group (IRSG). IRSG still sees the peak in Bank Rate at 4.5%, although there are several challenges ahead that could see the Bank leave rates at an elevated level for longer, once the peak is reached.
- The first of those challenges is the tight labour market (unemployment is at a near 48 year low 3.7%), and average wage increases are now above 6% y/y, against the backdrop of a significant number of high profile strikes throughout December and January (the Bank would broadly want wages to be in the range of 3% - 3.5%). There is also the prospect that unless the workforce participation rate increases and/or immigration policies are relaxed, there is no clear route that would give rise to sustainable increases in economic growth.
- So much of the eventual numbers will also be guided by what happens in Ukraine too, particularly the implications for further need for energy subsidies for UK households and businesses. The current Government support is due to be extended from April, but households can typically expect to pay £3,000 per annum under the revised scheme compared to the current £2,500.
- Regarding our forecast for PWLB rates, investors will likely remain a little nervous over the UK's future fiscal policy and foreign investors may require a "confidence premium" until it is clear that the Sunak Government is able to meet most of its spending commitments within acceptable financial constraints. However, in addition, the OBR forecasts the Central Government Net Cash Requirement is £650bn between 2023/24 and 2027/28 and maturing gilts will swell that figure to >£1.2trillion, and Quantitative Tightening will potentially push the eventual number even higher. So, the Bank and the Government will need to tread carefully in their messaging to markets and the way that funding requirements are met.
- As for the housing market, the most recent surveys by Halifax and Nationwide Building Society show house prices falling. Historically, the MPC has appeared reluctant to tighten monetary policy in a falling housing market, but it looks like it is going to have to at least for a further three to six months whilst unemployment remains low and wages are rising fast.
- Of course, what happens outside of the UK is also critical to movement in gilt yields. The US FOMC has led with increases of 425 basis points in the year to date and is expected to increase rates further into 2023. Similarly, the ECB has also started to tighten monetary policy, currently to 2%, Nonetheless, it is US monetary policies that will continue to have the greatest impact on global bond markets.

- From a practical standpoint those clients looking to borrow will, most probably, need to continue to focus on optimising their cashflow forecasts, and given the (still) relatively elevated level of rates right across the curve at present, seek to fund either temporarily from local authorities or with short-dated loans from the PWLB. You will see from our forecast that we expect both short- and longer-term rates to be somewhat lower over the duration of the forecast. Nonetheless, if certainty is paramount within your debt management strategy, we will help you to optimise any longer dated borrowing requirements you may have.
- On the flipside, if you are an authority that is fully funded or wishes to reduce its exposure to long-dated debt, there may still be scope to repay loans prematurely (both market and PWLB) whilst the high discount rates prevail. Your Client Relationship Manager should be contacted if this is something you wish to look at.
- In terms of our forecast, 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 1 November 2012.

Link Group Interest Rate View 19.12.22													
	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
<b>BANK RATE</b>	3.50	4.25	4.50	4.50	4.50	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
3 month ave earnings	3.60	4.30	4.50	4.50	4.50	4.00	3.80	3.30	3.00	3.00	2.80	2.50	2.50
6 month ave earnings	4.20	4.50	4.60	4.50	4.20	4.10	3.90	3.40	3.10	3.00	2.90	2.60	2.60
12 month ave earnings	4.70	4.70	4.70	4.50	4.30	4.20	4.00	3.50	3.20	3.10	3.00	2.70	2.70
5 yr PWLB	4.20	4.20	4.20	4.10	4.00	3.90	3.80	3.60	3.50	3.40	3.30	3.20	3.10
10 yr PWLB	4.30	4.40	4.40	4.30	4.10	4.00	3.90	3.80	3.60	3.50	3.40	3.30	3.30
25 yr PWLB	4.60	4.60	4.60	4.50	4.40	4.20	4.10	4.00	3.90	3.70	3.60	3.50	3.50
50 yr PWLB	4.30	4.30	4.30	4.20	4.10	3.90	3.80	3.70	3.60	3.50	3.30	3.20	3.20

Link Group Interest Rate View 08.11.22													
	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
<b>BANK RATE</b>	3.50	4.25	4.50	4.50	4.50	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
3 month ave earnings	3.60	4.30	4.50	4.50	4.50	4.00	3.80	3.30	3.00	3.00	2.80	2.50	2.50
6 month ave earnings	4.20	4.50	4.60	4.50	4.20	4.10	3.90	3.40	3.10	3.00	2.90	2.60	2.60
12 month ave earnings	4.70	4.70	4.70	4.50	4.30	4.20	4.00	3.50	3.20	3.10	3.00	2.70	2.70
5 yr PWLB	4.30	4.30	4.20	4.10	4.00	3.90	3.80	3.60	3.50	3.40	3.30	3.20	3.10
10 yr PWLB	4.50	4.50	4.40	4.30	4.20	4.00	3.90	3.70	3.60	3.50	3.40	3.30	3.20
25 yr PWLB	4.70	4.70	4.60	4.50	4.40	4.30	4.10	4.00	3.90	3.70	3.60	3.50	3.50
50 yr PWLB	4.30	4.40	4.30	4.20	4.10	4.00	3.80	3.70	3.60	3.40	3.30	3.20	3.20



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

- Our central forecast for interest rates was previously updated on 8 November and reflected a view that the MPC would be keen to further demonstrate its anti-inflation credentials by delivering a succession of rate increases. This has happened but the Government's policy of emphasising fiscal rectitude will probably mean Bank Rate will not need to increase to further than 4.5%.
- Further down the road, we anticipate the Bank of England will be keen to loosen monetary policy when the worst of the inflationary pressures are behind us – but that timing will be one of fine judgment: cut too soon, and inflationary pressures may well build up further; cut too late and any downturn or recession may be prolonged.
- The CPI measure of inflation looks to have peaked at 11.1% in Q4 2022 (currently 10.7%). Despite the cost-of-living squeeze that is still taking shape, the Bank will want to see evidence that wages are not spiralling upwards in what is evidently a very tight labour market.
- Regarding the plan to sell £10bn of gilts back into the market each quarter (Quantitative Tightening), this has started and will focus on the short, medium and longer end of the curve in equal measure, now that the short-lived effects of the Truss/Kwarteng unfunded dash for growth policy are firmly in the rear-view mirror.
- In the upcoming months, our forecasts will be guided not only by economic data releases and clarifications from the MPC over its monetary policies and the Government over its fiscal policies, but the on-going conflict between Russia and Ukraine. (More recently, the heightened tensions between China/Taiwan/US also have the potential to have a wider and negative economic impact.)
- On the positive side, consumers are still 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 challenges. However, most of those are held by more affluent people whereas lower income families already spend nearly all their income on essentials such as food, energy and rent/mortgage payments.

## PWLB RATES

- The yield curve movements have become less volatile of late and PWLB 5 to 50 years Certainty Rates are, generally, in the range of 4.10% to 4.80%.
- 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 elevated inflation outlook.

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

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

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

- **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).
- **The Bank of England** acts too quickly, or too far, over the next year to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- **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, China/Taiwan/US, Iran, 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 and for a longer period within the UK economy, which then necessitates Bank Rate staying higher for longer than we currently project or even necessitates a further series of increases in Bank Rate.

- **The Government** acts too quickly to cut taxes and/or increases expenditure in light of the cost-of-living squeeze.
- **The pound weakens** because of a lack of confidence in the UK Government's fiscal policies, resulting in investors pricing in a risk premium for holding UK sovereign debt.
- Longer term **US treasury yields** rise strongly and pull gilt yields up higher than currently forecast.
- Projected **gilt issuance, inclusive of natural maturities and QT**, could be too much for the markets to comfortably digest without higher yields consequently.

## LINK GROUP FORECASTS

We now expect the MPC to continue to increase Bank Rate during Q1 and Q2 2023 to combat on-going inflationary and wage pressures. We do not think that the MPC will increase Bank Rate above 4.5%, but it is possible.

### Gilt yields and PWLB rates

The overall longer-run trend is for gilt yields and PWLB rates to fall back over the timeline of our forecasts, as inflation starts to fall through 2023.

Our target borrowing rates two years forward (as we expect rates to fall back) and the current PWLB (certainty) borrowing rates are set out below: -

PWLB debt	Current borrowing rate as at 19.12.22 p.m.	Target borrowing rate now (end of Q4 2024)	Target borrowing rate previous (end of Q4 2024)
5 years	4.24%	3.50%	3.50%
10 years	4.35%	3.60%	3.60%
25 years	4.68%	3.90%	3.90%
50 years	4.34%	3.60%	3.60%

**Borrowing advice:** Our long-term (beyond 10 years) forecast for Bank Rate stands at 2.5%. As all PWLB certainty rates are currently above this level, borrowing strategies will need to be reviewed in that context. Better value can generally be obtained at the shorter end of the curve and short-dated fixed LA to LA monies should be considered. Temporary borrowing rates are likely, however, to remain near Bank Rate and may also prove attractive whilst the market waits for inflation, and therein gilt yields, to drop back later in 2023.

Our suggested budgeted earnings rates for investments up to about three months' duration in each financial year are rounded to the nearest 10bps as follows (unchanged from 8 November): -

Average earnings in each year	Now	Previously
2022/23 (remainder)	4.00%	4.00%
2023/24	4.40%	4.40%
2024/25	3.30%	3.30%
2025/26	2.60%	2.60%
2026/27	2.50%	2.50%
Years 6 to 10	2.80%	2.80%
Years 10+	2.80%	2.80%

As there are so many variables at this time, caution must be exercised in respect of all interest rate 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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