Economic and Interest Rate Forecast (Link Group)

1 Prospect for Interest Rates

1.1 The County Council has appointed Link Group (Treasury Solutions) as its treasury advisor and part of their service is to assist the authority in formulating a view on interest rates. The following table gives their central view (updated December 2021) and reflects PWLB borrowing calculated at the 0.80% margin over gilt yields (PWLB Certainty Rate) available to local authorities:

Rate (%)	**Mar 2022**	**Jun 2022**	**Sep 2022**	**Dec 2022**	**Mar 2023**	**Jun 2023**	**Sep 2023**	**Dec 2023**	**Mar 2024**	**Jun 2024**	**Sep 2024**	**Dec 2024**	**Mar 2025**
Bank Rate	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3-Month *(i)*	0.30	0.50	0.50	0.60	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00
6-Month *(i)*	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.00	1.10	1.10	1.10	1.10	1.10
12-Month *(i)*	0.70	0.70	0.70	0.80	0.90	1.00	1.10	1.10	1.20	1.20	1.20	1.20	1.20
5-Yr PWLB	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.80	1.90	1.90	1.90	2.00	2.00
10-Yr PWLB	1.70	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10	2.20	2.30
25-Yr PWLB	1.90	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.50	2.50
50-yr PWLB	1.70	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.20	2.20	2.30	2.30

(i) Link Group's forecast for average investment earnings (replacing previous LIBID forecasts); however, rates offered by individual counterparties may differ significantly from these averages reflecting their different needs for borrowing short term cash at any one point in time.

1.2 Over the last two years, the coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings until raising it back up to 0.25% at its December 2021 meeting (reversing the emergency action made at the outset of the pandemic). Going forward it is not expected that Bank Rate will go up fast after this initial rate rise as the supply potential of the UK economy is not likely to have taken a major hit during the pandemic. Therefore, the economy should be able to cope well with meeting demand after supply shortages subside over the next year, without causing inflation to remain elevated in the medium-term, or to inhibit inflation from falling back towards the Bank of England's 2% target after the expected spike to over 5% in 2022.

1.3 As shown in the table above, Link Group's forecast for Bank Rate now includes four increases: one 0.25% increase in the first quarter of 2022/23, then further 0.25% increases in the fourth quarter of 2022/23, the fourth quarter of 2023/24 and the fourth quarter of 2024/25. Therefore, Bank Rate is forecast to increase from 0.25% to 1.25% over the three-year forecast period to March 2025. However, it is likely that these forecasts will need changing within a relatively short timeframe given the following significant risks to the forecasts:

- Mutations of the coronavirus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed, or cannot be administered fast enough to prevent further lockdowns. 25% of the population not being vaccinated is also a significant risk to the NHS being overwhelmed and lockdowns being the only remaining option *(for example, we currently do not know with any certainty how severe the impact of the Omicron variant could have on the UK economy and whether there will be another lockdown or similar and, if there is, whether there would be significant fiscal support from the Government for businesses and jobs)*.
- Labour and supply shortages prove more enduring and disruptive and depress economic activity. There were already increasing grounds for viewing the economic recovery as running out of steam during the autumn and now into the winter of 2021; even before the outbreak of the Omicron variant posing a significant downside threat to economic activity. This could lead into stagflation, or even into recession, which would then create a dilemma for the Bank of England as to whether to focus on combating inflation or supporting economic growth through keeping interest rates low.
- Rising gas and electricity prices in October 2021 (and next April) and increase in other prices caused by current supply shortages and increases in taxation next April, are already going to deflate consumer spending power without the Bank of England's Monetary Policy Committee (MPC) having to take any action on Bank Rate to cool inflation. Therefore, risk that the MPC acts too quickly (or goes too far) over the next three years to raise Bank Rate and causes UK economic growth and increases in inflation to be weaker than currently anticipated. On the flip side however, there is the risk that the MPC tightens monetary policy too late in warding off building inflationary pressures.
- If there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out the significant remaining issues of post-Brexit UK/EU trade arrangements; for example, if the UK invokes article 16 of the Brexit deal over the dislocation in trading arrangements with Northern Ireland, this has the potential to end up in a no-deal Brexit.

1.4 The overall balance of risks to economic growth in the UK is now to the downside when including risks from Covid and its variants; both domestically and their potential effects worldwide. In summary therefore, with the high level of uncertainty prevailing on several different fronts, Link Group expect to have to revise their forecasts again - in line with whatever the new news is. It should also be borne in mind that Bank Rate being cut to 0.25% and then to 0.10% were emergency measures to deal with the Covid crisis hitting the UK in March 2020. As recently shown, the MPC could decide to reverse such emergency cuts given they are no longer warranted, and as a step forward in the return to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth

1.5 **Borrowing Rates**: Since the start of 2021, we have seen a lot of volatility in UK gilt yields, and hence Public Works Loan Board (PWLB) borrowing rates. As the interest forecast table for PWLB certainty rates shows (paragraph 1.1) there is forecast to be a steady, but slow, rise in Bank Rate and PWLB borrowing rates (UK gilt yields) during the period up to March 2025, though there will doubtless be a lot of unpredictable volatility during this forecast period.

1.6 While monetary policy in the UK will have a major impact on gilt yields, there is also a need to consider the potential impact that rising treasury yields in the US could have on our gilt yields. As an average since 2011, there has been a 75% correlation between movements in US 10-year treasury yields and UK 10-year gilt yields. This is a significant upward risk exposure to the forecasts for longer term PWLB rates; however, gilt yields and treasury yields do not always move in unison.

1.7 **US Treasury Yields:** During the first part of 2021, 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 was what unsettled financial markets. However, this was in addition to the $900bn support package already passed in December 2020. This was then followed by additional Democratic ambition to spend $1trn on infrastructure (which was eventually passed by both houses later in 2021) and an even larger sum on an American families plan over the next decade; subject to ongoing Democrat / Republican haggling. Financial markets were alarmed that all this stimulus was happening at a time when:

- A fast vaccination programme had enabled a rapid opening up of the US economy during 2021;
- The US economy was growing strongly during the first half of 2021 (although it has weakened overall during the second half);
- It started from a position of little spare capacity due to less severe lockdown measures than in many other countries; and
- The Fed was still providing substantial stimulus through monthly Quantitative Easing (QE) purchases during 2021.

1.8 It was not much of a surprise that a combination of these factors would eventually cause an excess of demand in the US economy which generated strong inflationary pressures. This has eventually been recognised by the Fed at its December 2021 meeting, with an aggressive response to damp inflation down during 2022 and 2023. At its November 2021 meeting, the Fed had already announced a start on tapering its $120bn per month of QE purchases so that they ended next June. However, at its December 2021 meeting the Fed doubled the pace of tapering so that they will end all purchases in February 2022. These purchases are currently acting as downward pressure on yields and so it would be expected that treasury yields will rise over the taper period and after the taper ends, all other things being equal. The Fed also forecast that it expected there would be three interest rate rises in 2022 of 0.25% from near zero currently, followed by three in 2023 and two in 2024, taking rates back above 2% to a neutral level for monetary policy.

1.9 As the US financial markets are, by far, the biggest financial markets in the world, any upward trend in treasury yields will invariably impact and influence financial markets in other countries. Inflationary pressures and erosion of surplus economic capacity look much stronger in the US compared to those in the UK, which would suggest that Fed rate increases eventually needed to suppress inflation, are likely to be faster and stronger than Bank Rate increases in the UK. This is likely to put upward pressure on treasury yields which could then spill over into putting upward pressure on UK gilt yields.

1.10 There are also possible downside risks from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices thereby helping to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to monitor.

1.11 Additionally, Link Group's forecasts are predicated on an assumption that there is no break-up of the Eurozone or EU within the forecasting period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and Russia, China / North Korea and Iran, which have a major impact on international trade and world GDP growth; all of which could significantly impact the future path of rates.

2 Counterparty Creditworthiness Update

2.1 Significant levels of downgrades to counterparty (including financial institutions) short- and long-term credit ratings have not materialised since the outset of the coronavirus crisis in March 2020. In the main, where ratings did change, any alterations were limited to Outlooks (a longer-term view of the creditworthiness of a counterparty). However, as economies are beginning to reopen, there have been some instances of previous lowering of Outlooks being reversed.

2.2 Additionally, although bank Credit Default Swap prices (these are market indicators of credit risk) spiked upwards at the end of March and early April 2020 due to the heightened market uncertainty and the ensuing liquidity crisis that affected financial markets, they have returned to more average levels since then. However, sentiment can easily shift, so it will remain important to undertake continual monitoring of all aspects of risk and return in the current circumstances. Link Group monitor CDS prices as part of their creditworthiness service to local authorities and the County Council has access to this information via its Link-provided Passport portal.

3 Investment and Borrowing Advice

3.1 One of the key results of the coronavirus pandemic has been a fundamental rethinking and shift in monetary policy by major central banks (including the Fed, the Bank of England, and the European Central Bank) to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation before consideration would be given to increasing rates.

3.2 For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion. However, investment returns are expected to improve in 2022/23 as financial markets price in a series of Bank Rate hikes; but returns may experience periods of short-term volatility if actual economic circumstances see the Bank of England fall short of market expectations.

3.3 Based on the current Link Group central assumptions for interest rates, the suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year (based on the next increase in Bank Rate occurring during the first quarter of 2022/23) are as follows:

Average Earnings per Financial Year	**Dec-21 Forecast**
2022/23	0.50%
2023/24	0.75%
2024/25	1.00%
2025/26	1.25%
Long-term (periods over 10 years in the future)	2.00%

3.4 Internally managed investments should continue to be made with reference to the County Council's core working balances and cash flow requirements; together with the outlook for short-term interest rates (rates for investments up to 12 months). While most cash balances are required in order to manage short-term (up to one year) cash flow requirements, greater returns are usually obtainable for cash sums which are identified as being available for longer-periods; however, the value to be obtained from such longer term investments must always be carefully assessed.

3.5 **Borrowing Advice:** The policy of avoiding new borrowing by running down spare cash balances has served many local authorities well over the last few years. However, borrowing interest rates fell to historically very low rates as a result of the coronavirus crisis and the quantitative easing operations of the Bank of England, and still remain at historically low levels. Furthermore, in November 2020 HM Treasury announced the conclusion to their review of margins over gilt yields for PWLB rates; with the PWLB Certainty Rate margin (across all periods up to 50-years) being returned to the corresponding UK Gilt yield plus 80 basis points. However, a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which has the purchase of assets primarily for yield in its three-year capital programme.

3.6 Link Group's long-term (10-year) forecast for Bank Rate is 2.00% (see paragraph 3.3). As some PWLB certainty rates are currently below 2.00%, there remains value in considering long-term borrowing from the PWLB for appropriate capital expenditure. Longer-term borrowing could also be considered for the purpose of certainty, where that is desirable, or for flattening the profile of a heavily unbalanced debt maturity profile. Temporary borrowing rates are however likely to remain near Bank Rate and may also prove attractive as part of a balanced debt portfolio (together with any internal borrowing as set out in approved borrowing strategies). In addition, there are also some cheap alternative sources of long-term borrowing if a local authority is seeking to avoid a "cost of carry" but also wishes to mitigate future re-financing risks.