Economic and Interest Rate Forecast (Link Group)

1 Prospect for Interest Rates

1.1 The County Council has appointed Link Group (Link Treasury Services Ltd) as its treasury advisor and part of their service is to assist the Council in formulating a view on interest rates. The following table gives their central view (updated December 2022) and reflects PWLB borrowing calculated at the 0.80% margin over gilt yields (PWLB Certainty Rate) available to local authorities:

Rate (%)	**Dec 2022**	**Mar 2023**	**Jun 2023**	**Sep 2023**	**Dec 2023**	**Mar 2024**	**Jun 2024**	**Sep 2024**	**Dec 2024**	**Mar 2025**	**Jun 2025**	**Sep 2025**	**Dec 2025**
Link Forecast Bank Rate	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 *(i)*	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 *(i)*	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 *(i)*	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

(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 Link Group's current central forecast reflects a view that the Bank of England's Monetary Policy Committee (MPC) will be keen to demonstrate its anti-inflation credentials by delivering a succession of rate increases over the coming months. This has happened throughout 2022, but the new Government's policy of emphasising fiscal rectitude will probably mean Bank Rate does not now need to increase to further than 4.5%

1.3 Further down the road, Link anticipate the Bank of England will then be keen to loosen monetary policy when the worst of the inflationary pressures have lessened – 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.

1.4 The Consumer Price Index (CPI) measure of inflation will likely peak at close to 11% in the fourth quarter of 2022. 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.

1.5 Regarding the plan to sell £10bn of gilts back into the market each quarter (Quantitative Tightening), this has started but will focus on the short to medium end of the curve for the present. This approach will prevent any further disruption to the longer end of the curve following on from the short-lived effects of the UK Government's Mini-Budget in September 2022.

1.6 In the upcoming months, Link's 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.

1.7 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.

1.8 **Borrowing (PWLB) Rates**: Yield curve movements have become less volatile since the November 2022 Autumn Statement. PWLB 5 to 50 years Certainty Rates are currently generally in the range of 4.10% to 4.80%. Link 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.

1.9 **Balance of Risks to the UK Economy**: The overall balance of risks to economic growth in the UK is to the downside. Indeed, the Bank of England projected two years of negative growth in their November 2022 Quarterly Monetary Policy Report. Risks to current forecasts for UK gilt yields and PWLB borrowing rates include:

Downside Risks	Upside Risks
• **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 two years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate. *Continued overpage*	• 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 an even more rapid series of increases in Bank Rate faster than we currently expect. • **The Government** acts too slowly to increase taxes and/or cut expenditure to balance the public finances, in the light of the cost-of-living squeeze. *Continued overpage*

Downside Risks	Upside Risks
• **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.	• **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, if inflation numbers disappoint on the upside, and pull gilt yields up higher than currently forecast.

2 Counterparty Creditworthiness Update

2.1 Significant levels of downgrades to Short and Long-Term credit ratings have not materialised since the crisis in March 2020. In the main, where they did change, any alterations were limited to Outlooks. However, more recently the UK sovereign debt rating has been placed on Negative Outlook by the three major rating agencies in the wake of the Truss/Kwarteng unfunded tax-cuts policy. Although the Sunak/Hunt government has calmed markets, the outcome of the rating agency reviews is unknown at present, but it is possible the UK sovereign debt rating will be downgraded. Accordingly, when setting minimum sovereign debt ratings, Link recommends that local authorities do not set a minimum sovereign rating for the UK.

2.2 Additionally, although bank Credit Default Swap prices (these are market indicators of credit risk) spiked upwards during the days of the Truss/Kwarteng government, 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 In the current economic climate, it is considered appropriate to maintain a degree of liquidity to cover cash flow needs but to also consider "laddering" investments for periods up to 12 months with high credit rated financial institutions, whilst investment rates remain elevated, as well as wider range fund options.

3.2 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 final quarter of 2022/23) are as follows:

Average Earnings per Financial Year	Dec-22 Forecast
2023/24	4.40%
2024/25	3.30%
2025/26	2.60%
2026/27	2.50%
2027/28 to 2031/32	2.80%
Long-term (periods over 10 years in the future)	2.80%

3.3 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 potentially 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.

3.4 **Borrowing Advice:** Link Group’s long-term (beyond 10 years) forecast for Bank Rate stands at 2.5%. As all PWLB certainty rates are now 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 local authority-to-local authority monies should be considered. Temporary borrowing rates are likely however to remain near Bank Rate whilst the market waits for inflation, and therein gilt yields, to subside. Consequently, the policy of avoiding new borrowing by running down spare cash balances (that has served many local authorities well over the last few years) may continue to prove beneficial through to 2024/25 when PWLB rates are forecast to gradually fall.