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 November 2023) and reflects PWLB borrowing calculated at the 0.80% margin over gilt yields (PWLB Certainty Rate) available to local authorities:

Rate (%)	Dec 2023	Mar 2024	Jun 2024	Sep 2024	Dec 2024	Mar 2025	Jun 2025	Sep 2025	Dec 2025	Mar 2026	Jun 2026	Sep 2026	Dec 2026
Link Forecast Bank Rate	5.25	5.25	5.25	5.00	4.50	4.00	3.50	3.25	3.00	3.00	3.00	3.00	3.00
3-Month *(i)*	5.30	5.30	5.30	5.00	4.50	4.00	3.50	3.30	3.00	3.00	3.00	3.00	3.00
6-Month *(i)*	5.60	5.50	5.40	5.10	4.60	4.10	3.60	3.40	3.10	3.10	3.10	3.10	3.10
12-Month *(i)*	5.80	5.70	5.50	5.20	4.70	4.20	3.70	3.50	3.30	3.30	3.30	3.30	3.30
5-Yr PWLB	5.00	4.90	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.60	3.50	3.50	3.50
10-Yr PWLB	5.10	5.00	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.70	3.60	3.60	3.50
25-Yr PWLB	5.50	5.30	5.10	4.90	4.70	4.50	4.30	4.20	4.10	4.10	4.00	4.00	4.00
50-yr PWLB	5.30	5.10	4.90	4.70	4.50	4.30	4.10	4.00	3.90	3.90	3.80	3.80	3.80

(i) Link Group's forecast for average investment earnings; 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 further demonstrate its anti-inflation credentials by keeping Bank Rate at 5.25% until at least the second half of 2024. Link expect rate cuts to start when both the Consumer Price Index (CPI) inflation and wage/employment data are supportive of such a move, and that there is a likelihood of the overall UK economy enduring at least a mild recession over the coming months, although most recent Gross Domestic Product (GDP) releases have surprised with their on-going robustness. The exact timing on this matter will however remain 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.

1.3 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 UK Government over its fiscal policies, but also international factors such as policy development in the US and Europe, the provision of fresh support packages to support the faltering recovery in China as well as the on-going conflict between Russia and Ukraine, and Gaza and Israel.

1.4 On the positive side, consumers are still anticipated to be sitting on some excess savings left over from the pandemic, which could cushion some of the impact of the above challenges and may be the reason why the economy is performing somewhat better at this stage of the economic cycle than may have been expected. However, most of those excess savings are being held by more affluent households whereas lower income families already spend nearly all their income on essentials such as food, energy and rent/mortgage payments.

1.5 **Borrowing (PWLB) Rates**: The overall longer-run trend is for UK gilt yields and PWLB rates to fall back over the timeline of Link's forecasts, as inflation starts to fall through the remainder of 2023 and into 2024. More recently however, gilt yield curve movements have broadened and whilst the short part of the curve has not moved too far, the longer-end continues to ease. At the time of writing there is 50 basis points difference between the 2- and 50-year parts of the curve.

1.6 **Balance of Risks to the UK Economy**: The overall balance of risks to economic growth in the UK is to the downside. 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, could keep gilt yields high for longer). • **The Bank of England** has increased Bank Rate too fast and too far over recent months, and subsequently brings about a deeper and longer UK recession 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, the Middle East, China/Taiwan/US, Iran and North Korea, which could lead to increasing safe-haven flows.	• Despite the recent tightening to 5.25%, the **Bank of England proves too timid** in its pace and strength of increases in Bank Rate, and therefore allows inflationary pressures to remain elevated for a longer period within the UK economy, which then necessitates Bank Rate staying higher for longer than we currently project. • **The pound weakens** because of a lack of confidence in the UK Government's pre-election fiscal policies, resulting in investors pricing in a risk premium for holding UK sovereign debt. • Longer-term **US treasury yields** rise strongly if inflation remains more stubborn there than the market currently anticipates, consequently pulling UK gilt yields up higher (we saw some movements of this type through October). • Projected **UK gilt issuance, inclusive of natural maturities and Quantitative Tightening,** could be too much for the markets to comfortably digest without higher yields compensating.

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. 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 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 are set-out below:

Average Earnings per Financial Year	Dec-23 Forecast
2024/25	4.70%
2025/26	3.20%
2026/27	3.00%
2027/28	3.25%
2028/29 to 2032/33	3.25%
Long-term (periods over 10 years in the future)	3.25%

3.2 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.

3.3 **Borrowing Advice:** Link Group's long-term (beyond 10 years) forecast for Bank Rate currently stands at 3% reflecting research that suggests general improvements in productivity will be supportive of a higher neutral interest rate. As all PWLB certainty rates are currently significantly above this level, borrowing strategies will need to be reviewed in that context. Currently, 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 will however remain elevated in 2024/25 but may prove the best option whilst the market continues to wait for inflation, and therein gilt yields, to drop back in 2025/26.