Economic and Interest Rate Forecast (Link Asset Services)

1 Prospect for Interest Rates

1.1 The Council has appointed Link Asset Services (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 2018):

Link Asset Services Interest Rate View	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	1.75%	2.00%
3 Month LIBID	0.80%	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	0.90%	1.00%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.10%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
10yr PWLB Rate	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%
25yr PWLB Rate	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%

1.2 The flow of generally positive economic statistics after the quarter ending 30 June 2018 meant that it came as no surprise that the Bank of England's Monetary Policy Committee (MPC) came to a decision in August 2018 to make the first increase in Bank Rate above 0.5% since the financial crash (to 0.75%). At this meeting the MPC emphasised again that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate (where monetary policy is neither expansionary of contractionary) than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast.

1.3 UK Growth whilst remaining healthy since that meeting is expected to weaken somewhat during the last quarter of 2018. At their November 2018 meeting the MPC left the Bank Rate unchanged but expressed some concerns regarding future inflationary pressures. Against this backdrop Link Asset Services do not consider that the MPC will increase Bank Rate in February 2019 ahead of the March deadline for Brexit, but forecast the next increase in May 2019 (+0.25%) followed by increases in February and November 2020, before ending up at 2.0% in February 2022. However, the cautious pace of these rate increases is dependent on a reasonably orderly Brexit.

1.4 The overall longer run future trend is for UK gilt yields and PWLB borrowing rates to rise, albeit gently. However, over about the last 25 years we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and central banks implemented substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing,

conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets.

1.5 In 2016 we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016; yields then rose further as a result of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Fed has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.00 – 2.25% in September 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing when they mature. We have therefore seen US 10-year bond Treasury yields rise above 3.2% during October 2018 and also seen investors causing a sharp fall in equity prices as they sold out of holding riskier assets.

1.6 Rising bond yields in the US have also caused some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure has been dampened by how strong or weak the prospects for economic growth and rising inflation are in each country and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures. From time to time, gilt yields (and therefore PWLB borrowing rates) can additionally be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

1.7 Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. Interest rate forecasts (and future MPC decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments (especially in the EU) could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

2 Investment and Borrowing Rates

2.1 Investment returns are likely to remain low during 2019/20 but to be on a gently rising trend over the next few years. The suggested budgeted earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

Average Earnings per Financial Year	**Nov-18 Forecast**
2018/19	0.75%
2019/20	1.00%
2020/21	1.50%
2021/22	1.75%

Average Earnings per Financial Year	**Nov-18 Forecast**
2022/23	1.75%
2023/24	2.00%
Later years	2.50%

2.2 **Borrowing Advice:** Borrowing rates have been volatile so far in 2018/19 and have increased modestly since the summer. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. This however needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

2.3 There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost – the difference between borrowing costs and investment returns.